



## Management's Discussion & Analysis

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Management's discussion and analysis ("MD&A") provides a review of our performance for the three-month period ended December 31, 2004, and should be read in conjunction with the unaudited interim consolidated financial statements of LMS Medical Systems Inc. ("the Company") as at December 31, 2004 and for the three-month and nine-month period then ended and with the Company's annual audited financial statements. We prepared these unaudited interim consolidated financial statements in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") for interim financial information. These financial statements have not been reviewed or audited by our external auditors. This MD&A is current as of February 10, 2005.

On April 1, 2004, we acquired 99.98% of the shares and unsecured convertible debentures from the shareholders and debenture holders of LMS Medical Systems Ltd. in exchange for 2.70727 of our common shares for each share LMS Medical Systems Ltd. acquired and 300 of our common shares for each \$1,000 of principal amount of the unsecured convertible debentures of LMS Medical Systems Ltd. acquired. As a result, LMS Medical Systems Ltd. became a subsidiary of our Company. All of the previously issued outstanding options and warrants of LMS Medical Systems Ltd. were exchanged for economically equivalent options and warrants of our Company. Effective September 30, 2004 LMS Medical Systems Ltd. became a wholly owned subsidiary of our Company, the holders of the outstanding 0.02% having tendered their shares on the 2.70727 basis noted above.

This transaction with our Company, a non-operating public enterprise with nominal net non-monetary assets, is in substance a capital transaction for LMS Medical Systems Ltd. ("LMS"). As a result, this transaction is viewed as the issuance of equity by LMS to the extent of the net cash available in our Company. Accordingly, the following interim financial statements as of December 31, 2004 represent a continuation of LMS, which has been renamed LMS Medical Systems (Canada) Ltd.. Following the above-described transaction the historical comparative financial information is that of LMS. In addition, the year-end for our Company and our subsidiary LMS has been changed to March 31st.

As of December 31, 2004 there were 15,791,829 common shares outstanding, and 1,412,272 options as well as 1,819,287 warrants outstanding to purchase common shares.

All dollar amounts herein are in Canadian dollars unless otherwise indicated. "We", "us", "our" or "our Company" means LMS Medical Systems Inc. and its subsidiaries unless otherwise indicated.

### **Note regarding forward-looking statement**

Our MD&A contains forward-looking statements, which reflect our current expectations regarding future events. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect" and "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties which could cause actual results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in our industry and others are more specific to our Company. Investors should consult the "Risk Factors" section of the MD&A as well as our quarterly financial statements, annual reports, annual information forms and other continuous disclosure filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. We assume no obligation to update or amend any forward-looking statements whether as a result of new information, future events or otherwise.

### **Overall performance**

We are an obstetrics-focused healthcare technology company. Based on advanced medical research focusing on the Labor & Delivery cycle, our unique technology provides obstetrics and gynecology teams and hospitals with state-of-the-art clinical decision support tools to assist them in achieving clinically and cost effective interventions.

Our core technology, Computer Assisted Labor Management (CALM™) was developed at the Faculty of Medicine, McGill University in Montréal, with Dr. Emily Hamilton as the principal investigator.

### **Overview**

For the past eight years, we have been actively developing a series of software-based products that are focused in the area of obstetrics. Our products specifically deal with the labor and delivery process. In particular, our products focus on how labor develops in the mother and impacts the fetus. It is well known that distress created by the labor and delivery process often results in birth related brain damage.



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The most significant developments affecting our Company in the third quarter ended December 31, 2004 were:

- Record quarterly revenue of \$678,000;
- Installation of our products at US and Canadian hospitals include but are not limited to the University of Maryland Medical Center in Baltimore, Maryland and Sacré-Coeur Hospital in Montreal, Canada;
- CALM™ Patterns, a Class II medical device for U.S. regulatory purposes, is currently completing its review by the United States Food and Drug Administration;
- McKesson Provider Technologies installed their initial clients having assumed distribution responsibilities to McKesson customers earlier in the fall under its private label agreement with LMS;
- Completion of the registration process with the United States Securities and Exchange Commission, on Form 20-F under the Securities Exchange Act of 1934, establishing the Company as a U.S. reporting issuer;
- The Company's shares will begin trading mid-February 2005 on the American Stock Exchange under the symbol LMZ;
- The exercise of 1,292,569 warrants generating cash of \$4,175,000.

The most significant developments affecting our Company in the first half of the year, to September 30, 2004 were:

- Completion in April of a round of financing by which we have raised total gross proceeds of \$12.0M;
- Completion in April 2004 of a listing on the Toronto Stock Exchange;
- Appointment of Mr. André Bérard, Terrence H. Gregg and Harry G. Hohn to the Board of Directors;
- Signing of sales agreements with leading U.S. and Canadian based hospitals for the installation of our products;
- McKesson Information Solutions assumed responsibility for the sales and marketing of our products to McKesson customers under its Horizon Clinicals™ private label;
- CALM™ Patterns, an advanced obstetrical tool that uses the power of the computer to provide objective, real-time detection, classification and labeling of fetal heart rate patterns in the assessment of fetal distress, received marketing clearance from Health Canada;
- CALM™ Patterns, a Class II medical device for U.S. regulatory purposes, is currently being reviewed by the United States Food and Drug Administration;
- Filing of a registration statement on Form 20-F with the United States Securities and Exchange Commission under the Securities Exchange Act of 1934 to become a registrant under that Act;
- Filing of an application for the listing of the Company's shares on the American Stock Exchange;
- Exercise of 155,482 warrants generating cash of \$503,000.

#### **Critical accounting estimates**

Our financial statements are prepared in accordance with Canadian GAAP. Our critical accounting estimates include revenue recognition, the recording of research and development expenses and related investment tax credits, stock-based compensation expenses, financial instruments and income taxes. For a more detailed discussion of our critical accounting estimates, please refer to the MD&A included in our 20-F filings with the United States Securities and Exchange Commission and our March 31st, 2004 Annual Report. There have been no material changes to such estimates since that time.



**Selected Financial Information – Three-month and nine-month period ended  
December 31, 2004 and 2003** (in thousands of Canadian dollars).

	3 months		9 months	
	Dec. 31, 2004 \$	Dec. 31, 2003 \$	Dec. 31, 2004 \$	Dec. 31, 2003 \$
<b>Revenues</b>	<b>678</b>	<b>32</b>	<b>986</b>	<b>90</b>
<b>Operating expenses:</b>				
Research & development costs	1,128	536	2,734	1,794
Investment tax credits	(175)	(221)	(436)	(664)
<b>Net Research &amp; Development</b>	<b>953</b>	<b>315</b>	<b>2,298</b>	<b>1,130</b>
Cost of hardware	5	–	86	–
Other Direct costs	77	3	99	3
Selling and market development	637	335	1,697	1,219
Administrative	966	450	1,903	1,100
Customer support	215	123	569	407
Quality assurance	40	32	114	113
Special charges	43	–	614	–
Other (net)	76	39	124	133
Total expenses	3,012	1,297	7,504	4,105
Operating loss	2,334	1,265	6,518	4,015
<b>Net loss</b>	<b>2,275</b>	<b>1,260</b>	<b>6,351</b>	<b>4,080</b>
<b>Basic and diluted loss per share</b>	<b>(0.15)</b>	<b>(0.35)</b>	<b>(0.42)</b>	<b>(1.08)</b>
<b>Cash flow related to:</b>				
Operating Activities	(2,980)	(1,413)	(6,113)	(3,045)
Investing Activities	(98)	(65)	(239)	(77)
Financing Activities	4,144	1,484	16,811	2,492
<b>Net Change</b>	<b>1,066</b>	<b>6</b>	<b>10,459</b>	<b>(630)</b>

	Dec. 31, 2004	March 31, 2004
<b>Balance sheet information:</b>		
Cash and short-term investments	11,940	1,481
Total assets	15,177	4,040
Total debt	104	95
Total shareholders' equity	13,590	2,410

### Results of operations

**Three-month period ended December 31, 2004 compared to the three-month period ended December 31, 2003 and the nine-month period ended December 31, 2004 compared to the nine-month period ended December 31, 2003.**

#### Revenues

Our revenues for the three-month period ended December 31 increased from \$32,000 in 2003 to \$678,000 for the same period in 2004. The increase is due to new installations completed during the period. Maintenance revenues increased as a result of an expanded installed base of maintenance contracts. Revenues in the nine-month period increased by \$896,000 from \$90,000 in 2003 to \$986,000 in 2004, due to increases in: software installations of \$701,000; maintenance and technical support revenues of \$78,000; and hardware revenues relating to a turnkey project of \$117,000. Revenues in the nine-month period ended December 31, 2003 related to maintenance contracts.

#### Research and Development expenses and Investment Tax Credits

For the three-month period ended December 31, 2004 expenditures before investment tax credits were \$1,128,000 as compared to \$536,000 for the same period in 2003. These expenditures were incurred in the development of a new version of our technology, which is expected to be released in early 2005, and the interfacing of our products with a U.S. distributor. The overall increases relate primarily to the growth in the number of our permanent employees, as well as outsourcing to temporary consultants to meet our development milestones. Based on our current operating plan, we expect our permanent development staffing levels to increase slightly throughout the end of fiscal 2005 and level off in mid fiscal 2006. For the nine-month period ended December 31, 2004 R&D expenditures increased from \$1,794,000 in 2003 to \$2,734,000 for the same period in 2004. As described above, the increases were primarily due to increased staffing levels.

Investment tax credits decreased for the three-months ended December 31 from \$221,000 in 2003 to \$175,000 for the same period in 2004. For the nine-month period ended December 31 investment tax credits decreased from \$664,000 in 2003 to \$436,000 for the same period in 2004. This decrease is primarily due to the fact that, following the Company's listing on the Toronto Stock Exchange, the Canadian federal investment tax credits are no longer refundable. Public companies may however, carry forward their federal investment tax credits for a ten-year period to reduce future federal taxes payable. No amounts related to carry forward investment tax credits have been recorded in the financial statements. Eligible expenditures incurred in Québec remain qualified for the refundable provincial research and development investment tax credits. The overall decrease in the investment tax credits, as a result of federal investment tax credits no longer being refundable, was partially offset by the overall increases in the salary expenditures and consulting contracts which are the primary eligible expenses for purposes of investment tax credits.

#### Selling and Market Development

Selling and Market Development expenses for the three-month period ended December 31, 2004 were \$637,000 as compared to \$335,000 for the same period in 2003. The increase is the result of the addition of sales account managers and new employees engaged in marketing, as well as commissions paid related to revenues generated during the quarter. Due to increases in staffing, related travel and tradeshow expenses were increased. As a result, for the nine-month period ended December 31 these expenses increased from \$1,219,000 in 2003 to \$1,697,000 for the same period in 2004. We expect to continue to gradually increase the sales and market development expenses in order to further promote and sell our products.

#### Other direct costs and cost of hardware

Our other direct costs for the three-month period ended December 31 increased from \$3,000 in 2003 to \$77,000 for the same period in 2004. The increase is primarily due to product royalties on software installations completed during the period. Direct costs in the nine-month period ended December 31, 2003 were \$99,000 compared to \$3,000 for the same period in 2003. The 2004 nine-month period also included the hardware costs related to the turnkey operation described above of \$86,000.

#### Administrative

Administrative expenses for the three-month period ended December 31, 2004 increased to \$966,000 compared to \$450,000 for the same period in 2003. The increases relate to: the recording of a \$210,000 (nil in 2003) expense with respect to stock options issued (\$280,000 for nine-months ended December 31, 2004, nil in 2003); additional accounting, legal and related expenses related to being a public company; an increase in insurance premiums for commercial, product and director and officer coverage; an increase in salaries; and additional office, general and rental expenses related to increased staffing levels. As a result, expenses for the nine-month period ended December 31 also increased from \$1,100,000 in 2003 to \$1,903,000 for the same period in 2004.

#### Customer Support

Our Customer Support department is a dedicated 24/7-service center for our customers. For the three-month period ended December 31 our Customer Support department expenses increased from \$123,000 in 2003 to \$215,000 for the same period in 2004. For the nine-month period ended December 31, 2004, these expenses were \$569,000 compared to \$407,000 for the same period in 2003. The change in 2004 results mainly from the addition of new employees to support the expansion of our customer support activities relating to increased number of installations of our software.

### Quality Assurance

In 2002, we created departments of Quality Assurance and Regulatory Affairs with the responsibility of ensuring compliance with all applicable requirements and regulations of each country where our products are expected to be marketed. For the three-month period ended December 31 these expenses increased slightly from \$32,000 in 2003 to \$40,000 for the same period in 2004. For the nine-month period ended December 31, these expenses increased from \$113,000 in 2003 to \$114,000 for the same period in 2004.

### Special charges

Special charges relate to professional legal and accounting fees, listing fees and other expenses incurred in connection with the listing of our common shares on the Toronto Stock Exchange on April 22, 2004, as well as the filing of a registration statement on Form 20-F with the United States Securities and Exchange Commission under the Securities Exchange Act of 1934 to become a foreign registrant under that Act. The registration statement was accepted by the United States Securities and Exchange Commission in early 2005. Approximately \$43,000 of these expenses were recorded during the third quarter of fiscal 2005. We expect to incur additional, charges related to the completion of the registration process and the listing with the American Stock during the last quarter of fiscal 2005. The total special charges recorded for the nine-month period ended December 31, 2004 were 614,000 (nil in 2003).

### Other expenses/income

Other expenses incurred and other revenue generated includes our technical showcase project, amortization of property, plant and equipment, amortization of patents and foreign exchange gain or loss. We incurred other expenses of \$33,000 for the three-month period ended December 31, 2003 compared to \$16,000 in the same period of 2004. Following the additional liquidities that were generated during the nine-month period ended December 31, 2004 we generated net interest income of \$60,000 compared to \$4,000 for the same period in 2003. For the three-month period ended December 31, 2003, we spent \$14,000 on our technological showcase project compared to nil for the same period in 2004. For the nine-month period ended December 31, 2004 we generated net interest income of \$167,000 (net expense of \$64,000 for the same period in 2003), we incurred \$1,000 on our technological showcase project (\$80,000 for the same period in 2003). As a result, we have generated other income for an amount of \$42,000 for the nine-month period ended December 31, 2004 compared to an expense of \$198,000 for the same period in 2003.

### Net Loss

Our net loss for the three-month period ended December 31, 2004 was \$2,275,000 (\$0.15 per share) compared with \$1,260,000 for same period in 2003 (\$0.35 per share). For the nine-month period ended December 31, 2004 our net loss was \$6,351,000 (\$0.42 per share) compared to \$4,080,000 (\$1.08 per share) for the same period in 2003. Although there was an increase in the net loss, the loss per share decreased as a result of a greater number of shares outstanding.

### Liquidity and Capital Resources

#### Operating activities

Cash flow used for operations totaled \$2,980,000 for the three month period ended December 31, 2004 compared to \$1,413,000 for the same period in 2003.

In 2004, cash used in our operating activities is mainly explained by our net loss of \$2,275,000 (\$1,260,000 for the same period in 2003) and by a negative net change in non-cash operating working capital of \$1,410,000 (\$225,000 for the same period in 2003), which resulted mainly from the increased revenues and related receivables and reduced payables.

For the nine-month period ended December 31, 2004 we used \$6,113,000 for our operations compared to \$3,045,000 for the same period in 2003. The difference is mainly explained by the increase in our net loss from \$4,080,000 in the nine-month period ended December 31, 2003 to \$6,351,000 for the same period in 2004.

#### Investing activities

Our investing activities consisted of the acquisition of equipment required for our activities. For the three-month period ended December 31, 2004 we spent \$98,000 (\$65,000 for the same period in 2003) and for the nine-month period ended December 31, 2004 we spent \$239,000 (\$77,000 for the same period in 2003) for equipment.



### Financing activities

We have financed our operations, technology development, patents filings and capital expenditures primarily through equity offerings of shares, issuance of convertible notes, the receipt of investment tax credits earned on eligible expenditures, by loans from financial institutions and by capital leases. Since our inception, we have raised gross proceeds in excess of \$48 million from the issuance of equity.

During the three-month period ended December 31, 2004, the financing activities generated \$4,144,000 compared to \$1,484,000 for the same period in 2003. The increase was due to the exercise of warrants when compared to issuance of convertible debentures and debt of \$1,490,000 in 2003. For the nine-month period ended December 31, 2004 the financing activities generated \$16,811,000 primarily from the issuance of common shares, compared to \$2,492,000 for the same period in 2003 relating to issuance of shares, convertible debentures and debt.

Our cash and cash equivalents increased by \$1,066,000 for the three-month period ended December 31, 2004 compared to an increase of \$6,000 for the same period in 2003. For the nine-month period ended December 31, 2004 our cash and cash equivalents increased by \$10,459,000 compared to a decrease of \$630,000 for the same period in 2003, leaving a balance at the end of the 2004 period of \$11,940,000 compared to a deficit of \$159,000 at the end of the same period in 2003.

As of December 31, 2004, we have no debt other than capital leases, which totaled \$104,000 and are repayable over the next 5 years. Our operating obligations are as follows:

Less than 1 year	\$200,000
1 to 3 years	<u>\$406,000</u>
Total	\$606,000

We may require additional financing to expand our operations and intend to raise funds from time to time. Funding requirements may vary depending on a number of factors, including the progress of our research and development program, the establishment of collaborations and the market acceptance of our products in North America and internationally.

We expect to continue to incur operating losses as we focus on the interfacing of our system with those of our distributors, commercialization of a new product during fiscal 2005 and a new release of the CALM™ View system during 2005. Based on current plans, it is anticipated that total expenses will increase during fiscal 2005 as a result of the factors mentioned above. We believe we have sufficient resources to fund operations through the next twelve months. However, in light of the inherent uncertainties associated with the regulatory approval process and our ability to secure sales and additional distribution agreements, further financing may be required to support our operations in the future.

When additional funds are required, potential sources of financing include strategic relationships and public or private sales of our common shares. We do not have any committed sources of financing at this time and it is uncertain whether additional funding will be available when the need arises on terms that will be acceptable to us. If funds are raised by issuing additional common shares, or other securities convertible into our common shares, the ownership interests of our existing shareholders will be diluted. If we are unable to obtain financing when required, we will not be able to carry out our business plan, including our marketing and distribution initiatives. We would have to significantly limit our operations and business, and our financial condition and results of operations would be materially harmed.

### Related party transaction

The Company incurred fees of \$45,000 during the period (\$135,000 for the nine-month period) under a management services agreement with a related company having one common director.

### Risk factors

For a more detailed discussion of risk factors that could materially affect our results of operations and financial condition, please refer to the company's Annual Information Form.

### Other MD&A requirements

All relevant information related to our Company is filed, in Canada, electronically at [www.sedar.com](http://www.sedar.com) and in the United States of America at [www.sec.gov](http://www.sec.gov).