



Management's Discussion & Analysis

Management discussion and analysis ("MD&A") provides a review of our performance for the three-month period ended September 30, 2004 and should be read in conjunction with our unaudited interim consolidated financial statements as at September 30, 2004 and for the three-month period then ended. We prepared these unaudited interim consolidated financial statements in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") for interim financial information but they have not been subject to a review by our auditors. This MD&A is current as of November 10, 2004.

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 2,707,277 of our common shares for each share of 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 options granted and warrants issued by 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, the holders of the outstanding 0.02% having tendered their shares on the 2,707,277 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. As a result, this transaction is viewed as the issuance of equity by LMS Medical Systems Ltd. to the extent of the net cash available in our Company. Accordingly, the following interim financial statements as of September 30, 2004 represent a continuation of LMS Medical Systems Ltd., which has been renamed LMS Medical Systems (Canada) Ltd. In addition, the year end of both companies has been changed to March 31st.

The chart below sets out the number of our issued and outstanding common shares and the number of issued and outstanding warrants and options to purchase our common shares in each case as at October 31, 2004.

Common shares		14,897,260
Options to purchase common shares	*	1,412,272
Warrants to purchase common shares		2,713,856

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.

Highlights for the period

The most significant developments affecting our Company in the last quarter ended September 30, 2004 were:

- Signing of sales agreements with leading U.S. and Canadian based hospitals for the installation of our products during the second half of the current fiscal year.
- 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. The registration statement is currently under review with the United States Securities and Exchange Commission.
- Filing of an application for the listing of the Company's shares on the American Stock Exchange.
- The exercise of 155,482 warrants generating cash of \$503,131. After September 30th, an additional 1,245,000 warrants were exercised generating cash of \$4,021,350.

The most significant developments affecting our Company in the first quarter ended June 30, 2004 were:

- completion in April a round of financing by which we have raised total gross proceeds of \$12.0M;
- completion in April of the listing on Toronto Stock Exchange;
- appointment of Mr. André Bérard, Terrence H. Gregg and Harry G. Hohn to the Board of Directors.

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, 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 March 31st, 2004 Annual Report. There have been no material changes to such estimates since that time.



Selected information – Three-month period ended September 30, 2004 and 2003 and six-month period ended September 30, 2004 and 2003.

	3 months		6 months	
	2004	2003	2004	2003
	\$	\$	\$	\$
Statement of operations and cash flow data				
Revenues				
Software & Maintenance	76,339	28,686	197,741	58,791
Hardware	–	–	110,055	–
	76,339	28,686	307,796	58,791
Cost of revenues	17,859	0	102,848	0
Net	58,480	28,686	204,948	58,791
Expenses				
Research and development costs	914,869	596,583	1,606,215	1,257,928
Less: Tax credits	(134,201)	(213,246)	(261,436)	(442,954)
	780,668	383,337	1,344,779	814,974
Administrative	472,775	331,476	936,510	649,596
Selling and market development	550,543	371,812	1,060,482	884,473
Customer support	185,962	158,914	353,255	284,281
Quality assurance	31,555	39,914	74,072	80,277
Other expenses (income), net	(35,194)	115,089	(58,502)	164,625
Special charges	347,443		570,884	
Net loss	2,275,272	1,371,856	4,076,532	2,819,435
Basic and diluted loss per share	(\$0.16)	(\$0.44)	(\$0.28)	(\$0.90)
Cash flow related to:				
Operating activities	(1,141,783)	(1,336,116)	(3,132,435)	(1,631,674)
Investing activities	(81,476)	(711)	(141,050)	(12,849)
Financing activities	494,807	1,130,214	12,667,046	1,007,149
			Sept 30	March 31
			2004	2004
			\$	\$
Balance sheet data				
Total assets			12,387,956	4,040,164
Total long term debt			79,012	94,763
Total shareholders' equity			11,085,792	2,409,527

Results of operation

Three-month period ended September 30, 2004 compared to the three-month period ended September 30, 2003 and the six-month period ended September 30, 2004 compared to the six-month period ended September 30, 2003.

Revenue

Our revenue for the three-month period ended September 30 increased from \$28,686 in 2003 to \$76,339 for the same period in 2004. The increase results from a service contract which generated revenue of \$48,000. The balance of the revenue is derived from fees earned from existing maintenance agreements. For the six-month period ended September 30, 2004, we completed the installation new software with a customer which generated software license revenue of \$93,871. We also installed equipment for a new customer which required a turn-key project and generated revenue of \$110,055.

Research and Development

For the three-month period ended September 30, 2004, expenditures before investment tax credit were \$ 914,869 as compared to \$596,593 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 integration of our products with a US distributor. To achieve these objectives, we have added three permanent employees and seven contractual employees. We have also incurred placement fees to fill these positions, resulting in additional expenses of \$76,000 compared to the same period in 2003. For the six-month period ended September 30, expenditures increased from \$1,257,928 in 2003 to \$1,606,215 for the same period in 2004. During the six-month period ended September 30, 2004, we employed an additional four permanent employees and seven contractual employees in addition to the staff in place in 2003. As a result, our placement fees increased from \$41,000 for the six-month period ended September 30, 2003 to \$97,000 for the same period in 2004.

Our investment tax credit decreased for the three-month ended September 30 from \$213,246 in 2003 to \$134,201 for the same period in 2004. For the six-month period ended September 30 our investment tax credit decreased from \$442,954 in 2003 to \$261,436 for the same period in 2004. The change is the result of the reduction of prescribed rates announced by the revenue authorities and a lower tax credit rate available to public companies. These tax credits will be applied in the future against our income taxes otherwise payable and are not refunded in the year we incurred the research and development expenses. As a result, we have not recorded the investment tax credits.

Administrative

Administrative expenses for the three-month period ended September 30, 2004 increased to \$ 472,775 compared to \$331,476 for the same period in 2003. The increase is mainly due to the following factors:

- an increase in insurance premiums;
- an increase of \$33,000 in salaries;
- additional expenses as a result of being a public company;
- the recording of a \$70,000 expense with respect to options issued during the period; and
- an increase in rental expense.

As a result, expenses for the six-month period ended September 30 also increased from \$649,596 in 2003 to \$936,510 for the same period in 2004.

Selling and Market Development

Selling and Market Development expenses for the three-month period ended September 30, 2004 were \$550,543 as compared to \$371,812 for the same period in 2003. The increase is mainly the result of the addition of two account managers and an increase in traveling expenses. As a result, for the six-month period ended September 30 these expenses increased from \$884,473 in 2003 to \$1,060,482 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 September 30 our Customer Support department expenses increased from \$158,914 in 2003 to \$185,962 for the same period in 2004. For the six-month period ended September 30, 2004, these expenses were \$353,255 compared to \$284,281 for the same period in 2003. The change in 2004 results mainly from the addition of two new employees to support the expansion of our customer support activities.

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. Expenses incurred by these departments include the salary of a full-time Quality Assurance and Regulatory Affairs Director and costs associated with obtaining approval to market our products in Canada, the United States and Europe. For the three-month period ended September 30 these expenses decreased from \$ 39,914 in 2003 to \$ 31,555 for the same period in 2004. For the six-month period ended September 30 these expenses decreased from \$80,277 in 2003 to \$74,072 for the same period in 2004. In 2003, we were subject to a special audit to qualify under ISO (International Organization for Standardization) and the European CE Mark resulting in a non-recurring expense of \$10,000.



Special charges

These expenses relate to professional 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.

Also, we have filed 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. The registration statement is currently under review with the United States Securities and Exchange Commission.

Other expenses/income

Other expenses incurred and other revenue generated includes our technical showcase project, amortization of property, plant and equipment, amortization of patents, government grants and foreign exchange gain or loss. We incurred other expenses of \$115,089 for the three-month period ended September 30, 2003 whereas we generated income of \$35,194 in the same period of 2004. Following the additional liquidities that were generated during the three-month period ended September 30, 2004 we generated interest income of \$63,284 compared to interest expenses incurred of \$9,680 for the same period in 2003. For the three-month period ended September 30, 2003, we spent \$37,246 on our technological showcase project compared to \$118 for the same period in 2004. We also reduced interest on our long term financing from \$16,532 in the three-month period ended September 30, 2003 to \$3,909 for the same period in 2004. For the six-month period ended September 30, 2004 we generated interest income of \$117,726 (expense of \$26,697 for the same period in 2003), we incurred \$818 on our technological showcase project (\$66,058 for the same period in 2003) and we reduced interest on long term financing from \$41,976 to \$10,118 for the same period in 2003. As a result, we have generated other income for an amount of \$58,502 for the six-month period ended September 30, 2004 compared to an expense of \$164,625 for the same period last year.

Net Loss

Our net loss for the three-month period ended September 30, 2004 was \$2,275,272 (\$0.16 per share) compared with \$1,371,856 for same period in 2003 (\$0.44 per share). For the six-month period ended September 30, 2004 our net loss was \$4,076,532 (\$0.28 per share) compared to \$2,819,435 (\$0.90 per share) for the same period in 2003.

Liquidity and Capital Resources

Operating activities

Cash flow used for operations totaled \$1,141,781 for the three month period ended September 30, 2004 compared to \$1,336,116 for the same period in 2003.

In 2004, cash used in our operating activities is mainly explained by our net loss of \$2,275,272 (\$1,371,856 for the same period in 2003) and by a positive net change in non-cash operating working capital of \$1,036,215 (\$-44,416 for the same period in 2003) which resulted mainly from the receipt of the federal portion of the investment tax credit for an amount of \$550,000 and an increase in accounts payable.

For the six-month period ended September 30, 2004 we used \$3,132,435 for our operations compared to \$1,631,674 for the same period in 2003. The difference is mainly explained by the increase in our net loss from \$2,819,435 in the six-month period ended September 30, 2003 to \$4,076,532 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 September 30, 2004 we spent \$81,476 (\$711 for the same period in 2003) and for the six-month period ended September 30, 2004 we spent \$141,050 (\$12,849 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 \$40 million from the issuance of equity.



During the three-month period ended September 30, 2004, net proceeds of \$503,131 were generated from the exercise of warrants. In 2003 we generated \$1,363,079 from the issuance of common shares. For the six-month period ended September 30, 2004 we raised net proceeds of \$12,682,797 from the issuance of common shares compared to \$1,378,829 for the same period in 2003. These proceeds were raised in connection with the acquisition of LMS Medical Systems Ltd.

Our cash and cash equivalents decreased by \$728,452 for the three-month period ended September 30, 2004 compared to \$206,613 for the same period in 2003. For the six-month period ended September 30, 2004 our cash and cash equivalents increased by \$9,393,561 compared to a decrease of \$637,374 for the same period in 2003, leaving a balance at the end of the 2004 period of \$10,824,684 compared to a deficit of \$166,558 at the end of the same period in 2003.

As of September 30, 2004, we have no debt other than capital leases, which totaled \$79,012 and are repayable over the next 5 years. Our operating obligations are as follows:

• Less than 1 year	\$200,126
• 1 to 3 years	<u>\$466,529</u>
• Total	\$666,655

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 integration of our system with those of our distributors, commercialization of a new product during fiscal 2005 and a new release of the CALMTM 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 (\$90,000 for the six-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.