

LML PAYMENT SYSTEMS INC
Form 10-Q
November 09, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _____ to _____

Commission File Number: 0-13959

LML PAYMENT SYSTEMS INC.
(Exact name of registrant as specified in its charter)

Yukon Territory

980-20-9289

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification
No.)

1680-1140 West Pender Street
Vancouver, British Columbia
Canada V6E 4G1

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: **(604) 689-4440**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act.). Yes No

The number of shares of the registrant's Common Stock outstanding as of October 15, 2004, was 20,143,594.

LML PAYMENT SYSTEMS INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

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In this Quarterly Report on Form 10-Q, unless otherwise indicated, all dollar amounts are expressed in United States Dollars.

PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

LML PAYMENT SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(In U.S. Dollars)

| | September 30, 2004 \$ (Unaudited) | March 31, 2004 \$ |
|--|---|-------------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | 6,330,299 | 4,981,343 |
| Short-term investments | - | 183,561 |
| Restricted cash | 300,000 | 300,000 |
| Accounts receivable, less allowances of \$41,331 and \$109,916, respectively | 472,510 | 784,617 |
| Prepaid expenses | 413,872 | 470,011 |
| Total Current Assets | 7,516,681 | 6,719,532 |

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| | | |
|---------------------|------------------|------------------|
| Capital Assets, net | 1,021,745 | 1,667,461 |
| Patents, net | 1,269,317 | 1,317,141 |
| Other Assets | 66,055 | 55,103 |
| TOTAL ASSETS | 9,873,798 | 9,759,237 |

LIABILITIES

Current Liabilities

| | | |
|-----------------------------------|---------|---------|
| Accounts payable | 601,848 | 482,224 |
| Accrued liabilities | 80,788 | 85,277 |
| Accrued compensation | 142,815 | 245,766 |
| Current portion of long-term debt | 46,882 | 37,434 |
| Current deferred revenue | 219,148 | 225,729 |

| | | |
|----------------------------------|------------------|------------------|
| Total Current Liabilities | 1,091,481 | 1,076,430 |
| Long-term debt | 47,774 | 56,150 |
| Total Liabilities | 1,139,255 | 1,132,580 |

SHAREHOLDERS' EQUITY

Capital Stock

| | | |
|---|------------|------------|
| Class A, preferred stock, \$1.00 CDN par value, 150,000,000 shares authorized, issuable in series, none issued or outstanding | - | - |
| Class B, preferred stock, \$1.00 CDN par value, 150,000,000 shares authorized, issuable in series, none issued or outstanding | 31,784,449 | 30,656,471 |

Common shares, no
par value,
100,000,000 shares
authorized,
19,972,283 and
19,659,851 shares
issued and
outstanding,
respectively

| | | |
|-------------------------------|--------------|--------------|
| Contributed surplus | 1,289,347 | 85,918 |
| Deficit | (24,339,253) | (22,115,732) |
| Total Shareholders' Equity | 8,734,543 | 8,626,657 |

| | | |
|---|-----------|-----------|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | 9,873,798 | 9,759,237 |
|---|-----------|-----------|

See accompanying notes to the consolidated financial statements.

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LML PAYMENT SYSTEMS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
(In U.S. Dollars, except share data)

(Unaudited)

REVENUE

COSTS AND EXPENSES

Cost of operations

Sales, general and administrative

Amortization and depreciation

Stock-based compensation

Thr

Sep

1,59

1,36

60

32

| | |
|--|-------------|
| | 129,175 |
| | 15,726 |
| | 1,171,737 |
| | 15,726 |
| Other expenses | |
| | 5,719 |
| | 40,338 |
| | 7,651 |
| | 56,685 |
| LOSS FROM CONTINUING OPERATIONS BEFORE INTEREST INCOME AND INCOME TAXES | |
| | (842,420) |
| | (1,137,473) |
| | (2,195,768) |

(2,200,310)

Interest income, net

15,111

17,836

22,339

27,437

LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES

(827,309)

(1,119,637)

(2,173,429)

(2,172,873)

Income tax expense

35,892

4,200

50,092

8,400

LOSS FROM CONTINUING OPERATIONS

(863,201)

(1,123,837)

(2,223,521)

(2,181,273)

Discontinued operations

-

(11,317)

-

588,109

NET LOSS

(863,201)

(1,135,154)

(2,223,521)

(1,593,164)

DEFICIT, beginning of period

(23,476,052)

(20,845,630)

(22,115,732)

(20,387,620)

DEFICIT, end of period

(24,339,253)

(21,980,784)

(24,339,253)

(21,980,784)

LOSS PER SHARE

Basic loss per share

Loss from continuing operations

(0.04)

(0.06)

(0.11)

(0.11)

Net loss

(0.04)

(0.06)

(0.11)

(0.08)

Diluted loss per share

Loss from continuing operations

(0.04)

(0.06)

(0.11)

(0.11)

Net loss

(0.04)

(0.06)

(0.11)

(0.08)

WEIGHTED AVERAGE SHARES OUTSTANDING

Basic

19,931,873

19,594,572

19,887,725

19,593,812

Diluted

19,931,873

19,594,572

19,887,725

19,593,812

See accompanying notes to the consolidated financial statements.

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LML PAYMENT SYSTEMS INC.
 CONSOLIDATED STATEMENTS OF CASH FLOWS
 (In U.S. Dollars)

(Unaudited)

| | Three Months Ended September 30 | | Six Months Ended September 30 | |
|---|------------------------------------|-------------|----------------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| | \$ | \$ | \$ | \$ |
| Operating Activities: | | | | |
| Loss from continuing operations | (863,201) | (1,123,837) | (2,223,521) | (2,181,273) |
| Adjustments to reconcile loss from continuing operations | | | | |

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| | | | | |
|--|-----------|-----------|-----------|-----------|
| to net cash (used in) provided by operating activities | (6,836) | - | 4,131 | 42,439 |
| Provision for losses on accounts receivable | | | | |
| Amortization and depreciation | 326,954 | 526,365 | 779,485 | 1,098,813 |
| Stock-based compensation | 129,175 | 15,726 | 1,171,737 | 15,726 |
| Income tax expense | 31,692 | - | 31,692 | - |
| Other | 761 | 41,519 | 761 | 41,519 |
| Changes in operating assets and liabilities | | | | |
| Accounts receivable | 140,792 | (41,018) | 307,976 | 19,333 |
| Prepaid expenses | 384 | (11,230) | 56,139 | 71,194 |
| Accounts payable and accrued liabilities | 113,152 | 243,299 | 12,184 | 15,035 |
| Other assets | (10,952) | 24,001 | (10,952) | 23,268 |
| Deferred revenue | 21,819 | 24,852 | (6,581) | (32,045) |
| Net cash (used in) provided by operating activities of continuing operations | (116,260) | (300,323) | 123,051 | (885,991) |
| Investing Activities: | | | | |
| Maturity of short-term investments | - | - | 183,561 | - |

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| | | | | |
|--|----------|-----------|-----------|-----------|
| Capital asset expenditures | (28,548) | (49,105) | (62,826) | (56,231) |
| Patents | (23,880) | - | (23,880) | (7,306) |
| Net cash (used in) provided by investing activities of continuing operations | (52,428) | (49,105) | 96,855 | (63,537) |
| Financing Activities: | | | | |
| Payments on capital leases | (8,850) | (48,648) | (16,249) | (90,016) |
| Payments on long-term borrowing | (5,314) | - | (5,314) | - |
| Proceeds from long-term borrowing | 22,635 | - | 22,635 | - |
| Proceeds from exercise of stock options | 264,228 | 43,750 | 1,127,978 | 43,750 |
| Net cash provided by (used in) financing activities of continuing operations | 272,699 | (4,898) | 1,129,050 | (46,266) |
| Net cash provided by (used in) continuing operations | 104,011 | (354,326) | 1,348,956 | (995,794) |
| Net cash (used in) provided by | - | (26,621) | - | 2,158,241 |

discontinued
operations

| | | | | |
|---------------------------------|---------|-----------|-----------|-----------|
| INCREASE (DECREASE) IN | 104,011 | (380,947) | 1,348,956 | 1,162,447 |
| CASH AND CASH EQUIVALENTS | | | | |

| | | | | |
|---|-----------|-----------|-----------|-----------|
| Cash and cash equivalents, beginning of period | 6,226,288 | 5,027,084 | 4,981,343 | 3,483,690 |
|---|-----------|-----------|-----------|-----------|

| | | | | |
|--|-----------|-----------|-----------|-----------|
| Cash and cash equivalents, end of period | 6,330,299 | 4,646,137 | 6,330,299 | 4,646,137 |
|--|-----------|-----------|-----------|-----------|

See accompanying notes to the consolidated financial statements.

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LML PAYMENT SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Basis of Presentation

The consolidated balance sheet as of September 30, 2004 and the consolidated statements of operations and deficit and cash flows for the three months and six months ended September 30, 2004 and 2003 of LML Payment Systems Inc. and its subsidiaries (collectively, the "Corporation") are unaudited. The Corporation's consolidated balance sheet as of March 31, 2004, was derived from audited financial statements. In the opinion of management, all adjustments necessary for a fair presentation of such financial statements are included herein. Other than those discussed in the notes below, such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year. The Corporation's consolidated financial statements and notes are presented in accordance with generally accepted accounting principles in Canada for interim financial information and in accordance with the instructions for Form 10-Q and Article 10 of Regulation S-X, and do not contain certain information included in the Corporation's consolidated audited annual financial statements and notes. The consolidated financial statements and notes appearing in this report should be read in conjunction with the Corporation's consolidated audited financial statements and related notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in the Corporation's Annual Report on Form 10-K for the fiscal year ended March 31, 2004, as filed with the Securities and Exchange Commission on June 14, 2004 (file no. 0-13959).

2. Financial instruments

a) Restricted cash

Under the terms of the processing agreement with one of the Corporation's processing banks, the Corporation has pledged a deposit of \$250,000 (September 30, 2003 - \$250,000) against charge back losses. The Corporation has also established an irrevocable standby letter of credit in favor of Citicorp Diners Club Inc. of \$50,000 (September 30, 2003 - \$50,000) under the terms of the corporate credit card agreement.

b) Concentration of credit risk

Financial instruments, which potentially subject the Corporation to concentrations of credit risk, consist primarily of cash and cash equivalents, short-term investments and accounts receivable.

During the three months ended September 30, 2004, revenue from the Corporation's largest customer amounted to approximately 21% of total revenue (three months ended September 30, 2003 - 14%). The amount of actual revenue from this customer amounted to approximately \$329,926 (three months ended September 30, 2003 - \$248,772). During the six months ended September 30, 2004, revenue from the Corporation's two (2) largest customers amounted to approximately 18% and 11% of total revenue (six months ended September 30, 2003 - 14% and 25%). The amount of actual revenue from these customers amounted to approximately \$674,400 and \$410,447 (six months ended September 30, 2003 - \$507,407 and \$901,624), respectively. The Corporation may be economically dependent on revenue from these customers. On March 31, 2004, one of the Corporation's largest customers notified the Corporation that its contract would not be extended and, therefore, the Corporation ceased providing services to this customer on May 31, 2004. The customer accounted for approximately 11% of total revenue in the six months ended September 30, 2004 (six months ended September 30, 2003 - 25%).

3. Stock-based compensation

Effective April 1, 2003, the Corporation prospectively early adopted CICA 3870 which corresponds to SFAS 123, as amended by SFAS 148, which requires fair value accounting for all stock options issued during the year. Prior to the adoption of the new accounting standard, the Corporation did not record the fair value of all stock options issued, rather, it provided pro-forma disclosure of the effect of applying the fair value based method to stock options issued to directors, officers and employees.

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During the three months ended September 30, 2004, the Corporation granted 105,000 stock options under the Corporation's 1996 Stock Option Plan and 75,000 stock options under the 1998 Stock Incentive Plan. The weighted average fair value for 80,000 of these stock options granted is \$3.41 and the remaining 100,000 stock options granted have a weighted average fair value of \$3.07. For the six months ended September 30, 2004, the Corporation has granted 485,000 stock options under the Corporation's 1996 Stock Option Plan and 150,000 stock options under the 1998 Stock Incentive Plan. The weighted average fair value of the 635,000 stock options granted during the six months ended September 30, 2004 range from a low of \$3.07 to a high of \$4.44. The total fair value of stock-based compensation is amortized over the vesting period resulting in stock-based compensation expense of \$129,175 for the three months ended September 30, 2004 (three months ended September 30, 2003 - \$15,726) and \$1,171,737 for the six months ended September 30, 2004 (six months ended September 30, 2003 - \$15,726). The fair value for the stock option grants was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

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Risk-free interest rate of 4.07% for 560,000 of the stock option grants and 4.35% for 75,000 of the stock option grants;

Expected volatility of 78.9% to 79.6%;

Expected life of the 560,000 stock option grants of 4 years and 6 years for the 75,000 stock option grants;

No dividend yields.

The pro-forma disclosure below relates to stock options granted prior to April 1, 2003 which have vested in the periods presented below. The pro-forma compensation expense recorded during the three months and six months ended September 30, 2004 represents the amortization of previously issued stock options. These previously issued options are amortized to pro-forma compensation expenses as the options vest.

| | Three Months Ended September 30 | | Six Months Ended September 30 | |
|--------------------|------------------------------------|-------------|----------------------------------|-------------|
| | J004 \$ | J003 \$ | J004 \$ | J003 \$ |
| Compensation cost | J70,957 | M09,043 | M66,825 | I,272,897 |
| Net loss | | | | |
| As reported | (863,201) | (1,135,154) | (2,223,521) | (1,593,164) |
| Pro forma | (1,134,158) | (1,644,197) | (2,790,346) | (2,866,061) |
| Net loss per share | | | | |
| As reported | (0.04) | (0.06) | (0.11) | (0.08) |
| Pro forma | (0.06) | (0.08) | (0.14) | (0.15) |

Fair value of options granted are estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions for the three months and six months ended September 30, 2004:

Risk free interest rate of 4% for the three months and six months ended September 30, 2004 and September 30, 2003;

Expected volatility of 104% for three months and six months ended September 30,2004 and September 30, 2003;

Expected life of the options of 4 years for the three months and six months ended September 30, 2004 and September 30, 2003;

No dividend yields.

4. Commitments and Contingencies

During the three months and six months ended September 30, 2004, a subsidiary of the Corporation filed suit in the U.S. District Court for the District of Delaware against four companies who provide equipment, systems and services that convert paper checks presented at the point of sale into electronic transactions. In the suit, the subsidiary of the Corporation alleges that these four companies infringe three patents owned by the subsidiary of the Corporation. The subsidiary of the Corporation is seeking damages, injunctive and other relief for the alleged willful infringement of these patents. Subsequent to the three months and six months ended September 30, 2004 a federal judge has set a trial date of April 17, 2006 in this matter.

5. Reconciliation of United States to Canadian Generally Accepted Accounting Principles

These financial statements are prepared using Canadian generally accepted accounting principles ("CDN GAAP") which do not differ materially from United States generally accepted accounting principles ("U.S. GAAP") with respect to the accounting policies and disclosures in these financial statements except as set out below:

a) Under U.S. GAAP, the Corporation could not effect the reduction in deficit of \$22,901,744 (performed in fiscal 2001 and disclosed in the Corporation's Form 10-K for the fiscal year ended March 31, 2001) by reducing the stated capital of the shares of the Corporation's common stock.

Under U.S. GAAP there are no adjustments that resulted in changes to the Consolidated Statements of Operations and Deficit, Consolidated Statements of Cash Flows or the Consolidated Balance Sheets of the Corporation.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Unless the context otherwise requires, references in this report on Form 10-Q to the "Corporation", "LML", "we", "us" or "our" refer to LML Payment Systems Inc. and its direct and indirect subsidiaries. LML Payment Systems Inc.'s direct subsidiaries include LML Corp., Legacy Promotions Inc. and LHTW Properties Inc. LML Corp.'s subsidiaries are LML Patent Corp., and LML Payment Systems Corp. Unless otherwise specified herein, all references herein to dollars or "\$" are to U.S. Dollars.

The following discussion and analysis should be read in conjunction with the consolidated audited financial statements and related notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended March 31, 2004, filed with the Securities and Exchange Commission on June 14, 2004 (file no. 0-13959). We believe that all

necessary adjustments (consisting only of normal recurring adjustments) have been included in the amounts stated below to present fairly the following quarterly information. Quarterly operating results have varied significantly in the past and can be expected to vary in the future. Results of operations for any particular quarter are not necessarily indicative of results of operations for a full year.

Forward Looking Information

All statements other than statements of historical fact contained herein are forward-looking statements. Forward-looking statements generally are accompanied by words such as "anticipate," "believe," "estimate," "intend," "project," "potential" or "expect" or similar statements. The forward-looking statements were prepared on the basis of certain assumptions which relate, among other things, to the demand for and cost of marketing our services, the volume and total value of transactions processed by merchants utilizing our services, the technological adaptation of electronic check conversion end-users, the renewal of material contracts in our business, our ability to anticipate and respond to technological changes, particularly with respect to financial payments and e-commerce, in a highly competitive industry characterized by rapid technological change and rapid rates of product obsolescence, our ability to develop and market new product enhancements and new products and services that respond to technological change or evolving industry standards, no unanticipated developments relating to previously disclosed lawsuits against us, and the cost of protecting our intellectual property. Even if the assumptions on which the forward-looking statements are based prove accurate and appropriate, the actual results of our operations in the future may vary widely due to technological change, increased competition, new government regulation or intervention in the industry, general economic conditions, other risks described in our filings with the Securities and Exchange Commission. Accordingly, the actual results of our operations in the future may vary widely from the forward-looking statements included herein. All forward-looking statements included herein are expressly qualified in their entirety by the cautionary statements in this paragraph.

Overview

LML Payment Systems Inc. is a financial payment processor. We provide check risk services such as electronic check authorization, electronic check processing services such as electronic check conversion and return check management such as traditional and electronic recovery services to retail clients. We also provide mainframe payment processing software modules and rights to use our patented intellectual property to retailers and other payment processors.

When we provide return check management services, we typically receive revenue when we are successful at recovering the principal amount of the original transaction on behalf of the client. In some instances we also earn a percentage of the principal amount and in some other instances our secondary recovery services provide for us to earn additional fees when legal action is required.

When we provide check authorization and electronic check conversion services we typically earn revenue based upon the number of transactions we process through our data center.

Due to their interrelated nature, we often bundle check authorization, check processing and check recovery services into combined service packages and market these packages under our LASR™ brand name (Live Authorization Settlement and Recovery).

When we provide mainframe based payment software modules to clients who are of sufficient size and possess the technical capability to process financial transactions in-house, or through their own data center, we typically earn revenue by way of a fixed software license fee. In some instances we also earn revenue by way of royalties that are typically based upon a fixed sale price or on a usage or transaction basis.

When we provide clients licenses to our intellectual property estate that includes four U.S. patents describing electronic check processing methods, we typically earn revenue from release fees for potential past infringement and ongoing royalty fees.

In a former, separate business segment, we owned and managed a 332-acre manufactured home retirement property known as Wildwood Estates, in Wildwood, Florida. Operations included the sale of manufactured homes and lots. In exchange for monthly maintenance fees, we provided the resident community with certain amenities and services commonly associated with similar developments. During the year ended March 31, 2004, we sold the Wildwood Estates property for total gross proceeds of approximately \$2.4 million cash.

We now concentrate all our activity in the financial payment processing segment and provide our financial payment processing services from our office locations in Scottsdale, Arizona, Wichita, Kansas and Dallas, Texas.

Results of Operations

Three Months Ended September 30, 2004 results compared to Three Months Ended September 30, 2003

Revenue

Total revenue for the three months ended September 30, 2004 was approximately \$1.6 million, approximately an 11.1% decrease over total revenue of approximately \$1.8 million for the three months ended September 30, 2003. This decrease is primarily attributable to a decrease in revenue associated with our electronic check verification and primary check collections business.

Revenue from electronic check verification decreased approximately 29% from approximately \$283,000 for the three months ended September 30, 2003 to approximately \$201,000 for the three months ended September 30, 2004. This decrease was mainly attributable to us no longer providing check authorization services to 7-Eleven, formerly one of our largest customers which was responsible for approximately 17% of our electronic check verification revenue for the three months ended September 30, 2003.

Revenue from our primary check collections business decreased approximately 40.8% from approximately \$836,000 for the three months ended September 30, 2003 to approximately \$495,000 for the three months ended September 30, 2004. Revenue from our secondary check collections business increased approximately 33.7% from approximately \$492,000 for the three months ended September 30, 2003 to approximately \$658,000 for the three months ended September 30, 2004. The reduction in revenue from our primary check collections business was mainly attributable to us no longer providing check recovery services to 7-Eleven, formerly one of our largest customers which was responsible for approximately 42.7% of revenue from our primary check collections business for the three months ended September 30, 2003.

Revenue from our licensing of certain payment software modules was approximately \$30,000 for the three months ended September 30, 2004, compared to approximately \$25,000 for the three months ended September 30, 2003.

Revenue from royalties received from CheckFree Corporation pertaining to their marketing of the PEP+ reACH™ product was approximately \$34,000 for the three months ended September 30, 2004, versus Nil for the three months ended September 30, 2003. We believe future royalties are dependent upon the continued successful marketing by CheckFree Corporation of the PEP+ reACH™ product.

During the three months ended September 30, 2004, revenue from and associated with our largest customer amounted to approximately 20.7% of total revenue as compared to approximately 14% of total revenue for the three months ended September 30, 2003. We may be economically dependent on revenue from this customer.

Costs of operations

Costs of operations decreased from approximately \$1.7 million for the three months ended September 30, 2003, to approximately \$1.4 million for the three months ended September 30, 2004, a decrease of approximately 17.6%. Cost of operations consist of transaction processing costs, personnel costs, equipment related costs and telecommunication costs. The decrease was partially attributable to certain cost reductions, including staff reductions, implemented during the third quarter of our fiscal year ended March 31, 2004 and partially attributable to certain cost reductions associated with us no longer providing check authorization and recovery services to 7-Eleven. We continue to seek ways to reduce costs of operations.

Sales, general and administrative expenses

Sales, general and administrative expenses consist primarily of personnel costs, commissions, office facilities, travel, promotional events such as trade shows, seminars and technical conferences, public relations and professional service fees, which include legal fees, audit fees, SEC compliance costs and costs related to compliance with the Sarbanes-Oxley Act of 2002. Sales, general and administrative expenses decreased to approximately \$608,000 from approximately \$670,000 for the three months ended September 30, 2004 and 2003, respectively, a decrease of approximately 9.3%. The decrease in sales, general and administrative expense is primarily attributable to lower costs associated with the reduction of personnel and reduced general corporate expenses. We expect that professional fees for legal matters will continue to fluctuate depending on the timing and development of on-going legal matters, and we expect increases in professional fees associated with the continuing compliance with the Sarbanes-Oxley Act of 2002.

Amortization and depreciation

Amortization and depreciation decreased to approximately \$327,000 from approximately \$526,000 for the three months ended September 30, 2004 and 2003, respectively. The decrease was primarily attributable to certain capital assets, acquired through previous years' acquisitions, which had become fully depreciated.

Stock-based compensation

In our fiscal year ended March 31, 2004, we adopted new accounting standards which require fair value accounting for all stock options issued subsequent to April 1, 2003. During the three months ended September 30, 2004, we granted a total of 180,000 stock options under our 1996 Stock Option Plan and 1998 Stock Incentive Plan. The total fair value stock-based compensation is amortized over the vesting period resulting in a stock-based compensation expense of approximately \$129,000 for the three months ended September 30, 2004 versus approximately \$16,000 for the three months ended September 30, 2003.

Other expenses

Other expenses decreased to approximately \$6,000 from approximately \$40,000 for the three months ended September 30, 2004 and 2003, respectively.

Interest

Interest expense was approximately \$2,000 for the three months ended September 30, 2004 as compared to an interest expense credit of approximately \$3,000 for the three months ended September 30, 2003. Interest income increased to approximately \$17,000 from approximately \$15,000 for the three months ended September 30, 2004 and 2003, respectively.

Loss from continuing operations

Loss from continuing operations decreased to approximately \$863,000 from approximately \$1.1 million for the three months ended September 30, 2004 and 2003, respectively. The decrease was primarily attributable to a decrease in cost of operations and sales, general and administrative expenses as well as a decrease in amortization and depreciation offset by an increase in stock-based compensation expense of approximately \$113,000 from approximately \$16,000 for the three months ended September 30, 2003 to approximately \$129,000 for the three months ended September 30, 2004.

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Basic and diluted loss per share from continuing operations were both approximately (\$0.04) for the three months ended September 30, 2004, as compared to approximately (\$0.06) for the three months ended September 30, 2003.

Six Months Ended September 30, 2004 results compared to Six Months Ended September 30, 2003

Revenue

Total revenue was approximately \$3.7 million for the six months ended September 30, 2004 and 2003, respectively.

Revenue from electronic check verification decreased approximately 13.6% from approximately \$616,000 for the six months ended September 30, 2003 to approximately \$532,000 for the six months ended September 30, 2004.

Revenue from our primary check collections business decreased approximately 29.4% from approximately \$1.7 million for the six months ended September 30, 2003 to approximately \$1.2 million for the six months ended September 30, 2004. Revenue from our secondary check collections business increased approximately 40% from approximately \$1 million for the six months ended September 30, 2003 to approximately \$1.4 million for the six months ended September 30, 2004. The reduction in revenue from our primary check collections business was primarily attributable to us no longer providing check recovery services to 7-Eleven, formerly one of our largest customers which was responsible for approximately 43.4% of revenue from our primary check collections business for the six months ended September 30, 2003.

Revenue from our licensing of certain payment software modules was approximately \$55,000 for the six months ended September 30, 2004, compared to approximately \$70,000 for the six months ended September 30, 2003.

Revenue from royalties received from CheckFree Corporation pertaining to their marketing of the PEP+ reACH™ product was approximately \$133,000 for the six months ended September 30, 2004, versus Nil for the six months

ended September 30, 2003. We believe future royalties are dependent upon the continued successful marketing by CheckFree Corporation of the PEP+ reACH™ product.

During the six months ended September 30, 2004, revenue from and associated with our two largest customers amounted to approximately 29.3% of total revenue as compared to approximately 37.2% of total revenue for the six months ended September 30, 2003. We may be economically dependent on revenue from these customers.

We ceased providing check authorization and recovery services to 7-Eleven on May 31, 2004. We believe that replacement revenue may come from sales of our electronic check verification, recovery and electronic check conversion products and services to existing and new merchant clients, the licensing of our patented technology regarding electronic check processing and royalties from software licensing agreements. Failure to successfully replace some or all of this revenue could have a material adverse effect on our liquidity, capital resources or results of operations.

Costs of operations

Costs of operations decreased from approximately \$3.4 million for the six months ended September 30, 2003, to approximately \$2.8 million for the six months ended September 30, 2004, a decrease of approximately 17.6%. Cost of operations consist of transaction processing costs, personnel costs, equipment related costs and telecommunication costs. The decrease was partially attributable to certain cost reductions, including staff reductions, implemented during the third quarter of our fiscal year ended March 31, 2004 and partially attributable to certain cost reductions associated with us no longer providing check authorization and recovery services to 7-Eleven. We continue to seek ways to reduce costs of operations.

Sales, general and administrative expenses

Sales, general and administrative expenses consist primarily of personnel costs, commissions, office facilities, travel, promotional events such as trade shows, seminars and technical conferences, public relations and professional service fees, which include legal fees, audit fees, SEC compliance costs and costs related to compliance with the Sarbanes-Oxley Act of 2002. Sales, general and administrative expenses decreased to approximately \$1.1 million from approximately \$1.3 million for the six months ended September 30, 2004 and 2003, respectively, a decrease of approximately 15.4%. The decrease in sales, general and administrative expense is primarily attributable to lower costs associated with the reduction of personnel and reduced general corporate expenses. We expect that professional fees for legal matters will continue to fluctuate depending on the timing and development of on-going legal matters, and we expect increases in professional fees associated with the continuing compliance with the Sarbanes-Oxley Act of 2002.

Amortization and depreciation

Amortization and depreciation decreased to approximately \$779,000 from approximately \$1.1 million for the six months ended September 30, 2004 and 2003, respectively. The decrease was primarily attributable to certain capital assets, acquired through previous years' acquisitions, which had become fully depreciated.

Stock-based compensation

In our fiscal year ended March 31, 2004, we adopted new accounting standards which require fair value accounting for all stock options issued subsequent to April 1, 2003. During the six months ended September 30, 2004, we granted

a total of 635,000 stock options under our 1996 Stock Option Plan and 1998 Stock Incentive Plan. The total fair value stock-based compensation is amortized over the vesting period resulting in a stock-based compensation expense of approximately \$1.2 million for the six months ended September 30, 2004 versus approximately \$16,000 for the six months ended September 30, 2003.

Other expenses

Other expenses decreased to approximately \$8,000 from approximately \$57,000 for the six months ended September 30, 2004 and 2003, respectively.

Interest

Interest expense increased to approximately \$5,000 from approximately \$2,000 for the six months ended September 30, 2004 and 2003 respectively. Interest income decreased to approximately \$27,000 from approximately \$29,000 for the six months ended September 30, 2004 and 2003, respectively.

Loss from continuing operations

Loss from continuing operations was approximately \$2.2 million for the six months ended September 30, 2004 and 2003, respectively. The loss from continuing operations for the six months ended September 30, 2004 includes stock-based compensation expense of approximately \$1.2 million versus approximately \$16,000 for the six months ended September 30, 2003.

Basic and diluted loss per share from continuing operations were both approximately (\$0.11) for the six months ended September 30, 2004 and 2003, respectively.

Liquidity and Capital Resources

Our liquidity and financial position consisted of approximately \$6.4 million in working capital as of September 30, 2004, compared to approximately \$5.6 million in working capital as of March 31, 2004. The increase in working capital was attributable to cash flows provided by financing activities of continuing operations of approximately \$1.1 million and cash provided by operating activities of continuing operations of approximately \$123,000. Cash provided by operating activities of continuing operations related to normal operating activities and a decrease in accounts payable and accrued liabilities of approximately \$12,000, a decrease of prepaid expenses of approximately \$56,000 and a decrease in accounts receivable of approximately \$308,000. Cash flows provided by operating activities of continuing operations were approximately \$123,000 for the six months ended September 30, 2004 compared to cash flows used in operating activities of continuing operations of approximately \$886,000 for the six months ended September 30, 2003. Cash provided by investing activities of continuing operations was approximately \$97,000 for the six months ended September 30, 2004 as compared to cash used in investing activities of continuing operations of approximately \$64,000 for the six months ended September 30, 2003, respectively. The increase was primarily attributed to the maturity of short-term investments of approximately \$184,000 during the six months ended September 30, 2004. Cash provided by financing activities of continuing operations was approximately \$1.1 million for the six months ended September 30, 2004 compared to cash used in financing activities of continuing operations of approximately \$46,000 for the six months ended September 30, 2003. The increase in cash provided by financing activities of continuing operations is primarily due to the increase in proceeds from exercise of options of our common stock.

We believe that existing cash and cash equivalent balances, and potential cash flows from operations should satisfy our working capital and capital expenditure requirements in the foreseeable future. However, any material acquisitions of complementary businesses, products or technologies, other arrangements, unexpected losses, or a further economic slowdown in the retail industry could require us to obtain additional equity or debt financing. There can be no

assurance that such financing would be available on acceptable terms, if at all.

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Critical Accounting Policies

There have been no changes to our critical accounting policies since March 31, 2004. For a description of our critical accounting policies, see our Annual Report on Form 10-K for the year ended March 31, 2004 filed with the Securities and Exchange Commission.

Contingencies

In addition to the legal matters previously reported in our Annual Report filed on Form 10-K for the year ended March 31, 2004, as filed with the Securities and Exchange Commission on June 14, 2004 (file no. 0-13959), we are party from time to time to ordinary litigation incidental to our business, none of which is expected to have a material adverse effect on our results of operations, financial position or liquidity. See also "Part II - Other Information (Item 1 - Legal Proceedings)".

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

From March 31, 2004, until September 30, 2004, there were no material changes from the information concerning market risk contained in our Annual Report on Form 10-K for the year ended March 31, 2004, as filed with the Securities and Exchange Commission on June 14, 2004 (file no. 0-13959).

ITEM 4. Controls and Procedures

An evaluation of the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), was carried out by management with the participation of the Chief Executive Officer and Chief Accounting Officer as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Accounting Officer have concluded that such controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q. As required by Exchange Act Rule 13a-15(d), management, with the participation of the Chief Executive Officer and Chief Accounting Officer, also conducted an evaluation of our internal control over financial reporting to determine whether changes occurred during the quarter ended September 30, 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there has been no such change during the quarter ended September 30, 2004.

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PART II.

OTHER INFORMATION

ITEM 1. Legal Proceedings

On July 14, 2004 we filed suit in the U.S. District Court for the District of Delaware against four companies who provide equipment, systems and services that convert paper checks presented at the point of sale into electronic

transactions. In the suit, we allege that these four companies infringe three of our U.S. patents. We are seeking damages and injunctive and other relief for the alleged willful infringement of these patents. A federal judge has set a trial date of April 17, 2006 in this matter. In addition to the legal matters as described herein and as previously reported in our Annual Report on Form 10-K for the year ended March 31, 2004, as filed with the Securities and Exchange Commission on June 14, 2004 (file no. 0-13959), we are party from time to time to ordinary litigation incidental to our business, none of which is expected to have a material adverse effect on our results of operations, financial position or liquidity.

ITEM 4. Submission of Matters to a Vote of Security Holders

At the Corporation's Annual General Meeting of Shareholders held August 25, 2004 (the "Meeting"), the following proposals were adopted by shareholders of the Corporation (the "Shareholders") by ordinary resolution: (1) to elect PATRICK H. GAINES, GREG A. MACRAE, L. WILLIAM SEIDMAN, ROBIN B. MARTIN and JACQUELINE PACE as directors of the Corporation for terms expiring at the Annual General Meeting of Shareholders in 2005, as described in the Corporation's Information Circular and Proxy Statement for the Meeting; and (2) to appoint Grant Thornton LLP as auditor of the Corporation to hold office until the Annual General Meeting of Shareholders in 2005.

The number of shares cast for, against, withheld and spoiled, as well as the number of abstentions and broker non-votes as to each of these matters, are as follows:

| PROPOSAL | SHARES FOR | SHARES AGAINST | WITHHELD | SPOILED | ABSTENTIONS | BROKER NON-VOTES |
|--|---------------|-------------------|----------|---------|-------------|---------------------|
| Ordinary Resolutions: | | | | | | |
| 1. <u>Election of Directors</u> | | | | | | |
| : | | | | | | |
| a. Patrick H. Gaines | 17,320,061 | 0 | 51,460 | 0 | 0 | 0 |
| b. Greg A. MacRae | 17,320,286 | 0 | 51,235 | 0 | 0 | 0 |
| c. L. William Seidman | 17,316,058 | 0 | 55,463 | 0 | 0 | 0 |
| d. Robin B. Martin | 17,317,728 | 0 | 53,793 | 0 | 0 | 0 |
| e. Jacqueline Pace | 17,315,461 | 0 | 56,060 | 0 | 0 | 0 |
| 2. Appointment of G r a n t T h o r n t o n | 17,330,661 | 8,029 | 32,831 | 0 | 0 | 0 |

LLP,
as Auditors

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ITEM 6. Exhibits

Exhibit

Number Description of Document

3.1 Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended September 30, 2000, of LML Payment Systems Inc. (File No. 0-13959)).

3.2 Bylaws (incorporated by reference to Exhibit 1.2 to the Annual Report on Form 20-F for the fiscal year ended March 31, 1998, of LML Payment Systems Inc. (File No. 0-13959)).

3.3 Amendment to Bylaws of LML Payment Systems Inc. (incorporated by reference to Exhibit 3.3 to the Quarterly Report on Form 10-Q for the period ended September 30, 2001, of LML Payment Systems Inc. (File No. 0-13959)).

31.1 Rule 13a-14(a) Certification of Chief Executive Officer (filed herewith).

31.2 Rule 13a-14(a) Certification of Principal Financial Officer (filed herewith).

32 Section 1350 Certifications of Chief Executive Officer and Controller and Chief Accounting Officer (furnished herewith).

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LML PAYMENT SYSTEMS INC.

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LML PAYMENT SYSTEMS INC.

By: /s/ Richard R. Schulz

Chief Accounting Officer (Duly Authorized Officer and Chief Accounting Officer)

Date: November 9, 2004