

LML PAYMENT SYSTEMS INC
Form 10-Q
February 14, 2011

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 December 31, 2010

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: 000-13959

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

Yukon Territory
(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405) of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to

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submit and post such files). Yes No (not applicable to registrant)

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

L a r g e Accelerated Non-Accelerated Filer S m a l l e r
Accelerated Filer Reporting
Filed Company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant's Common Stock outstanding as of February 3, 2011, was 27,329,484.

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FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2010

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

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PART I. FINANCIAL INFORMATION
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

LML PAYMENT SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(In U.S. Dollars, except as noted below)
(Unaudited)

	December 31, 2010	March 31, 2010
ASSETS		
Current Assets		
Cash and cash equivalents (Note 6)	\$ 11,779,289	\$ 5,069,763
Funds held for merchants (Note 6)	8,175,053	5,804,752
Restricted cash	175,000	175,000
Accounts receivable, less allowances of \$31,339 and \$31,463, respectively	1,141,865	799,584
Corporate taxes receivable	1,632,383	1,072,930
Prepaid expenses	276,114	416,507
Current portion of future income tax assets	527,824	1,280,860
Total current assets	23,707,528	14,619,396
Property and equipment, net	166,288	219,580
Patents, net	329,734	455,304
Restricted cash	258,556	255,247
Future income tax assets	817,480	2,406,473
Other assets	20,822	20,641
Goodwill	17,874,202	17,874,202
Other intangible assets, net	4,338,975	4,710,337
TOTAL ASSETS	\$47,513,585	\$40,561,180
LIABILITIES		
Current Liabilities		
Accounts payable	\$ 1,309,644	\$ 836,274
Accrued liabilities	849,814	1,040,443
Corporate taxes payable	1,076,558	-
Funds due to merchants (Note 6)	8,175,053	5,804,752
Current portion of obligations under capital lease	2,460	11,195
Current portion of deferred revenue	1,314,733	1,325,983
Total current liabilities	12,728,262	9,018,647
Obligations under capital lease	9,225	9,840
Deferred revenue	1,274,961	2,155,162
TOTAL LIABILITIES	14,012,448	11,183,649

Commitments and Contingencies (Note 9)

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	-	-
Common shares, no par value, 100,000,000 shares authorized, 27,293,984 and 27,241,408 issued and outstanding, respectively	50,284,080	50,152,385
Contributed surplus	8,784,979	7,952,343
Deficit	(25,858,705)	(28,877,282)
Accumulated other comprehensive income	290,783	150,085
Total shareholders' equity	33,501,137	29,377,531
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$47,513,585	\$40,561,180

See accompanying notes to the unaudited 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)

	Three Months Ended December 31		Nine months Ended December 31	
	2010	2009	2010	2009
REVENUE	\$11,060,030	\$4,742,568	\$22,010,200	\$11,229,773
COST OF REVENUE (includes stock-based compensation ("s.b.c.") expense of \$18,773 for three months ended December 31, 2010 (2009 - \$37,464) and \$101,460 for nine months ended December 31, 2010 (2009 - \$111,579))	5,017,906	2,329,810	10,758,827	5,670,576
GROSS PROFIT (excludes amortization and depreciation expense)	6,042,124	2,412,758	11,251,373	5,559,197
OPERATING EXPENSES				
General and administrative (includes s.b.c. expense of \$211,254 for three months ended December 31, 2010 (2009 - \$243,028) and \$691,751 for nine months ended December 31, 2010 (2009- \$781,386))	1,179,386	1,059,165	3,346,474	3,083,629
Sales and marketing (includes s.b.c. expense of \$16,779 for three months ended December 31, 2010 (2009 - \$765) and \$32,589 for nine months ended December 31, 2010 (2009 - \$2,277))	191,754	103,481	453,177	296,084
Product development and enhancement (includes s.b.c. expense of \$14,891 for three months ended December 31, 2010 (2009 - \$12,233) and \$46,165 for nine months ended December 31, 2010 (2009 - \$36,434))	137,311	122,759	410,888	342,585
Amortization of property and equipment	30,514	34,702	97,847	99,748
Amortization of intangible assets	165,644	165,644	496,932	497,182
Gain on sale of assets	-	-	-	(3,830)
INCOME BEFORE OTHER INCOME (EXPENSES) AND INCOME TAXES	4,337,515	927,007	6,446,055	1,243,799
Foreign exchange (loss) gain	(102,369)	10,928	(101,298)	135,296
Other expenses	(626)	-	(5,464)	(50,641)
Interest income	16,873	4,285	29,170	20,549
Interest expense	-	(846)	-	(47,676)
INCOME BEFORE INCOME TAXES	4,251,393	941,374	6,368,463	1,301,327
Income tax expense (recovery) (Note 8)				
Current	1,281,285	(324,275)	983,532	(323,647)

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Future	850,875	1,661,740	2,366,354	1,565,586
	2,132,160	1,337,465	3,349,886	1,241,939
NET INCOME (LOSS)	2,119,233	(396,091)	3,018,577	59,388
DEFICIT, beginning of period	(27,977,938)	(28,295,977)	(28,877,282)	(28,751,456)
DEFICIT, end of period	\$(25,858,705)	\$(28,692,068)	\$(25,858,705)	\$(28,692,068)
EARNINGS (LOSS) PER SHARE, basic	\$0.08	\$(0.02)	\$0.11	\$-
EARNINGS (LOSS) PER SHARE, diluted	\$0.08	\$(0.02)	\$0.11	\$-
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	27,253,886	27,116,408	27,252,620	27,116,408
Diluted	28,285,669	27,252,792	27,707,532	27,150,430

See accompanying notes to the unaudited consolidated financial statements.

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LML PAYMENT SYSTEMS INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In U.S. Dollars)

(Unaudited)

	Three Months Ended December 31		Nine months Ended December 31	
	2010	2009	2010	2009
Net income (loss)	\$2,119,233	\$(396,091)	\$3,018,577	\$59,388
Unrealized foreign exchange gain on translation of self-sustaining operations	126,872	23,174	140,698	190,017
Comprehensive income (loss)	\$2,246,105	\$(372,917)	\$3,159,275	\$249,405

See accompanying notes to the unaudited consolidated financial statements.

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LML PAYMENT SYSTEMS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In U.S. Dollars)

(Unaudited)

	Three Months Ended December 31		Nine months Ended December 31	
	2010	2009	2010	2009
Operating Activities:				
Net income (loss)	\$2,119,233	\$ (396,091)	\$3,018,577	\$59,388
Adjustments to reconcile net income (loss) to net cash provided by operating activities				
Provision for losses on accounts receivable	-	-	-	5,705
Amortization of property and equipment	30,514	34,702	97,847	99,748
Amortization of intangible assets	165,644	165,644	496,932	497,182
Gain on sale of assets	-	-	-	(3,830)
Stock-based compensation	261,697	293,490	871,965	931,676
Stock-based compensation – future income taxes	24,325	-	24,325	-
Future income taxes	826,550	1,661,740	2,342,029	1,565,586
Foreign exchange gain	(730)	(52,253)	(2,226)	(331,716)
Changes in non-cash operating working capital				
Funds held in trust	361,684	(718,093)	-	(718,093)
Restricted cash	-	(100,000)	-	(100,000)
Accounts receivable	(196,246)	(145,436)	(319,316)	71,714
Corporate taxes receivable	(69,898)	(432,147)	(496,025)	(582,863)
Prepaid expenses	152,522	152,228	142,697	3,202
Accounts payable and accrued liabilities	9,061	(4,503)	252,771	(70,949)
Corporate taxes payable	1,076,558	(6,991)	1,076,558	(327,673)
Deferred revenue	(341,216)	(377,545)	(893,994)	(923,947)
Net cash provided by operating activities	4,419,698	74,745	6,612,140	175,130
Investing Activities:				
Acquisition of property and equipment	(14,717)	(75,497)	(44,998)	(90,017)
Proceeds from disposal of property and equipment	-	-	-	3,830
Net cash used in investing activities	(14,717)	(75,497)	(44,998)	(86,187)
Financing Activities:				
Payments on capital leases	-	(39,552)	(9,202)	(140,882)
Payment on promissory notes	-	-	-	(2,321,460)
Proceeds from exercise of stock options	68,040	-	68,040	-
Net cash provided by (used in) financing activities	68,040	(39,552)	58,838	(2,462,342)
Effects of foreign exchange rate changes on cash and cash equivalents				
	84,236	16,457	83,546	214,356

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INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,557,257	(23,847)	6,709,526	(2,159,043)
Cash and cash equivalents, beginning of period	7,222,032	4,003,334	5,069,763	6,138,530
Cash and cash equivalents, end of period	\$11,779,289	\$ 3,979,487	\$11,779,289	\$3,979,487
Supplemental disclosure of cash flow information:				
Interest paid	\$-	\$ 846	\$-	\$47,939
Taxes paid	\$137,000	\$ -	\$137,000	\$435,138

See accompanying notes to the unaudited 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 December 31, 2010, the consolidated statements of operations and deficit for the three and nine months ended December 31, 2010 and 2009, the consolidated statements of cash flows for the three and nine months ended December 31, 2010 and 2009 and the consolidated statements of comprehensive income (loss) for the three and nine months ended December 31, 2010 and 2009, of LML Payment Systems Inc. and its subsidiaries (collectively, the “Corporation”) are unaudited. 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 balance sheet as of March 31, 2010, was derived from audited financial statements. 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 annual audited consolidated financial statements and notes. Unless otherwise noted, the accounting policies of the Corporation are unchanged from the Corporation’s annual audited consolidated financial statements contained in the Corporation's Annual Report on Form 10-K for the fiscal year ended March 31, 2010. The consolidated financial statements and notes appearing in this report should be read in conjunction with the Corporation's annual audited consolidated 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, 2010, as filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959).

These consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries as set out below. All significant inter-company balances and transactions have been eliminated on consolidation.

CANADA	UNITED STATES
Legacy Promotions Inc.	LHTW Properties Inc.
Beanstream Internet Commerce Inc. (“Beanstream”) 0858669 B.C. Ltd.	LML Corp.
	LML Patent Corp.
	LML Payment Systems Corp.
	Beanstream Internet Commerce Corp.

2. Recent accounting pronouncements

International Financial Reporting Standards (“IFRS”)

The Accounting Standards Board of the Canadian Institute of Chartered Accountants (“CICA”) announced that Canadian GAAP for publicly accountable enterprises will be replaced with IFRS, as published by the International

Accounting Standards Board, for fiscal years beginning on or after January 1, 2011.

Implementing IFRS will have an impact on accounting, financial reporting and supporting IT systems and processes. It may also have an impact on taxes, contractual commitments involving clauses based on generally accepted accounting principles, long-term employee compensation plans and performance metrics. Accordingly, when the Corporation executes its IFRS implementation plan, it will have to include measures to provide extensive training to key finance personnel, to review contracts and agreements and to increase the level of awareness and knowledge among management, the Board of Directors and the Audit Committee. Additional resources have been engaged to ensure the timely conversion to IFRS. As at December 31, 2010, the Corporation has completed an IFRS diagnostic, is in the process of finalizing its elections under IFRS 1 "First Time Adoption to IFRS", and is in the process of determining its accounting policy choices and identifying any modifications to internal processes, IT and data systems, and internal control over financial reporting required to support the change, and identifying the training needs of its employees impacted by the conversion to IFRS. The Corporation is in the process of completing its IFRS compliant April 1, 2010 transition date balance sheet and expects it to be completed by the end of fiscal 2011.

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2. Recent accounting pronouncements (continued)

Business Combinations

In December 2008, the CICA issued Section 1582 – “Business Combinations”, which will replace Section 1581 – “Business Combinations”. This section establishes revised standards for the accounting for a business combination which are aligned with IFRS on business combinations. The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. The Corporation will not be adopting this standard because, effective April 1, 2011, it will be required to adopt IFRS.

Consolidated Financial Statements and Non-Controlling Interests

In January 2009, the CICA issued CICA Handbook Section 1601, “Consolidated Financial Statements” and Section 1602, “Non-controlling interest”. Together these sections replace the former Section 1600, “Consolidated Financial Statements”. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for non-controlling interests in a subsidiary in consolidated financial statements subsequent to a business combination and is equivalent to the corresponding provisions of International Accounting Standard (IAS) 27, “Consolidated and Separate Financial Statements”.

The new standards result in measuring business acquisitions at the fair value of the acquired business and a prospectively applied shift from a parent corporation conceptual view of consolidation theory (which results in the parent corporation recording book values attributable to non-controlling interests) to an entity conceptual view (which results in the parent corporation recording fair values attributable to non-controlling interests).

These sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011 and are to be applied prospectively. Earlier adoption is permitted as of the beginning of a fiscal year. An entity adopting these Sections for a fiscal year beginning before January 1, 2011 also adopts Section 1582, “Business Combinations”.

The Corporation will not be adopting these standards because, effective April 1, 2011, it will be required to adopt IFRS.

3. Foreign currency translation

Except as described below, the Corporation’s functional and reporting currency is the United States dollar. Monetary assets and liabilities denominated in foreign currencies are translated in accordance with CICA Handbook Section 1651 “Foreign Currency Translation” (“Section 1651”) (and the Financial Accounting Standards Board (“FASB”) issued authoritative guidance regarding foreign currency translation) using the exchange rate prevailing at the balance sheet date and non-monetary assets and liabilities are translated at exchange rates prevailing at the historical transaction date. Average rates for the period are used to translate the Corporation’s revenue and expenses. Gains and losses arising on settlement of foreign currency denominated transactions or balances are included in the determination of income.

The functional currency of the Corporation’s Beanstream subsidiary is the Canadian dollar. Beanstream’s financial statements are translated to United States dollars under the current rate method in accordance with Section 1651 and the FASB issued authoritative guidance regarding foreign currency translation. Beanstream’s assets and liabilities are translated into U.S. dollars at rates of exchange in effect at the balance sheet date. Average rates for the period are

used to translate Beanstream's revenues and expenses. Gains and losses arising on the translation of Beanstream's financial statements are reported as a cumulative translation adjustment which is a component of accumulated other comprehensive income.

4. Economic dependence

During the three months ended December 31, 2010, the Corporation earned revenue from two licensees amounting to approximately \$5,150,000 or 46.6% of total revenue (three months ended December 31, 2009 – nil). The revenue earned from these two licensees is non-recurring.

During the nine months ended December 31, 2010, the Corporation earned revenue from one licensee amounting to approximately \$3,900,000 or 17.7% of total revenue (nine months ended December 31, 2009 – nil). The revenue earned from this licensee is non-recurring.

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5. Financial instruments

(a) The Corporation classifies its cash and cash equivalents, funds held for merchants and restricted cash as held-for-trading. Accounts receivable are classified as loans and receivables. Accounts payable and certain accrued liabilities and funds due to merchants are classified as other liabilities, all of which are measured at amortized cost (using the effective interest rate method).

CICA Handbook Section 3862, “Financial Instruments – Disclosures”, establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair values. The Corporation’s held-for-trading financial instruments at December 31, 2010 and March 31, 2010 are classified as “Level One – Quoted prices in active markets” and consist of cash and cash equivalents, funds held for merchants and restricted cash. The Corporation’s loans and receivables at December 31, 2010 and March 31, 2010 are classified as “Level One – Quote prices in active markets” and consist of accounts receivable. The Corporation’s other liabilities at December 31, 2010 and March 31, 2010 are classified as “Level One – Quoted prices in active markets” and consist of accounts payable and certain accrued liabilities and funds due to merchants.

Carrying value and fair value of financial assets and liabilities as at December 31, 2010 and March 31, 2010 are summarized as follows:

	December 31, 2010		March 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Held-for-trading	\$ 20,387,898	\$ 20,387,898	\$ 11,304,762	\$ 11,304,762
Loans and receivables	1,141,865	1,141,865	799,584	799,584
Held-to-maturity	-	-	-	-
Available-for-sale	-	-	-	-
Other liabilities	10,334,511	10,334,511	7,681,469	7,681,469

Management reviewed all significant financial instruments held by the Corporation and determined that no material differences between fair value and carrying value existed as at the reporting date.

(b) Restricted cash

Under the terms of the processing agreement with one of the Corporation’s processing banks, the Corporation pledged a deposit of \$175,000 (March 31, 2010 - \$175,000) against chargeback losses. Non-current restricted cash represents funds held by a third party processor as security for the Corporation’s merchant accounts.

(c) Market Risk

Currency Risk

The Corporation’s functional currency is the U.S. dollar except for the Corporation’s Beanstream subsidiary whose functional currency is the Canadian dollar. Movements in the foreign currency exchange rate between the Canadian and U.S. dollar will give rise to gains and losses to the Corporation due to the existence of cash balances and other monetary assets and liabilities denominated in a currency other than the functional currency of each entity within the consolidated group. Significant losses may occur due to significant balances of cash and cash equivalents and

short-term investments held in Canadian dollars (U.S. dollars for Beanstream) that may be affected negatively by an increase in the value of the U.S. dollar as compared to the Canadian dollar (Canadian dollar as compared to the U.S. dollar for Beanstream). The Corporation has not hedged its exposure to foreign currency fluctuations.

As at December 31, 2010 and March 31, 2010, the Corporation was exposed to currency risk through its cash and restricted cash, funds held for merchants, accounts receivable, accounts payable, accrued liabilities and funds due to merchants denominated in Canadian dollars (U.S. dollars for Beanstream).

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5. Financial instruments (continued)

Based on the foreign currency exposure as at December 31, 2010 and March 31, 2010 and assuming all other variables remain constant, a 10% depreciation or appreciation of the Canadian dollar against the U.S. dollar would result in an increase/decrease of \$362,129 and \$243,571, respectively, in the Corporation's foreign currency loss/gain.

As at December 31, 2010 and March 31, 2010, the Corporation's Beanstream subsidiary was exposed to currency risk on the translation of its financial statements to U.S. dollars under the current rate method in accordance with Section 1651 and the FASB issued authoritative guidance regarding foreign currency translation. Beanstream's assets and liabilities are translated into U.S. dollars at rates of exchange in effect at the balance sheet date. Average rates for the period are used to translate Beanstream's revenues and expenses. Gains and losses arising on the translation of Beanstream's financial statements are reported as a cumulative translation adjustment which is a component of accumulated other comprehensive income. Based on the foreign currency exposure as at December 31, 2010 and March 31, 2010 and assuming all other variables remain constant, a 10% depreciation or appreciation of the Canadian dollar against the U.S. dollar would result in an increase/decrease of \$52,893 and \$18,922, respectively, in the Corporation's other comprehensive income.

Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Corporation's exposure to interest rate risk is limited as its cash and payment processing accounts are short-term in nature.

Other Price Risk

Other price risk is the risk that the future value or cash flows of a financial instrument will fluctuate because of changes in market prices. Exposure to price risk is low as the Corporation's cash management policy is to invest excess cash in high grade/low risk investments over short periods of time.

(d)

Credit Risk

Credit risk is the risk of a financial loss if a customer or counter party to a financial instrument fails to meet its contractual obligations. Any credit risk exposure on cash balances is considered negligible as the Corporation places funds or deposits only with major established banks in the countries in which it has payment processing services. The credit risk arises primarily from the Corporation's trade receivables from customers.

On a regular basis, the Corporation reviews the collectability of its trade accounts receivable and establishes an allowance for doubtful accounts based on its best estimates of any potentially uncollectible accounts. As at December 31, 2010, the balance of the Corporation's allowance for doubtful accounts was \$31,339 (March 31, 2010 - \$31,463). The Corporation has a good credit history with its customers and the amounts due from them generally are received as expected.

Pursuant to their respective terms, accounts receivable are aged as follows at December 31, 2010:

0-30 days	\$915,592
31-60 days	195,631
61-90 days	6,777

Over 90 days due	55,204
	\$1,173,204

Concentration of credit risk

Financial instruments that potentially subject the Corporation and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable.

Cash and cash equivalents are invested in major financial institutions in the U.S. and Canada. Such deposits may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Corporation's investments are financially sound and, accordingly, relatively minimal credit risk exists with respect to these investments.

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5. Financial instruments (continued)

The accounts receivable of the Corporation and its subsidiaries are derived from sales to customers located primarily in the U.S. and Canada. The Corporation performs ongoing credit evaluations of its customers. The Corporation generally does not require collateral.

An allowance for doubtful accounts is determined with respect to those amounts that the Corporation has determined to be doubtful of collection. At December 31, 2010, three customers accounted for 19%, 19% and 15% of the Corporation's accounts receivable balance (March 31, 2010: 25%, 2% and 19%).

(e) Liquidity Risk

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. The Corporation continuously monitors actual and forecasted cash flows to ensure, as far as possible, there is sufficient working capital to satisfy its operating requirements.

6. Cash and cash equivalents and funds held for /due to merchants

Cash and cash equivalents

At December 31, 2010, the Corporation held \$11,779,289 (March 31, 2010: \$5,069,763) in cash and cash equivalents. Included in this balance was \$1 million in cash and cash equivalents used as continuing collateral security with the Corporation's primary financial institution which is available for use by the Corporation (March 31, 2010 - \$1 million).

Funds held for/due to merchants

At December 31, 2010, the Corporation held funds due to merchants in the amount of \$8,175,053 (March 31, 2010 - \$5,804,752). The funds held for/due to merchants were comprised of the following:

- funds held in reserves calculated by applying contractually determined percentages of the gross transaction volume for a hold-back period of up to nine months;
 - funds from transaction payment processing which may be held for up to approximately fifteen days, the actual number of days depends on the contractual terms with each merchant; and
- funds from payroll/pre-authorized debit services provided on behalf of merchants, which may be held for up to approximately two days.

7. Stock-based compensation

The Corporation accounts for all stock options issued based on their fair value as required by the CICA Section 3870 which does not differ materially from the application required under the FASB issued authoritative guidance regarding share-based payment.

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During the three months ended December 31, 2010, the Corporation did not grant any stock options under the Corporation's 1996 Stock Option Plan, its 1998 Stock Incentive Plan or its 2009 Stock Incentive Plan.

During the three months ended September 30, 2010, the Corporation granted 575,000 stock options under the Corporation's 2009 Stock Incentive Plan and 1,170,000 stock options under the 1996 Stock Option Plan (no stock options were granted during the three month period ended June 30, 2010). The weighted average grant date fair value for these stock options was \$1.04 per stock option. The fair value of these stock options was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

Risk-free interest rate of 2.79%;

Expected volatility of 88.09%;

Expected life of the stock options of 4 years; and

No dividend yields.

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7. Stock-based compensation (continued)

During the three months ended December 31, 2009, the Corporation granted 125,000 stock options under the Corporation's 2009 Stock Incentive Plan. The weighted average grant date fair value for these stock options was \$0.44 per stock option. The fair value of these stock options was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

Risk-free interest rate of 2.32%;

Expected volatility of 78.09%;

Expected life of the stock options of 4 years; and

No dividend yields.

During the three months ended September 30, 2009, the Corporation granted 75,000 stock options under the Corporation's 2009 Stock Incentive Plan and 300,000 stock options under the 1996 Stock Option Plan (no stock options were granted during the three month period ended June 30, 2009). The weighted average grant date fair value for these stock options was \$0.38 per stock option. The fair value of these stock options was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

Risk-free interest rate of 2.30%;

Expected volatility of 77.93%;

Expected life of the stock options of 4 years; and

No dividend yields.

8. Income taxes

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. During the prior fiscal year ended March 31, 2010, the Corporation implemented certain tax planning strategies relating to its subsidiary, Beanstream. These strategies are expected to permit the recovery of income taxes previously paid on behalf of Beanstream. During the three months ended December 31, 2010, the Corporation recorded \$1,281,285 in current income tax expense (nine months ended December 31, 2010 - \$983,532) and a corresponding charge of \$850,875 to future income tax expense (nine months ended December 31, 2010 - \$2,366,354) relating to the impact of the implementation of the tax planning strategies as well as the effect of licensing revenue generated from the Corporation's Intellectual Property Licensing ("IPL") segment.

9. Commitments and contingencies

All commitments and contingencies remain unchanged from the Corporation's annual audited consolidated financial statements contained in the Corporation's Annual Report on Form 10-K for the fiscal year ended March 31, 2010 except as noted below:

During the three months ended December 31, 2010, a subsidiary of the Corporation entered into Settlement and License Agreements with each of the Bank of New York Mellon (“BNYM”), First National Bank of Omaha and First National Merchant Solutions LLC (collectively, “First National”), Regions Bank (“Regions”), Fifth Third Bank “Fifth Third”), and Marshall and Ilsley Bank (“M&I”) (collectively, the “Third Quarter License Agreements”), all defendants in the patent infringement lawsuit originally filed on November 19, 2008 in the U.S. District Court for the Eastern District of Texas (the “Patent Litigation”) against nineteen defendants in the United States alleging that the defendants infringe U.S. Patent No. RE40,220, which is held by the subsidiary (the “40,220 Patent”). The Corporation’s subsidiary sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The Third Quarter License Agreements provided each of BNYM, First National, Regions, Fifth Third and M&I with a fully paid-up license to certain patents of the Corporation’s subsidiary for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the Third Quarter License Agreements, the Corporation’s subsidiary received compensation totaling approximately \$6,465,000 for releases, licenses, covenants and all other rights granted under the Third Quarter License Agreements. Pursuant to a retention agreement with its legal firm, the Corporation’s subsidiary paid approximately \$2,687,383 in legal fees for the firm’s services in connection with the Third Quarter License Agreements.

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9. Commitments and contingencies (continued)

Given the number and size of the defendants in the Patent Litigation, during the three months ended December 31, 2010, the subsidiary of the Corporation that is the plaintiff in the Patent Litigation filed a motion to separate the defendants in the Patent Litigation into groups for the purpose of holding separate trials so that each trial can be conducted in a feasible and judicious manner. In January 2011, the Court in the Patent Litigation issued a trial order that: (i) defendants Citibank, HSBC Bank USA N.A. and PayPal be grouped together for a trial to begin on March 8, 2011 (the “Phase I trial”); (ii) defendants JPMorgan, Wells Fargo and Wachovia be grouped together for a trial to begin on October 4, 2011 (the “Phase II trial”) and (iii) defendants Capital One, Northern Trust and Deutsche Bank be grouped together for another trial also to begin on October 4, 2011 (the “Phase III trial”). In addition, to enable the Court and the parties to the Phase I trial to better focus on the issues pertinent to the Phase I trial, the Court also ordered that pre-trial proceedings be stayed until further notice as to all defendants in the Phase II and Phase III trials.

During the three months ended September 30, 2010, a subsidiary of the Corporation entered into a Settlement and License Agreement with Union Bank N.A. (“Union Bank”) and M&T Bank Corporation, M&T Bank and M&T Bank N.A. (collectively, “M&T”) (collectively, the “Second Quarter License Agreements”), both defendants in the Patent Litigation. The Corporation’s subsidiary sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The Second Quarter License Agreements provide Union Bank and M&T each with a fully paid-up license to certain patents of the Corporation’s subsidiary for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the Second Quarter License Agreements, the Corporation’s subsidiary received compensation totaling approximately \$1,895,000, for releases, licenses, covenants and all other rights granted under the Second Quarter License Agreements. Pursuant to a retention agreement with its legal firm, the Corporation’s subsidiary paid approximately \$593,000 in legal fees for the firm’s services in connection with the Second Quarter License Agreements.

During the three months ended June 30, 2010, a subsidiary of the Corporation entered into a Settlement and License Agreement with PNC Bank N.A. (“PNC”) (the “First Quarter License Agreement”), one of the defendants in the Patent Litigation. The Corporation’s subsidiary sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The First Quarter License Agreement provided PNC with a fully paid-up license to certain patents of the Corporation’s subsidiary for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the First Quarter License Agreement, PNC paid the Corporation’s subsidiary compensation in the amount of approximately \$1,375,000 for releases, licenses, covenants and all other rights granted under the First Quarter License Agreement. Pursuant to a retention agreement with its legal firm, the Corporation’s subsidiary paid approximately \$379,944 in legal fees for the firm’s services in connection with the First Quarter License Agreement.

Each of the license agreements described above contain a number of elements for which revenue has been recognized in these consolidated financial statements under the guidance of EIC-175, which does not differ materially from the application required under the FASB issued authoritative guidance on revenue arrangements with multiple deliverables. Total consideration received under the license agreements has been allocated to each of the following deliverables using the relative selling price method:

- Licenses – the Corporation has issued a license for the use of existing patents. This revenue has been recognized in the period in which the settlement and license agreement occurred.
- Release from litigation – the Corporation has agreed to release BNYM, First National, Regions, Fifth Third, M&I, Union Bank, M&T and PNC from any claims or causes of action for patent infringement as of the effective date of the applicable license agreement. This revenue has been recognized in the period in which the settlement and license agreement occurred.
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Covenant-not-to-sue provision – the Corporation has agreed to a covenant-not-to-sue provision for infringement of any existing patents as of the effective date of the license agreements. This revenue has been recognized in the period in which the settlement and license agreement occurred.

Also during the three months ended September 30, 2010, the complaints for patent infringement brought against (i) LML Payment Systems Corp. (an indirect, wholly-owned subsidiary of the Corporation) by CitiBank, N.A. in the U.S. District Court for the Northern District of Illinois, Eastern Division (the “Citibank Suit”), and (ii) LML Payment Systems Corp. and Beanstream Internet Commerce Inc. (a wholly-owned subsidiary of the Corporation) by JP Morgan Chase Bank N.A. in the U.S. District Court for the District of Delaware (the “JP Morgan Suit”) have both been dismissed with prejudice. Citibank N.A. and JP Morgan Chase Bank are each an affiliate of a defendant in the Patent Litigation. In the Citibank Suit, Citibank, N.A. alleged that the Corporation’s subsidiary infringed U.S. Patent No. 7,020,639 and in the JP Morgan Suit, JP Morgan Chase Bank N.A. alleged the Corporation’s subsidiaries infringed U.S. Patent Nos. 5,917,965, 6,341,724, 5,940,844 and 6,098,052. Both suits sought damages and injunctive and other relief.

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9. Commitments and contingencies (continued)

The dismissals of the Citibank Suit and the JP Morgan Suit were reached without the Corporation or its subsidiaries incurring any liability to the other parties to the suits, and all parties will bear their own costs of litigation arising out of such suits. In addition, the dismissals of the Citibank Suit and the JP Morgan Suit do not affect the Patent Litigation.

On July 29, 2010, in response to a request for inter-partes reexamination submitted by four of the defendants in the Patent Litigation, the United States Patent and Trademark Office (“USPTO”) posted a non-final office action on its public Patent Application Information Retrieval (“PAIR”) website ordering an inter-partes reexamination proceeding with respect to the 40,220 Patent pursuant to which 16 of the 40,220 Patent’s 100 claims are now subject to reexamination and have been rejected. Generally, an inter-partes reexamination is a USPTO administrative proceeding requested by a third party (the “Third Party Requester”) to challenge the validity of patents that have already issued. All 16 of the patent claims that were rejected and are now subject to re-examination are claims that the Corporation’s subsidiary asserted and seeks to enforce in the Patent Litigation. During the three months ended September 30, 2010, the Corporation’s subsidiary filed a response to this non-final office action with the USPTO and then the Third Party requester filed a response with the USPTO to the response of the Corporation’s subsidiary. The Examiner is considering the filings and is expected to issue an “Action Closing Prosecution” in due course. The Action Closing Prosecution is not final and may be appealed by either party. The Corporation’s subsidiary may respond to the Action Closing Prosecution and if it does so, the Third Party Requester may again file comments. A “Right of Appeal Notice” typically follows. The “Right of Appeal Notice” is a final but appealable office action. From there, either party may appeal the decision to the Patent Office Board of Appeals and Interferences (“Board”) and then to the Court of Appeals for the Federal Circuit (“Federal Circuit”). The ultimate outcome of the reexamination proceeding (including any appeals that may be made) is indeterminable at this time.

During the fiscal year ended March 31, 2007, a subsidiary of the Corporation received notification that it had been named in a class-action lawsuit filed in the United States District Court, Eastern District, Marshall Division, Texas, alleging that numerous defendants, including the subsidiary of the Corporation, violated the Driver’s Privacy Protection Act regulating the use of personal information such as driver’s license numbers and home addresses contained in motor vehicle records held by motor vehicle departments, by not having a permissible use in obtaining the State of Texas’ entire database of names, addresses and other personal information. During the fiscal year ended March 31, 2009, the complaint was dismissed with prejudice. Also during the fiscal year ended March 31, 2009, the plaintiffs appealed this decision. On November 4, 2009 oral arguments were heard by the Fifth Circuit of appeals and on July 14, 2010, the Fifth Circuit of appeals affirmed the dismissal of the complaint. During the three months ended December 31, 2010, the plaintiffs filed a writ of certiorari with the Supreme Court of the United States appealing the dismissal of the complaint. In January 2011, the Corporation received notice that the Supreme Court had denied the writ of certiorari, which means that the decisions of the lower courts resolving the lawsuit in the Corporation’s favor have become final.

During the three months ended December 31, 2010, the Canadian Revenue Agency (“CRA”) verbally requested certain documentation relating to the sale of Beanstream to the Corporation in 2007 and the tax treatment of the sale with respect to the former shareholders of Beanstream. The Corporation has provided the CRA with all requested documentation. The ultimate outcome of this request is indeterminable at this time.

10. Subsequent event

In January 2011, a subsidiary of the Corporation entered into a Settlement and License Agreement with Texas Heritage National Bank (“Heritage”), PlainsCapital Bank (“PlainsCapital”) and First Bank (“First”) (collectively, the “Subsequent License Agreements”), all defendants in the patent infringement lawsuit originally filed on June 4, 2009 in the U.S. District Court for the Eastern District of Texas (the “Second Patent Litigation”) against six defendants in the United States alleging that the defendants infringe the 40,220 Patent. The Corporation’s subsidiary sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The Subsequent License Agreements provide Heritage, PlainsCapital and First each with a fully paid-up license to certain patents of the Corporation’s subsidiary for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the Subsequent License Agreements, the Corporation’s subsidiary received compensation totaling approximately \$63,500 for releases, licenses, covenants and all other rights granted under the Subsequent License Agreements. The claims of patent infringement against the remaining defendants in the Second Patent Litigation were dismissed without prejudice on January 26, 2011.

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11. Industry and geographic segments

Based upon the way financial information is provided to the Corporation's Chief Executive Officer for use in evaluating allocation of resources and assessing performance of the business, the Corporation reports its operations in three distinct operating segments, described as follows:

Transaction Payment Processing ("TPP") operations involve financial payment processing, authentication and risk management services provided by Beanstream. The services are accessible via the Internet and are offered in an application service provider (ASP) model.

IPL operations involve licensing an intellectual property estate, which includes five U.S. patents describing electronic check processing methods.

Check Processing/Software Licensing ("CP/SL") operations involve primary and secondary check collection including electronic check re-presentation (RCK) and software licensing.

Within these segments, performance is measured based on revenue, factoring in interest income and expenses and amortization and depreciation as well as income before income taxes from each segment. There are no transactions between segments. The Corporation does not generally allocate corporate or centralized marketing and general and administrative expenses to its business unit segments because these activities are managed separately from the business units. Asset information by operating segment is not reported to or reviewed by the Corporation's decision makers on an interim basis and therefore, the Corporation has not disclosed asset information for each operating segment.

Financial information for each reportable segment for the three and nine months ended December 31, 2010 and 2009 was as follows:

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11. Industry and geographic segments (continued)

Three Months Ended December 31, 2010	TPP Canada	IPL U.S.	CP/SL U.S.	Reconciling Items	Consolidated Total
Total revenue	\$3,496,860	\$6,909,964	\$653,206	\$-	\$ 11,060,030
Revenue: major customers	564,186	5,150,000	371,442	-	6,085,628
Cost of revenue	1,966,893	2,622,012	410,228	18,773	5,017,906
General and administrative	260,658	233,623	98,702	586,403	1,179,386
Sales and marketing	170,469	-	4,506	16,779	191,754
Product development and enhancement	122,420	-	-	14,891	137,311
Amortization	15,566	41,857	11,003	127,732	196,158
Income (losses) from operations before income taxes	874,429	4,016,744	131,302	(771,082)	4,251,393
)4	
Three Months Ended December 31, 2009	TPP Canada	IPL U.S.	CP/SL U.S.	Reconciling Items	Consolidated Total
Total revenue	\$2,674,557	\$1,534,333	\$533,678	\$-	\$ 4,742,568
Revenue: major customers	574,690	1,382,669	278,368	-	2,235,727
Cost of revenue	1,488,974	446,637	356,735	37,464	2,329,810
General and administrative	258,457	(30,315)	136,969	694,054	1,059,165
Sales and marketing	97,323	-	5,393	765	103,481
Product development and enhancement	110,526	-	-	12,233	122,759
Amortization	15,628	41,857	13,657	129,204	200,346
Income (losses) from operations before income taxes	659,262	1,076,596	19,881	(814,365)	941,374
)4	
Nine months Ended December 31, 2010	TPP Canada	IPL U.S.	CP/SL U.S.	Reconciling Items	Consolidated Total
Total revenue	\$9,167,458	\$11,077,848	\$1,764,894	\$-	\$ 22,010,200
Revenue: major customers	1,717,278	7,725,000	1,000,574	-	10,442,852
Cost of revenue	5,405,888	4,044,231	1,207,248	101,460	10,758,827
General and administrative	730,324	249,906	425,214	1,941,030	3,346,474
Sales and marketing	406,686	-	13,902	32,589	453,177
Product development and enhancement	364,723	-	-	46,165	410,888
Amortization	48,357	125,571	36,683	384,168	594,779
Income (losses) from operations before income taxes	2,146,153	6,667,414	80,692	(2,525,796)	6,368,463
)4	
Nine months Ended December 31, 2009	TPP Canada	IPL U.S.	CP/SL U.S.	Reconciling Items	Consolidated Total

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Total revenue	\$7,060,499	\$2,428,351	\$1,740,923	\$-		\$11,229,773
Revenue: major customers	1,736,013	1,993,781	959,475	-		4,689,269
Cost of revenue	4,032,550	447,477	1,078,970	111,579	1	5,670,576
General and administrative	629,149	9,579	361,600	2,083,301	2	3,083,629
Sales and marketing	277,855	-	15,952	2,277	1	296,084
Product development and enhancement	306,151	-	-	36,434	1	342,585
Amortization	42,761	125,820	40,658	387,691	3	596,930
Gain on sale of assets	-	-	(1,656)	(2,174)	5	(3,830)
Income (losses) from operations before income taxes	1,570,111	1,846,769	245,261	(2,360,814)	4	1,301,327

1 Represents stock-based compensation expense.

2 Represents stock-based compensation expense and other unallocated corporate or centralized marketing, general and administrative expenses.

3 Represents amortization included in the unallocated corporate or centralized marketing, general and administrative expenses.

4 Represents earnings (losses) included in the unallocated corporate or centralized marketing, general and administrative expenses.

5 Represents gain on sale of assets included in the unallocated corporate or centralized marketing general and administrative expenses.

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

These consolidated financial statements are prepared using Canadian GAAP, which does not differ materially from generally accepted accounting principles in the United States (“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 affect the reduction in deficit of \$22,901,744 by reducing the stated capital of the shares of the Corporation’s common stock.

(b) Income Taxes

In June 2006, the FASB issued authoritative guidance regarding accounting for uncertainty in income taxes. This guidance clarifies the recognition threshold and measurement of a tax position taken or expected to be taken on a tax return, and requires expanded disclosure with respect to the uncertainty in income taxes. The guidance also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. The guidance is effective for fiscal years beginning after December 15, 2006.

The Corporation adopted the provisions of the guidance on April 1, 2007. No cumulative effect adjustment to the April 1, 2007 balance of the Corporation’s deficit was required upon the implementation. As of the date of adoption there were no unrecognized tax benefits. Under current conditions and expectations, management does not foresee any unrecognized tax benefits that would have a material impact on the Corporation’s consolidated financial statements.

(c) Changes in U.S. GAAP

Recent accounting pronouncements affecting the Corporation’s financial reporting under U.S. GAAP are summarized below:

(i) In December 2007, the FASB issued authoritative guidance regarding business combinations. This guidance is broader in scope than previous guidance that applied only to business combinations in which control was obtained by transferring consideration. The new guidance applies to all transactions and other events in which one entity obtains control over one or more other businesses. The new guidance is effective for fiscal years beginning after December 15, 2008. The Corporation has adopted the guidance as at April 1, 2009. Adoption of this guidance did not have an impact on the consolidated financial statements and the accompanying notes. The impact of this guidance will not be known until such time as the Corporation enters into a business combination, however, a difference between Canadian GAAP and U.S. GAAP would probably arise on business combinations entered into prior to April 1, 2011 due to the equivalent Canadian guidance not being adopted until April 1, 2011. In addition, on April 1, 2011, the Corporation will be adopting IFRS and not Canadian GAAP.

(ii) In October 2009, the FASB issued authoritative guidance on certain revenue arrangements that include software elements that is effective for fiscal years beginning on or after June 15, 2010, with earlier adoption permitted. Under the new guidance, tangible products that contain software components and non-software components that function together to deliver the tangible product’s essential functionality and undelivered elements that relate to software that is essential to the functionality of the tangible product are not within the scope of the software revenue recognition guidance. The Corporation has early adopted this guidance in the fiscal year ended March 31, 2010.

(iii) In October 2009, the FASB issued authoritative guidance on multiple-deliverable revenue arrangements that is effective for fiscal years on or after June 15, 2010, with earlier adoption permitted. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements including, but not limited to, significant judgments made in applying the guidance and how changes in the judgments or in the application of the guidance may significantly affect either the timing or amount of revenue recognition. The Corporation has early adopted this guidance in the fiscal year ended March 31, 2010. Under the previous revenue recognition guidance, some of the revenue related to the IPL segment may have been deferred.

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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 Beanstream Internet Commerce Inc., LML Corp., Legacy Promotions Inc., 0858669 B.C. Ltd. and LHTW Properties Inc. LML Corp.'s subsidiaries are LML Patent Corp., LML Payment Systems Corp. and Beanstream Internet Commerce 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, 2010, filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959). 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 operating three separate lines of business: transaction payment processing, intellectual property licensing and check processing/software licensing. Our transaction payment processing services consist predominantly of Internet-based services; while our check processing services involve predominantly traditional and electronic check processing and recovery services that do not utilize the Internet. We believe that electronic transaction processing services, including Internet-based payment services, will continue to be used in greater frequency than traditional payment methods, such as checks and cash, and we are therefore focusing on these services. Accordingly, we expect that our transaction payment processing services will be our principal line of

business for the foreseeable future, while our other lines of business (including the electronic check processing services that we have historically relied on for a significant source of revenue) will become less important to our overall service offerings and less significant to the financial performance of our corporation.

TPP Segment

Our TPP operations involve financial payment processing, authentication and risk management services. We provide a service that acts as a bank neutral interface between businesses and consumers processing financial or authentication transactions. Our transaction payment processing services are accessible via the Internet and are offered in an application service provider (ASP) model. We focus on product development, project management and third tier technical support of our products and services and rely primarily on strategic business partners to sell and market our products and services. In some instances, our transaction payment processing services and payment products are integrated into third party products in target vertical markets. Our revenues are derived from one-time set-up fees, monthly gateway fees, and transaction fees paid to us by merchants. Transaction fees are recognized in the period in which the transaction occurs. Gateway fees are monthly subscription fees charged to our merchant customers for the use of our payment gateway. Gateway fees are recognized in the period in which the service is provided. Set-up fees represent one-time charges for initiating our processing services. Although these fees are generally paid at the commencement of the agreement, they are recognized ratably over the estimated average life of the merchant relationship, which is determined through a series of analyses of active and deactivated merchants. We currently service a merchant base of over 9,400 customers primarily in Canada.

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IPL Segment

Our IPL operations involve licensing our intellectual property estate, which includes five U.S. patents describing electronic check processing methods. When we provide clients licenses to our intellectual property estate, we typically earn revenue or other income from ongoing royalty fees and, in some cases, release fees for potential past infringement. In some instances we also earn revenue from license agreements that provide for the payment of contractually determined paid-up license fees to us in consideration for the grant of a non-exclusive, retroactive and future license to our intellectual property estate and in other instances, where license agreements include multiple element arrangements, we may defer this revenue and recognize the revenue ratably over the license term.

CP/SL Segment

Our CP/SL operations involve primary and secondary check collection including electronic check re-presentation (RCK). Our check processing services involve check return management such as traditional and electronic recovery services to retail clients. 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 other instances our secondary recovery services provide for us to earn additional fees when legal action is required. Our check processing services are provided in the United States and are operated from our Wichita, Kansas location.

Within these segments, performance is measured based on revenue, factoring in interest income and expenses and amortization and depreciation as well as earnings from operations before income taxes from each segment. There are no transactions between segments. We do not generally allocate corporate or centralized marketing and general and administrative expenses to our business unit segments because these activities are managed separately from the business units. Asset information by operating segment is not reported to or reviewed by our senior management decision makers on an interim basis, and therefore we have not disclosed asset information for each operating segment.

Results of Operations

Three months ended December 31, 2010 compared to three months ended December 31, 2009

Revenue

Total revenue for the three months ended December 31, 2010 was approximately \$11,060,000, an increase of approximately \$6,317,000 or approximately 133.2% from total revenue of approximately \$4,743,000 for the three months ended December 31, 2009. This increase is primarily attributable to an increase in IPL revenues for the period of approximately \$5,376,000 and partially attributable to an increase in TPP revenues of approximately \$822,000.

During the three months ended December 31, 2010, we earned revenue from two licensees amounting to approximately 46.6% of total revenue as compared to NIL for the three months ended December 31, 2009. Revenue from these two licensees is non-recurring.

TPP Segment

Revenue pertaining to our TPP segment consists of one-time set-up fees, monthly gateway fees, transaction fees and software customization fees. TPP segment revenue for the three months ended December 31, 2010 was approximately \$3,497,000, an increase of approximately \$822,000 or approximately 30.7% from TPP segment

revenue of approximately \$2,675,000 for the three months ended December 31, 2009. TPP segment revenue originating in Canadian dollars was approximately \$3,541,000CAD for the three months ended December 31, 2010 compared to approximately \$2,827,000CAD for the three months ended December 31, 2009, an increase of approximately \$714,000CAD or approximately 25.3%. The increase in TPP segment revenue was primarily attributable to an increase in our merchant base of approximately 18.7%. Transaction fees for the three months ended December 31, 2010 were approximately \$2,763,000 compared to approximately \$2,042,000 for the three months ended December 31, 2009, an increase of approximately \$721,000 or approximately 35.3%. The amortized portion of one-time set-up fees recognized was approximately \$46,000 for the three months ended December 31, 2010 compared to approximately \$46,000 for the three months ended December 31, 2009. Monthly gateway fees for the three months ended December 31, 2010 were approximately \$402,000 compared to approximately \$318,000 for the three months ended December 31, 2009, an increase of approximately \$84,000 or approximately 26.4%.

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IPL Segment

Revenue from licensing our patented intellectual property increased by approximately \$5,376,000 or approximately 350.5%, from approximately \$1,534,000 for the three months ended December 31, 2009 to approximately \$6,910,000 for the three months ended December 31, 2010. The increase in revenue from licensing our patented intellectual property was primarily attributable to the non-recurring licensing revenue recognized of approximately \$6,465,000 from the Third Quarter License Agreements we entered into with five of the defendants in the Patent Litigation during the three months ended December 31, 2010.

CP/SL Segment

CP/SL segment revenue for the three months ended December 31, 2010 was approximately \$653,000, an increase of approximately \$119,000 or approximately 22.3% from CP/SL segment revenue of approximately \$534,000 for the three months ended December 31, 2009. The increase in CP/SL segment revenue was primarily attributable to an increase in revenue from our secondary check collections business.

Revenue from our primary check collections business increased approximately 5.8% from approximately \$86,000 for the three months ended December 31, 2009 to approximately \$91,000 for the three months ended December 31, 2010. Revenue from our secondary check collections business increased approximately 24.8% from approximately \$420,000 for the three months ended December 31, 2009 to approximately \$524,000 for the three months ended December 31, 2010. The increase in our secondary check collections business was primarily attributable to an increase in collections of the principal amount and related fees of returned checks assigned for secondary recovery.

Cost of Revenue

Cost of revenue consists primarily of costs incurred by the TPP and IPL operating segments and partially of costs incurred by the CP/SL operating segment. These costs are incurred in the delivery of e-commerce transaction services, customer service support and check collection services and include processing and interchange fees paid, other third-party fees, personnel costs and associated benefits and stock-based compensation. IPL segment costs of revenue are primarily legal retention fees and disbursement costs incurred in generating licensing revenue.

Cost of revenue increased from approximately \$2,330,000 for the three months ended December 31, 2009, to approximately \$5,018,000 for the three months ended December 31, 2010, an increase of approximately \$2,688,000 or approximately 115.4%. The increase was primarily attributable to an increase in our IPL segment cost of revenue of approximately \$2,175,000 from approximately \$447,000 for the three months ended December 31, 2009 to approximately \$2,622,000 for the three months ended December 31, 2010 and partially attributable to an increase in our TPP segment cost of revenue of approximately \$478,000 or approximately 32.1% from approximately \$1,489,000 for the three months ended December 31, 2009 to approximately \$1,967,000 for the three months ended December 31, 2010. The increase in IPL segment cost of revenue was primarily attributable to the costs incurred in entering into the Third Quarter License Agreements with five of the defendants in the Patent Litigation during the three months ended December 31, 2010. The increase in TPP segment cost of revenue was primarily attributable to an increase in our transaction processing of approximately 29.7% which coincides with increases in transaction processing revenue for the three months ended December 31, 2010 as compared to the three months ended December 31, 2009.

General and administrative expenses

General and administrative expenses consist primarily of personnel costs including associated stock-based compensation and employment benefits, office facilities, travel, 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. General and administrative expenses also include the costs of corporate and support functions including our executive leadership and administration groups, finance, information technology, legal, human resources and corporate communication costs.

General and administrative expenses increased to approximately \$1,179,000 from approximately \$1,059,000 for the three months ended December 31, 2010 and 2009, respectively, an increase of approximately \$120,000 or approximately 11.3%. The increase in general and administrative expenses are primarily attributable to IPL segment legal costs of approximately \$199,000 for the three months ended December 31, 2010, primarily attributable to the request for inter-partes reexamination submitted by four of the defendants in the Patent Litigation during the first quarter of our current fiscal year.

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Sales and Marketing

Sales and marketing expenses consist primarily of salaries paid to sales staff, sales commissions, travel and related expenses, trade shows, costs of lead generation, consulting fees and costs of marketing programs, such as internet, print and direct mail advertising costs.

Sales and marketing expenses increased to approximately \$192,000 from approximately \$103,000 for the three months ended December 31, 2010 and 2009, respectively, an increase of approximately 86.4%. The increase is primarily attributable to an increase of approximately \$73,000 in TPP segment sales and marketing expenses from approximately \$97,000 for the three months ended December 31, 2009 to approximately \$170,000 for the three months ended December 31, 2010. The increase in TPP segment sales and marketing expenses is primarily attributable to an increase in wages and commissions of approximately \$54,000, resulting from an increase in staffing levels.

Product Development and Enhancement

Product development and enhancement expenses consist primarily of compensation and related costs of employees engaged in the research, design and development of new services and in the improving and enhancing of the existing product and service lines.

Product development and enhancement expenses were approximately \$137,000 for the three months ended December 31, 2010 as compared to \$123,000 for the three months ended December 31, 2009. This increase is primarily attributable to an increase in TPP segment product development and enhancement expenses of approximately \$11,000 or approximately 9.9% from approximately \$111,000 for the three months ended December 31, 2009 to approximately \$122,000 for the three months ended December 31, 2010. The increase in TPP product development and enhancement expenses is primarily attributable to an increase in staffing levels for the three months ended December 31, 2010 as compared to the three months ended December 31, 2009.

Amortization

Amortization of property and equipment was approximately \$31,000 for the three months ended December 31, 2010 as compared to approximately \$35,000 for the three months ended December 31, 2009, a decrease of approximately \$4,000 or approximately 11.4%. Amortization of intangible assets was approximately \$166,000 for the three months ended December 31, 2010 and 2009.

Interest income

Interest income increased to approximately \$17,000 from approximately \$4,000 for the three months ended December 31, 2010 and 2009, respectively. The increase in interest income was primarily attributable to an increase in interest bearing cash investments.

Income tax expense (recovery)

Income tax expense (recovery) consists of current income tax expense of approximately \$1,281,000 for the three months ended December 31, 2010 compared to recovery of current income taxes of approximately \$324,000 for the three months ended December 31, 2009, an increase of current income tax expense of approximately \$1,605,000. The increase in current income tax expense was primarily attributable to the increase in taxable income attributable to entering into the Third Quarter License Agreements with five of the defendants in the Patent Litigation during the

three months ended December 31, 2010. Future income tax expense was approximately \$851,000 for the three months ended December 31, 2010 compared to \$1,662,000 for the three months ended December, 31, 2009, a decrease in future income tax expense of approximately \$811,000. The decrease in future income tax expense was primarily attributable to a smaller reduction in the future tax asset value as at December 31, 2010 as compared to December 31, 2009.

Net income (loss)

Net income increased by approximately \$2,515,000 from a net loss of approximately \$396,000 for the three months ended December 31, 2009 to net income of approximately \$2,119,000 for the three months ended December 31, 2010.

Basic and diluted earnings per share were both approximately \$0.08 for the three months ended December 31, 2010, as compared to basic and diluted loss per share of approximately \$0.02 for the three months ended December 31, 2009.

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Results of Operations

Nine months ended December 31, 2010 compared to nine months ended December 31, 2009

Revenue

Total revenue for the nine months ended December 31, 2010 was approximately \$22,010,000, an increase of approximately \$10,780,000 or approximately 96% from total revenue of approximately \$11,230,000 for the nine months ended December 31, 2009. This increase is primarily attributable to an increase in IPL revenues for the period of approximately \$8,650,000 and partially attributable to an increase in TPP revenues of approximately \$2,107,000.

During the nine months ended December 31, 2010, we earned revenue from a licensee amounting to approximately 17.7% of total revenue as compared to NIL for the nine months ended December 31, 2009. Revenue from this licensee is non-recurring.

TPP Segment

Revenue pertaining to our TPP segment consists of one-time set-up fees, monthly gateway fees, transaction fees and software customization fees. TPP segment revenue for the nine months ended December 31, 2010 was approximately \$9,167,000 as compared to TPP segment revenue of approximately \$7,060,000 for the nine months ended December 31, 2009, an increase of approximately \$2,107,000 or approximately 29.8%. The increase in TPP segment revenue was primarily attributable to an increase in transaction fees resulting from an increase in our merchant base and partially attributable to a strengthening Canadian dollar in relation to the U.S. dollar which increased approximately 7% from the prior fiscal nine month period. Since a significant amount of our TPP segment originates in Canadian dollars, the conversion of this revenue to U.S. dollars was at an increased exchange rate when compared to the prior fiscal nine month period conversion. TPP segment revenue originating in Canadian dollars was approximately \$9,404,000CAD for the nine months ended December 31, 2010 compared to \$7,789,000CAD for the nine months ended December 31, 2009, an increase of approximately \$1,615,000CAD or approximately 20.7%. Transaction fees for the nine months ended December 31, 2010 were approximately \$7,402,000 compared to transaction fees of approximately \$5,638,000 for the nine months ended December 31, 2009, an increase of approximately \$1,764,000 or approximately 31.3%. The amortized portion of one-time set-up fees recognized was approximately \$145,000 for the nine months ended December 31, 2010 compared to one-time set-up fees for the nine months ended December 31, 2009 of approximately \$121,000, an increase of approximately \$24,000 or approximately 19.8%. Monthly gateway fees for the nine months ended December 31, 2010 were approximately \$1,145,000 compared to monthly gateway fees for the nine months ended December 31, 2009 of approximately \$874,000, an increase of approximately \$271,000 or approximately 31%.

IPL Segment

Revenue from licensing our patented intellectual property increased by approximately \$8,650,000 or approximately 356.3%, from approximately \$2,428,000 for the nine months ended December 31, 2009 to approximately \$11,078,000 for the nine months ended December 31, 2010. The increase in revenue from licensing our patented intellectual property was primarily attributable to the non-recurring licensing revenue recognized of approximately \$9,735,000 from the License Agreements we entered into with eight of the defendants in the Patent Litigation during the nine months ended December 31, 2010.

CP/SL Segment

CP/SL segment revenue for the nine months ended December 31, 2010 was approximately \$1,765,000, an increase of approximately \$24,000 or approximately 1.4% from CP/SL segment revenue of approximately \$1,741,000 for the nine months ended December 31, 2009.

Revenue from our primary check collections business decreased approximately \$52,000 or approximately 17.3% from approximately \$301,000 for the nine months ended December 31, 2009 to approximately \$249,000 for the nine months ended December 31, 2010. Revenue from our secondary check collections business increased approximately \$83,000 or approximately 6.1% from approximately \$1,356,000 for the nine months ended December 31, 2009 to approximately \$1,439,000 for the nine months ended December 31, 2010.

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Cost of Revenue

Cost of revenue consists primarily of costs incurred by the TPP and IPL operating segments. TPP segment costs are incurred in the delivery of e-commerce transaction services, customer service support and include processing and interchange fees paid, other third-party fees, personnel costs and associated benefits and stock-based compensation. IPL segment costs of revenue are primarily legal retention fees and legal disbursement costs incurred in generating licensing revenue.

Cost of revenue increased from approximately \$5,671,000 for the nine months ended December 31, 2009, to approximately \$10,759,000 for the nine months ended December 31, 2010, an increase of approximately \$5,088,000 or approximately 89.7%. This increase was primarily attributable to an increase in our IPL segment cost of revenue of approximately \$3,597,000 from approximately \$447,000 for the nine months ended December 31, 2009 to approximately \$4,044,000 for the nine months ended December 31, 2010. The increase in IPL segment cost of revenue was primarily attributable to the costs incurred in entering into the License Agreements with eight of the defendants in the Patent Litigation during the nine months ended December 31, 2010. TPP segment cost of revenue increased approximately \$1,373,000 or approximately 34%, from approximately \$4,033,000 for the nine months ended December 31, 2009 to approximately \$5,406,000 for the nine months ended December 31, 2010. The increase in TPP segment cost of revenue was primarily attributable to an increase in transaction costs of approximately 36.3% consistent with the increase in transaction fee revenue and partially attributable to a strengthening Canadian dollar in relation to the U.S. dollar which increased approximately 7% from the prior nine month period. Since a significant amount of our TPP segment cost of revenue originates in Canadian dollars, the conversion of these costs to U.S. dollars was at an increased exchange rate when compared to the prior fiscal nine month period conversion. TPP segment costs of revenue originating in Canadian dollars was approximately \$5,547,000CAD for the nine months ended December 31, 2010 compared to \$4,448,000CAD for the nine months ended December 31, 2009, an increase of approximately \$1,099,000CAD or approximately 24.7%. CP/SL segment cost of revenue was approximately \$1,207,000 for the nine months ended December 31, 2010 as compared to approximately \$1,079,000 for the nine months ended December 31, 2009, an increase in CP/SL segment cost of revenue of approximately \$128,000 or approximately 11.9%.

General and administrative expenses

General and administrative expenses consist primarily of personnel costs including associated stock-based compensation and employment benefits, office facilities, travel, 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. General and administrative expenses also include the costs of corporate and support functions including our executive leadership and administration groups, finance, information technology, legal, human resources and corporate communication costs.

General and administrative expenses increased to approximately \$3,346,000 from approximately \$3,084,000 for the nine months ended December 31, 2010 and 2009, respectively, an increase of approximately \$262,000 or approximately 8.5%. Included in general and administrative expenses for the nine months ended December 31, 2010 are TPP segment expenses of approximately \$730,000 as compared to approximately \$629,000 for the nine months ended December 31, 2009, an increase of approximately \$101,000 or approximately 16.1%. CP/SL segment expenses increased to approximately \$425,000 from approximately \$362,000 for the nine months ended December 31, 2010 and 2009, respectively, an increase of approximately \$63,000 or approximately 17.4%. The increase in the TPP and CP/SL segment general and administrative expenses is primarily attributable to an increase of approximately \$71,000 in legal fees primarily pertaining to the two patent infringement complaints filed against our subsidiaries, LML Payment Systems Corp. and Beanstream Internet Commerce Inc. in April, 2009. Also included in general and

administrative expenses are stock-based compensation expenses of approximately \$692,000 for the nine months ended December 31, 2010 compared to approximately \$781,000 for the nine months ended December 31, 2009, a decrease of approximately \$89,000 or approximately 11.4%.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries paid to sales staff, sales commissions, sales operations and other personnel-related expenses, travel and related expenses, trade shows, costs of lead generation, consulting fees and costs of marketing programs, such as internet, print and direct mail advertising costs.

Sales and marketing expenses increased to approximately \$453,000 from approximately \$296,000 for the nine months ended December 31, 2010 and 2009, respectively, an increase of approximately \$157,000 or approximately 53%. The increase is primarily attributable to an increase in our TPP segment sales and marketing expenses of approximately \$129,000 from approximately \$278,000 for the nine months ended December 31, 2009 to approximately \$407,000 for the nine months ended December 31, 2010. The increase in TPP segment sales and marketing expenses is primarily attributable to an increase in wages and commissions of approximately \$111,000, resulting from an increase in staffing levels.

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Product Development and Enhancement

Product development and enhancement expenses consist primarily of compensation and related costs of employees engaged in the research, design and development of new services and in the improving and enhancing of the existing product and service lines.

Product development and enhancement expenses were approximately \$411,000 for the nine months ended December 31, 2010 as compared to approximately \$343,000 for the nine months ended December 31, 2009. The increase is primarily attributable to an increase in our TPP segment product development and enhancement expenses of approximately \$59,000 or approximately 19.3%, from approximately \$306,000 for the nine months ended December 31, 2009 to approximately \$365,000 for the nine months ended December 31, 2010. The increase in TPP product development and enhancement expenses is primarily attributable to an increase in staffing levels for the nine months ended December 31, 2010 as compared to the nine months ended December 31, 2009.

Amortization

Amortization of property and equipment was approximately \$98,000 for the nine months ended December 31, 2010 as compared to approximately \$100,000 for the nine months ended December 31, 2009, a decrease of approximately \$2,000 or approximately 2%. Amortization of intangible assets was approximately \$497,000 for the nine months ended December 31, 2010 and 2009.

Interest income

Interest income increased to approximately \$29,000 from approximately \$21,000 for the nine months ended December 31, 2010 and 2009, respectively. The increase in interest income was primarily attributable to an increase in interest bearing cash investments.

Interest expense

Interest expense decreased to approximately nil from approximately \$48,000 for the nine months ended December 31, 2010 and 2009, respectively. The decrease was primarily attributable to the payment of the final installment of approximately \$2,321,000 on the promissory notes relating to the acquisition of Beanstream, which was made in the first quarter of fiscal 2010.

Income tax expense (recovery)

Income tax expense (recovery) consists of current income tax expense of approximately \$984,000 for the nine months ended December 31, 2010 compared to recovery of current income taxes of approximately \$324,000 for the nine months ended December 31, 2009, an increase of current income tax expense of approximately \$1,308,000. The increase in current income tax expense was primarily attributable to the increase in taxable income attributable to the license agreements we entered into with eight of the defendants in the Patent Litigation during the nine months ended December 31, 2010. Future income tax expense was approximately \$2,366,000 for the nine months ended December 31, 2010 compared to approximately \$1,566,000 for the nine months ended December 31, 2009, an increase in future income tax expense of approximately \$800,000. The increase in future income tax expense was primarily attributable to a decrease in future income tax assets during the nine months December 31, 2010 resulting from the utilization of prior years' tax losses against current period taxable income.

Net income

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Net income increased approximately \$2,960,000 from net income of approximately \$59,000 for the nine months ended December 31, 2009 to approximately \$3,019,000 for the nine months ended December 31, 2010.

Basic and diluted earnings per share were both approximately \$0.11 for the nine months ended December 31, 2010, as compared to approximately \$0.00 for the nine months ended December 31, 2009.

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Liquidity and Capital Resources

Our liquidity and financial position consisted of approximately \$10,979,000 in working capital as of December 31, 2010 compared to approximately \$5,601,000 in working capital as of March 31, 2010, an increase of approximately \$5,378,000. The increase in working capital was primarily attributable to an increase in cash and cash equivalents of approximately \$5,847,000 resulting primarily from compensation received from license agreements entered into during the nine months ended December 31, 2010. Cash provided by operating activities was approximately \$6,612,000 for the nine months ended December 31, 2010, as compared to cash provided by operating activities of approximately \$175,000 for the nine months ended December 31, 2009, an increase in cash generated by operating activities of approximately \$6,437,000. The increase in cash provided by operating activities was primarily attributable to an increase in cash received from license agreements of approximately \$5,847,000 for the nine months ended December 31, 2010. Cash used in investing activities was approximately \$45,000 for the nine months ended December 31, 2010 as compared to approximately \$86,000 for the nine months ended December 31, 2009, a decrease in cash used in investing activities of approximately \$41,000. The decrease in cash used in investing activities was primarily attributable to a decrease in acquisition of property and equipment of approximately \$45,000 for the nine months ended December 31, 2010 as compared to the nine months ended December 31, 2009. Cash provided by financing activities was approximately \$59,000 for the nine months ended December 31, 2010 as compared to cash used in financing activities of approximately \$2,462,000 for the nine months ended December 31, 2009, a decrease in cash used in financing activities of approximately \$2,521,000. The decrease in cash used in financing activities was primarily due to the difference in the payments on the promissory notes relating to the acquisition of Beanstream. During the nine months ended December 31, 2009 we made the second and final payment of approximately \$2,321,000 on the promissory notes.

Management tracks projected cash collections and projected cash outflows to monitor short-term liquidity requirements and to make decisions about future resource allocations and take actions to adjust our expenses with the goal of remaining cash flow positive from operations on an annual basis. We believe that, as of December 31, 2010, the Corporation's cash resources will be sufficient to meet our operating requirements for the next twelve months.

In light of our strategic objective of acquiring electronic payment volume across all our financial payment processing services and strengthening our position as a financial payment processor (as demonstrated by our acquisition of Beanstream), our long-term plans may include the potential to strategically acquire complementary businesses, products or technologies and may also include instituting actions against other entities who we believe are infringing our intellectual property. While we believe that existing cash and cash equivalent balances and potential cash flows from operations should satisfy our long-term cash requirements, we may nonetheless have to raise additional funds for these purposes, either through equity or debt financing, as appropriate. There can be no assurance that such financing would be available on acceptable terms, if at all.

Critical Accounting Policies

There have been no changes to our critical accounting policies since March 31, 2010. For a description of our critical accounting policies, see our Annual Report on Form 10-K for the year ended March 31, 2010 filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959).

Future Change in Accounting Policies

International Financial Reporting Standards

The Canadian Institute of Chartered Accountants has announced that public companies will be required to transition from Canadian Generally Accepted Accounting Principles (GAAP) to International Financial Accounting Standards (IFRS). For us, this will take place with our fiscal period commencing April 1, 2011. This transition will require the restatement for comparative purposes of amounts reported by us for all interim and annual periods beginning on or after April 1, 2010.

We continue our process of transition from current Canadian GAAP to IFRS. We have a project team assigned to plan for and achieve a smooth transition to IFRS. Progress reporting to the Audit Committee of the Board of Directors on the status of the IFRS implementation continues to take place.

The transition plan consists of the following three phases: (i) initial scoping and diagnostic phase; (ii) detailed analysis and design phase; and (iii) the implementation phase.

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Initial scoping and diagnostic phase:

We have completed the initial scoping and diagnostic phase which included the review and identification of major differences between current Canadian GAAP and IFRS as well as an initial evaluation of IFRS 1 transition exemptions and elections.

Detailed analysis and design phase:

We are currently working on the second phase of our conversion plan which entails a detailed analysis of all relevant accounting differences between IFRS and existing Canadian GAAP, as identified in the initial scoping and diagnostic phase, which will be impacted by the conversion to IFRS. The analysis includes a review of the changes required to the current accounting policies as well as any policy alternatives. The implications of these changes on business processes, information systems and internal control over financial reporting are also analyzed. We are also in the process of preparing draft financial statements and related note disclosure in accordance with IAS 1 – “Presentation of Financial Statements”. Training is being provided on a continuous basis to key employees. To date, we have completed a portion of the detailed analysis of the significant areas and we expect to complete the balance by the end of fiscal 2011.

Implementation phase:

The final phase of our IFRS changeover plan will entail the implementation of the changes identified in the second phase as well as the approval of IFRS financial statements. Training will continue to be provided on an ongoing basis to key employees. The final phase will be completed during the fourth quarters of fiscal 2011.

Based on the progress to date, the following are some of the significant accounting policy changes that have been identified as having a potential impact on our financial statements. We are in the process of reviewing other accounting policies and will disclose additional information when available.

- IAS 1 “Presentation of Financial Statements”, which will require classification changes to the Statement of Earnings by using either the Function of Expense Method or the Nature of Expense Method, as well as additional disclosure requirements. We have yet to conclude on which method of presentation we will follow.
 - IAS 17 “Leases”, which may require changes to the basis of the expense recognition over the lease term.
- IAS 36 “Impairment of Assets”, which will require the impairment of assets to be assessed for the Corporation’s Cash Generating Units (CGU), the lowest level at which separately independent cash inflows can be identified. Assets will be assessed using a one-step test, where the carrying value of an asset or group of assets will be compared directly to its recoverable amount on an anticipated discounted cash flow basis.
- IFRS 2 “Share-based payments.” Canadian GAAP allows the preparer to choose from two methods namely, (a) treating all options granted at a particular date and with the same terms and conditions as one pool (pooling method) and (b) treating options with different vesting dates as different grants (vesting method). The cost of such methods is calculated according to Black-Scholes for both methods. For the pooling method, the total expense is amortized on a straight line basis over the longest vesting period of all of the options in the pool resulting in equal charges to income over the period. The vesting method looks at each vesting tranche and the expense associated with that particular vesting tranche and amortizes that in a straight line. This second method front-end loads the expense. Although available under Canadian GAAP, this method is rarely used. Under IFRS, the vesting method is the only method that may be used.

- Income taxes – Under Canadian GAAP, if additional deferred tax assets that were not recognized at the date of acquisition are realized subsequently, then the adjustment is recognized first against goodwill, then against intangible assets, before any adjustment is recognized as a tax recovery in profit or loss. Under IFRS, such adjustment is recognized directly in profit or loss. The recognition of deferred income taxes for temporary differences arising from intercompany transfer of property is prohibited under Canadian GAAP while there are no similar exceptions under IFRS. Other significant differences may impact the Corporation such as accounting for uncertain tax positions, backwards tracing, and differences relating to presentation and disclosure.

Based on our analysis to date, we expect our financial statement disclosure to be enhanced; however, we do not expect to have significant quantitative differences on transition with the potential exception of stock-based compensation.

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We are currently evaluating the implications of these changes on business processes, information systems, internal control over financial reporting and disclosure controls and procedures.

As we prepare for our transition, we continue to monitor ongoing changes to IFRS and adjust our transition and implementation plans accordingly. Our transition remains in line with our implementation schedule and we are on track to meet the timelines essential to changeover.

Contingencies

See Note 9. Commitments and Contingencies and Note 10. Subsequent event, and Part II, Item 1. Legal Proceedings for a discussion of contingencies.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

From March 31, 2010 until December 31, 2010, 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, 2010, as filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959).

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. As required by Rule 13a-15(b) under the Securities and Exchange Act of 1934 (Exchange Act), our management, including our Chief Executive Officer (“CEO”) and Chief Accounting Officer (“CAO”), carried out an evaluation of the effectiveness of the design and operation of our “disclosure controls and procedures” as of the end of the period covered by this report. As defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, disclosure controls and procedures are controls and other procedures of our Corporation that are designed to ensure that information required to be disclosed by our Corporation in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by our Corporation in the reports we file or submit under the Exchange Act is accumulated and communicated to our Corporation’s management, including our CEO and CAO, as appropriate, to allow timely decisions regarding required disclosure.

Based on their evaluation our CEO and CAO concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by our Corporation in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and to provide reasonable assurance that such information is accumulated and communicated to our Corporation’s management, including our CEO and CAO, as appropriate, to allow timely decisions regarding required disclosure. It should be noted that any system of controls, however well designed and operated, is based in part upon certain assumptions and can provide only reasonable, and not absolute, assurance that the objectives of the system are met.

Changes in Internal Control over Financial Reporting. As required by Rule 13a-15(d) under the Exchange Act, our management, including our CEO and CAO, also conducted an evaluation of our internal control over financial reporting to determine whether any change occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Based on our evaluation, during our most recent fiscal quarter there were no changes in our internal control over financial reporting that have

materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

During the three months ended December 31, 2010, LML Patent Corp., our indirect, wholly-owned subsidiary, entered into a Settlement and License Agreement with each of the Bank of New York Mellon (“BNYM”), First National Bank of Omaha and First National Merchant Solutions LLC (collectively, “First National”), Regions Bank (“Regions”), Fifth Third Bank (“Fifth Third”), and Marshall and Ilsley Bank (“M&I”) (collectively, the “Third Quarter License Agreements”), all defendants in the patent infringement lawsuit originally filed on November 19, 2008 in the U.S. District Court for the Eastern District of Texas (the “Patent Litigation”) against nineteen defendants in the United States alleging that the defendants infringe U.S. Patent No. RE40,220, which is held by the subsidiary (the “40,220 Patent”). LML Patent Corp. sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The Third Quarter License Agreements provided each of BNYM, First National, Regions, Fifth Third and M&I with a fully paid-up license to certain of LML Patent Corp.’s patents for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the Third Quarter License Agreements, LML Patent Corp. received compensation totaling \$6,465,000 for releases, licenses, covenants and all other rights granted under the Third Quarter License Agreements. Pursuant to a retention agreement with its legal firm, LML Patent Corp. paid approximately \$2,687,383 in legal fees for the firm’s services in connection with the Third Quarter License Agreements.

Given the number and size of the defendants in the Patent Litigation, during the three months ended December 31, 2010, LML Patent Corp., the plaintiff in the Patent Litigation, filed a motion to separate the defendants in the Patent Litigation into groups for the purpose of holding separate trials so that each trial can be conducted in a feasible and judicious manner. In January 2011, the Court in the Patent Litigation issued a trial order that: (i) defendants Citibank, HSBC Bank USA N.A. and PayPal be grouped together for a trial to begin on March 8, 2011 (the “Phase I trial”); (ii) defendants JPMorgan, Wells Fargo and Wachovia be grouped together for a trial to begin on October 4, 2011 (the “Phase II trial”) and (iii) defendants Capital One, Northern Trust and Deutsche Bank be grouped together for another trial also to begin on October 4, 2011 (the “Phase III trial”). In addition, to enable the Court and the parties to the Phase I trial to better focus on the issues pertinent to the Phase I trial, the Court also ordered that pre-trial proceedings be stayed until further notice as to all defendants in the Phase II and Phase III trials.

On July 29, 2010, in response to a request for inter-partes reexamination submitted by four of the defendants in the Patent Litigation, the United States Patent and Trademark Office (“USPTO”) posted a non-final office action on its public Patent Application Information Retrieval (“PAIR”) website ordering an inter-partes reexamination proceeding with respect to the 40,220 Patent pursuant to which 16 of the 40,220 Patent’s 100 claims are now subject to reexamination and have been rejected. Generally, an inter-partes reexamination is a USPTO administrative proceeding requested by a third party (the “Third Party Requester”) to challenge the validity of patents that have already issued. All 16 of the patent claims that were rejected and are now subject to re-examination are claims that the Corporation’s subsidiary asserted and seeks to enforce in the Patent Litigation. During the three months ended December 31, 2010, we filed a response to this non-final office action with the USPTO and then the Third Party requester filed a response to our response with the USPTO. The Examiner is considering the filings and is expected to issue an “Action Closing Prosecution” in due course. The Action Closing Prosecution is not final and may be appealed by either party. We may respond to the Action Closing Prosecution and if we do so, the Third Party Requester may again file comments. A “Right of Appeal Notice” typically follows. The “Right of Appeal Notice” is a final but appealable office action. From there, either party may appeal the decision to the Patent Office Board of Appeals and Interferences (“Board”) and then to the Court of Appeals for the Federal Circuit (“Federal Circuit”). The ultimate outcome of the reexamination proceeding (including any appeals that may be made) is indeterminable at this time.

In January 2011, LML Patent Corp. entered into a Settlement and License Agreement with each of Texas Heritage National Bank (“Heritage”), PlainsCapital Bank (“PlainsCapital”) and First Bank (“First”) (collectively, the “Subsequent License Agreements”), all defendants in the patent infringement lawsuit originally filed on June 4, 2009 in the U.S. District Court for the Eastern District of Texas (the “Second Patent Litigation”) against six defendants in the United States alleging that the defendants infringe the 40,220 Patent. LML Patent Corp. sought damages, injunctive and other relief for the alleged infringement of the 40,220 Patent. The Subsequent License Agreements provide Heritage, PlainsCapital and First each with a fully paid-up license to certain of LML Patent Corp.’s patents for electronic check conversion transactions including “ARC”, “WEB”, “POP”, “TEL” and “BOC”. In connection with the Subsequent License Agreements, LML Patent Corp. received compensation totaling \$63,500 for releases, licenses, covenants and all other rights granted under the Subsequent License Agreements. The claims for patent infringement against the remaining defendants in the Second Patent Litigation were dismissed without prejudice on January 26, 2011.

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During the fiscal year ended March 31, 2007, we received notification that we had been named in a class-action lawsuit filed in the United States District Court, Eastern District, Marshall Division, Texas, alleging that numerous defendants, including a subsidiary of the Corporation, violated the Driver's Privacy Protection Act regulating the use of personal information such as driver's license numbers and home addresses contained in motor vehicle records held by motor vehicle departments, by not having a permissible use in obtaining the State of Texas' entire database of names, addresses and other personal information. During the fiscal year ended March 31, 2009, the complaint was dismissed with prejudice. Also during the fiscal year ended March 31, 2009, the plaintiffs appealed this decision. On November 4, 2009 oral arguments were heard by the Fifth Circuit of appeals and on July 14, 2010, the Fifth Circuit of appeals affirmed the dismissal of the complaint. During the three months ended December 31, 2010, the plaintiffs filed a writ of certiorari with the Supreme Court of the United States appealing the dismissal of the complaint. In January 2011, we received notice that the Supreme Court had denied the writ of certiorari, which means that the decisions of the lower courts resolving the lawsuit in our favor have become final.

In addition to legal matters as previously reported in our Annual Report filed on Form 10-K for the year ended March 31, 2010, as filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959), 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 1A.

RISK FACTORS

There are no material changes to the risk factors as reported in our annual report on Form 10-K for the fiscal year ended March 31, 2010, as filed with the Securities and Exchange Commission on June 24, 2010 (file no. 000-13959).

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ITEM 6. EXHIBITS

Exhibits:

The following exhibits are attached hereto or are incorporated herein by reference as indicated in the table below:

E x h i b i t

Number	Description of Document
3.1	Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Annual Report on Form 10-K for the period ended March 31, 2006 of LML (File No. 000-13959)).
3.2	Bylaws of LML, as amended (incorporated by reference to Exhibit 3.2 to the Quarterly Report on Form 10-Q for the period ended September 30, 2007 of LML (File No. 000-13959)).
10.1*	<u>Settlement and License Agreement between LML Patent Corp. and Regions Bank dated November 12, 2010.</u>
10.2*	<u>Settlement and License Agreement between LML Patent Corp. and Marshall & Ilsley dated November 12, 2010.</u>
10.3*	<u>Settlement and License Agreement between LML Patent Corp. and Fifth Third Bank dated November 10, 2010.</u>
10.4	Settlement and License Agreement between LML Patent Corp. and The Bank of New York Mellon dated October 4, 2010 (incorporated by reference to Exhibit 10.2 to the Quarterly Report on Form 10-Q for the period ended September 30, 2010 of LML (File No. 000-13959)).
10.5	Settlement and License Agreement between LML Patent Corp. and First National Bank of Omaha and First National Merchant Solutions LLC dated October 4, 2010 (incorporated by reference to Exhibit 10.3 to the Quarterly Report on Form 10-Q for the period ended September 30, 2010 of LML (File No. 000-13959)).
31.1*	<u>Rule 13a-14(a) Certification of Principal Executive Officer.</u>
31.2*	<u>Rule 13a-14(a) Certification of Principal Financial Officer.</u>
32.1*	<u>Section 1350 Certification of Principal Executive Officer and Principal Financial Officer.</u>

*filed with this Quarterly Report on Form 10-Q

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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.

/s/ Richard R. Schulz
Richard R. Schulz
Controller and Chief Accounting
Officer
(Duly Authorized Officer and Chief
Accounting Officer)

February 11, 2011

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