

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 June 30, 2005

OR

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

For the Transition Period from _____ to _____

Commission File Number: 0-13959

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

Yukon Territory

(State or other jurisdiction of
incorporation or organization)

980-20-9289

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

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

(Address of principal executive offices) (Zip Code)

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

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

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

The number of shares of the registrant's Common Stock outstanding as of July 18, 2005, was 20,145,594.

LML PAYMENT SYSTEMS INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

INDEX

	<u>Page Number</u>
PART I. FINANCIAL INFORMATION	1
Item 1. Consolidated Financial Statements	1
Consolidated Balance Sheets at June 30, 2005 (unaudited) and March 31, 2005	1
Consolidated Statements of Operations and Deficit (unaudited) for the Three Months Ended June 30, 2005 and 2004	2
Consolidated Statements of Cash Flows (unaudited) for the Three Months Ended June 30, 2005 and 2004	3
Notes to Consolidated Financial Statements (unaudited)	4
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	7
Item 3. Quantitative and Qualitative Disclosures About Market Risk	11
Item 4. Controls and Procedures	11
PART II. OTHER INFORMATION	12
Item 1. Legal Proceedings	12
Item 6. Exhibits	12
SIGNATURE PAGE	13

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

PART I. FINANCIAL INFORMATION**Item 1. Consolidated Financial Statements****LML PAYMENT SYSTEMS INC.****CONSOLIDATED BALANCE SHEETS**
(In U.S. Dollars, except as noted below)

	June 30, 2005 \$ (Unaudited)	March 31, 2005 \$
ASSETS		
Current Assets		
Cash and cash equivalents	5,720,708	6,061,821
Restricted cash	250,000	250,000
Accounts receivable, less allowances of \$31,155 and \$31,155, respectively	605,893	508,625
Prepaid expenses	336,289	497,413
Total Current Assets	<u>6,912,890</u>	<u>7,317,859</u>
Capital Assets, net	239,782	508,981
Patents, net	1,163,618	1,202,188
Other Assets	41,055	41,055
TOTAL ASSETS	<u>8,357,345</u>	<u>9,070,083</u>
LIABILITIES		
Current Liabilities		
Accounts payable	640,190	620,006
Accrued liabilities	343,295	140,351
Accrued compensation	190,744	151,941
Current portion of long-term debt	48,323	48,323
Deferred revenue	202,392	243,667
Total Current Liabilities	<u>1,424,944</u>	<u>1,204,288</u>
Long-term debt	11,542	23,469
Total Liabilities	<u>1,436,486</u>	<u>1,227,757</u>
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, 20,145,594 and 20,145,594 shares issued and outstanding, respectively	32,476,693	32,476,693
Contributed surplus	1,788,340	1,631,471
Deficit	<u>(27,344,174)</u>	<u>(26,265,838)</u>
Total Shareholders' Equity	<u>6,920,859</u>	<u>7,842,326</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>8,357,345</u>	<u>9,070,083</u>

See accompanying notes to the consolidated financial statements.

LML PAYMENT SYSTEMS INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
(In U.S. Dollars, except share data)
(Unaudited)

	Three Months Ended June 30	
	2005	2004
	\$	\$
REVENUE	1,559,552	2,093,511
COSTS AND EXPENSES		
Cost of operations	1,135,296	1,483,439
Sales, general and administrative expenses (includes stock-based compensation expense of \$156,869 (June 30, 2004 - \$1,042,562)	1,210,598	1,508,957
Amortization and depreciation	325,665	452,531
Other (income) expenses	(406)	1,932
LOSS BEFORE INTEREST INCOME AND INCOME TAXES	(1,111,601)	(1,353,348)
Interest income, net	37,465	7,228
LOSS BEFORE INCOME TAXES	(1,074,136)	(1,346,120)
Income taxes	(4,200)	(14,200)
NET LOSS	(1,078,336)	(1,360,320)
DEFICIT, beginning of period	(26,265,838)	(22,115,732)
DEFICIT, end of period	(27,344,174)	(23,476,052)
LOSS PER SHARE, basic and diluted	(0.05)	(0.07)
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	20,145,594	19,843,093
Diluted	20,145,594	19,843,093

See accompanying notes to the consolidated financial statements.

LML PAYMENT SYSTEMS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In U.S. Dollars)
(Unaudited)

	Three Months Ended June 30	
	2005	2004
	\$	\$
Operating Activities:		
Net Loss	(1,078,336)	(1,360,320)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities		
Provision for losses on accounts receivable	-	10,967
Amortization and depreciation	325,665	452,531
Stock-based compensation	156,869	1,042,562
Changes in operating assets and liabilities		
Accounts receivable	(97,268)	167,184
Prepaid expenses	161,124	55,755
Accounts payable and accrued liabilities	261,931	(100,968)
Deferred revenue	(41,275)	(28,400)
Net cash (used in) provided by operating activities	(311,290)	239,311
Investing Activities:		
Maturity of short-term investments	-	183,561
Capital asset expenditures	(17,685)	(34,278)
Patents	(211)	-
Net cash (used in) provided by investing activities	(17,896)	149,283
Financing Activities:		
Payments on capital leases	(9,365)	(7,399)
Payments on long-term borrowing	(2,562)	-
Proceeds from exercise of stock options	-	863,750
Net cash (used in) provided by financing activities	(11,927)	856,351
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(341,113)	1,244,945
Cash and cash equivalents, beginning of period	6,061,821	4,981,343
Cash and cash equivalents, end of period	5,720,708	6,226,288

See accompanying notes to the consolidated financial statements.

LML PAYMENT SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. Basis of Presentation

The consolidated balance sheet as of June 30, 2005, the consolidated statements of operations and deficit for the three months ended June 30, 2005 and 2004, and the consolidated statements of cash flows for the three months ended June 30, 2005 and 2004, of LML Payment Systems Inc. and its subsidiaries (collectively, the "Corporation") are unaudited. The Corporation's consolidated balance sheet as of March 31, 2005, was derived from audited financial statements. In the opinion of management, all adjustments necessary for a fair presentation of such financial statements are included herein. Other than those discussed in the notes below, such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year. The Corporation's consolidated financial statements and notes are presented in accordance with generally accepted accounting principles in Canada for interim financial information and in accordance with the instructions for Form 10-Q and Article 10 of Regulation S-X, and do not contain certain information included in the Corporation's consolidated audited annual financial statements and notes. The consolidated financial statements and notes appearing in this report should be read in conjunction with the Corporation's consolidated audited financial statements and related notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in the Corporation's Annual Report on Form 10-K for the fiscal year ended March 31, 2005, as filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959).

2. Financial instruments

a) Restricted cash

Under the terms of the processing agreement with one of the Corporation's processing banks, the Corporation has pledged a deposit of \$250,000 (March 31, 2005 - \$250,000) against charge back losses.

b) Concentration of credit risk

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

During the three months ended June 30, 2005, revenue from the Corporation's largest customer amounted to approximately 21% of total revenue (June 30, 2004 - 16%). The amount of revenue from this customer amounted to approximately \$333,003 (June 30, 2004 - \$344,474). The Corporation may be economically dependent on revenue from this customer. On March 31, 2004, one of the Corporation's largest customers notified the Corporation that its contract would not be extended and, therefore, the Corporation ceased providing services to this customer on May 31, 2004. The customer did not account for any revenue in the three months ended June 30, 2005 (June 30, 2004 - 19%).

3. Stock-based compensation

Effective April 1, 2003, the Corporation prospectively early adopted the Canadian Institute of Chartered Accountants ("CICA") Section 3870 which corresponds to the Financial Accounting Standard Board's ("FASB") Statement of Financial Accounting Standards No. 123, ("SFAS 123"), as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148"), which requires fair value accounting for all stock options issued during the year. Prior to the adoption of the new accounting standard, the Corporation did not record the fair value of stock options issued, rather, it provided pro-forma disclosure of the effect of applying the fair value based method to stock options issued to directors, officers and employees.

During the three months ended June 30, 2005, the Corporation did not grant any stock options under the Corporation's 1996 Stock Option Plan or its 1998 Stock Incentive Plan. Stock-based compensation expense from prior

periods' stock option grants resulted in an expense of \$156,869 for the three months ended June 30, 2005. During the three months ended June 30, 2005, 50,000 stock options were terminated upon the departure of an employee.

During the three months ended June 30, 2004, the Corporation granted 380,000 stock options under the Corporation's 1996 Stock Option Plan and 75,000 stock options under the 1998 Stock Incentive Plan. The 380,000 stock options have a weighted average fair value of \$3.80 and the 75,000 stock options have a weighted average fair value of \$4.44. The total fair value of stock-based compensation is amortized over the vesting period resulting in additional stock-based compensation expense of \$1,007,658 for a total stock-based compensation expense of \$1,042,562 for the three months ended June 30, 2004. The fair value for the 380,000 and 75,000 stock option grants was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

Risk-free interest rate of 4.07% for the 380,000 stock option grants and 4.35% for the 75,000 stock option grants;

Expected volatility of 79.6%;

Expected life of the 380,000 stock option grants of 4 years and 6 years for the 75,000 stock option grants; and

No dividend yields.

The pro-forma disclosure below relates to stock options granted prior to April 1, 2003 that have vested in the periods presented below. The pro forma compensation expense recorded during the three months ended June 30, 2005 represents the amortization of previously issued stock options. These previously issued options are amortized to pro forma compensation expenses as the options vest.

	Three Months Ended June 30 2005 \$	Three Months Ended June 30 2004 \$
Net loss, as reported	(1,078,336)	(1,360,320)
Add: Stock-based compensation expense included in reported net loss, including related tax effects	156,869	1,042,562
Less: Total stock-based compensation expense determined under fair value method for all awards, including related tax effects	<u>(156,869)</u>	<u>(1,338,430)</u>
Pro forma net loss:	<u>(1,078,336)</u>	<u>(1,656,188)</u>
Basic and diluted loss per common share:		
As reported	(0.05)	(0.07)
Pro forma	(0.05)	(0.08)

The fair value of stock options granted prior to April 1, 2003 are estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions:

Risk free interest rate of 4%;

Expected volatility of 104%;

Expected life of the stock options of 4 years; and

No dividend yields.

4. Commitments and Contingencies

During the three months ended June 30, 2005, a former consultant to the Corporation filed a response to a demand for arbitration filed by the Corporation. The Corporation is involved in a dispute with the former consultant relating to the payment of finders fees with respect to certain acquisitions made by the Corporation in the fiscal years ended March 31, 2000 and March 31, 2001. The Corporation has initiated arbitration proceedings pursuant to the terms of the finder's fee agreement between the former consultant and the Corporation (the "Finder's Fee Agreement"). The former consultant has filed a counter claim in the arbitration proceedings alleging the Corporation breached the Finder's Fee Agreement. The likelihood of success of this counter claim is indeterminate and any amounts likely to be payable cannot be reasonably estimated. As such, no amounts have been recorded in the consolidated financial statements pertaining to this dispute for the three months ended June 30 2005.

During the three months ended June 30, 2005, Telecheck International Inc. filed a complaint for patent infringement in the United States District Court for the Eastern District of Texas Marshall Division against the Corporation and the Corporation's subsidiary LML Payment Systems Corp., in an action styled Telecheck International Inc. as plaintiff vs. LML Payment Systems Inc. and LML Payment Systems Corp. In the suit, Telecheck International Inc. alleges that the Corporation and its subsidiary, LML Payment Systems Corp., infringe U.S. Patent Nos. 5,679,938 and 5,679,940 and seeks damages, injunctive and other relief. The Corporation believes these allegations are without merit and intends to vigorously defend against them. The likelihood of success of this suit is indeterminate and any amounts likely to be payable cannot be reasonably estimated. As such, no amounts have been recorded in the consolidated financial statements pertaining to this dispute for the three months ended June 30 2005.

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

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

- a) Under U.S. GAAP, the Corporation could not effect the 2001 reduction in deficit of \$22,901,744 by reducing the stated capital of the shares of the Corporation's common stock.
- b) During the fiscal year ended March 31, 2004, the Corporation adopted the fair value based method of accounting for all stock-based compensation as prescribed by SFAS 123. The Corporation has chosen to adopt the fair value based method on a prospective basis from April 1, 2003 as permitted by SFAS 148. The prospective adoption of this new U.S. GAAP policy creates no differences with the Corporation's stock compensation expense reported under Canadian GAAP.

Previously under U.S. GAAP, the Corporation accounted for its 1996 Stock Option Plan and 1998 Stock Incentive Plan under the principles of Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees and related Interpretations" ("APB 25"). No compensation expense was recognized under APB 25, because the exercise price of the Corporation's stock options equals the market price of the underlying stock on the date of the grant

Under U.S. GAAP there are no adjustments that resulted in changes to the Consolidated Statements of Operations and Deficit, Consolidated Statements of Cash Flows or the Consolidated Balance Sheets of the Corporation, except that under U.S. GAAP the stated capital of the Corporation's shares would be \$22,901,744 higher, as would the Corporation's deficit due to the reporting difference disclosed under note 5(a).

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

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

The following discussion and analysis should be read in conjunction with the consolidated audited financial statements and related notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended March 31, 2005, filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959). We believe that all necessary adjustments (consisting only of normal recurring adjustments) have been included in the amounts stated below to present fairly the following quarterly information. Quarterly operating results have varied significantly in the past and can be expected to vary in the future. Results of operations for any particular quarter are not necessarily indicative of results of operations for a full year.

Forward Looking Information

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

Overview

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

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

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

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

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

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

We provide our financial payment processing services from our office locations in Scottsdale, Arizona, Wichita, Kansas and Dallas, Texas.

Results of Operations

Revenue

Total revenue for the three months ended June 30, 2005 was approximately \$1.6 million, approximately a 23.8% decrease from total revenue of approximately \$2.1 million for the three months ended June 30, 2004. This decrease is primarily attributable to a decrease in revenue associated with our primary and secondary check collection business.

Revenue from electronic check verification was approximately \$280,000 for the three months ended June 30, 2005, approximately a 15.4% decrease from revenue from electronic check verification of approximately \$331,000 for the three months ended June 30, 2004. This decrease is primarily attributable to us no longer providing electronic check verification services to 7-Eleven, formerly our largest customer which was responsible for approximately 44.7% of revenue from our electronic check verification services for the three months ended June 30, 2004.

Revenue from our primary check collections business decreased approximately 60.1% from approximately \$746,000 for the three months ended June 30, 2004 to approximately \$298,000 for the three months ended June 30, 2005. The reduction in revenue from our primary check collections business was primarily attributable to us no longer providing check recovery services to 7-Eleven, formerly our largest customer which was responsible for approximately 50.7% of revenue from our primary check collections business for the three months ended June 30, 2004. Revenue from our secondary check collections business decreased approximately 23.4% from approximately \$726,000 for the three months ended June 30, 2004 to approximately \$556,000 for the three months ended June 30, 2005. The decrease in revenue from our secondary check collections business was primarily attributable to a decrease in collections of the principal amount and related fees of returned checks assigned for secondary recovery.

Revenue from our licensing of certain payment software modules was approximately \$112,000 for the three months ended June 30, 2005, compared to approximately \$25,000 for the three months ended June 30, 2004.

Revenue from royalties received from CheckFree Corporation pertaining to their marketing of the PEP+ reACH™ product was approximately \$160,000 for the three months ended June 30, 2005, versus approximately \$99,000 for the three months ended June 30, 2004. We believe future royalties are dependent upon the continued successful marketing by CheckFree Corporation of the PEP+ reACH™ product.

During the three months ended June 30, 2005, revenue from and associated with our largest customer amounted to approximately 21.4% of total revenue as compared to approximately 16.4% of total revenue for the three months ended June 30, 2004. We may be economically dependent on revenue from this customer.

Costs of operations

Costs of operations decreased from approximately \$1.5 million for the three months ended June 30, 2004, to approximately \$1.1 million for the three months ended June 30, 2005, a decrease of approximately 26.7%. Costs of operations consist of transaction processing costs, personnel costs, equipment related costs and telecommunication costs. The decrease was primarily attributable to certain cost reductions such as transaction processing costs, personnel costs and telecommunication costs associated with us no longer providing check authorization and recovery services to 7-Eleven. We continue to seek ways to reduce costs of operations.

Sales, general and administrative expenses

Sales, general and administrative expenses consist primarily of stock-based compensation expense, personnel costs, commissions, office facilities, travel, promotional events such as trade shows, seminars and technical conferences, public relations and professional service fees, which include legal fees, audit fees, SEC compliance costs and costs related to compliance with the Sarbanes-Oxley Act of 2002. Sales, general and administrative expenses decreased to approximately \$1.2 million from approximately \$1.5 million for the three months ended June 30, 2005 and 2004, respectively, a decrease of approximately \$300,000 or approximately 20%. The decrease in sales, general and administrative expense is primarily attributable to a decrease in stock-based compensation expense of approximately \$843,000 from approximately \$1.0 million for the three months ended June 30, 2004 to approximately \$157,000 for the three months ended June 30, 2005. The decrease in sales, general and administrative expenses relating to stock-based compensation expense was offset by an increase in legal fees of approximately \$440,000 from approximately \$44,000 for the three months ended June 30, 2004 to approximately \$484,000 for the three months ended June 30, 2005. The increase in legal fees is primarily attributable to costs associated with the patent infringement suit we filed during the fiscal year ended March 31, 2005 and partially attributable to legal fees associated with ordinary legal matters incidental to our business.

Amortization and depreciation

Amortization and depreciation decreased to approximately \$326,000 from approximately \$453,000 for the three months ended June 30, 2005 and 2004, respectively. The decrease was primarily attributable to certain capital assets, acquired through previous years' acquisitions, which had become fully depreciated.

Other (income) expenses

During the three months ended June 30, 2005 we had other income of approximately \$400 compared to other expenses of approximately \$1,900 for the three months ended June 30, 2004.

Interest

Interest expense decreased to approximately \$1,000 from approximately \$3,000 for the three months ended June 30, 2005 and 2004, respectively. Interest income increased to approximately \$39,000 from approximately \$10,000 for the three months ended June 30, 2005 and 2004, respectively. The increase in interest income was partially attributable to an increase in interest bearing cash investments and partially attributable to an increase in interest rates from an average of approximately .94% for the three months ended June 30, 2004 to an average of approximately 2.66% for the three months ended June 30, 2005.

Net Loss

Net Loss decreased to approximately \$1.1 million from approximately \$1.4 million for the three months ended June 30, 2005 and 2004, respectively. The decrease was primarily attributable to a decrease in stock-based compensation expense of approximately \$843,000 from approximately \$1.0 million for the three months ended June 30, 2004 to approximately \$157,000 for the three months ended June 30, 2005.

Basic and diluted loss per share were both approximately (\$0.05) for the three months ended June 30, 2005, as compared to approximately (\$0.07) for the three months ended June 30, 2004.

Liquidity and Capital Resources

Our liquidity and financial position consisted of approximately \$5.5 million in working capital as of June 30, 2005, compared to approximately \$6.1 million in working capital as of March 31, 2005. The decrease in working capital was primarily attributable to cash flows used in operating activities of approximately \$311,000. Cash used in operating activities increased approximately \$550,000 from cash provided by operating activities of approximately \$239,000 for

the three months ended June 30, 2004 to cash used in operating activities of approximately \$311,000 for the three months ended June 30, 2005. The increase in cash used in operating activities was primarily attributable to an increase in sales, general and administrative expenses, exclusive of the decrease in non-cash stock-based compensation expense of approximately \$843,000, of approximately \$543,000. Cash used in investing activities was approximately \$18,000 for the three months ended June 30, 2005 as compared to cash provided by investing activities of approximately \$149,000 for the three months ended June 30, 2004, an increase in cash used in investing activities of approximately \$167,000. The increase in cash used in investing activities was primarily attributed to the maturity of short-term investments of approximately \$184,000 during the three months ended June 30, 2004. Cash used in financing activities was approximately \$12,000 for the three months ended June 30, 2005 compared to cash provided by financing activities of approximately \$856,000 for the three months ended June 30, 2004. The increase in cash used in financing activities was primarily due to the proceeds from exercise of options of our common stock of approximately \$864,000 during the three months ended June 30, 2004.

We anticipate the continued use of cash flows from operating activities in fiscal 2006. The cost of prosecuting a patent infringement claim against third parties can be expensive and we anticipate spending substantial funds that may be consistent with costs incurred during the three months ended June 30, 2005. Likewise, the cost of defending ourselves with respect to a patent infringement claim brought against us by third parties can be expensive. An affiliate of Telecheck Services Inc., one of the four companies we filed a patent infringement suit against, filed its own complaint against us for patent infringement. We intend to defend ourselves in this matter and anticipate spending substantial funds in our defense (see "Contingencies" and Part II, Item 1 -- "Legal Proceedings"). We believe that existing cash and cash equivalent balances should satisfy our working capital and capital expenditure requirements in fiscal 2006.

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, 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. We believe that existing cash and cash equivalent balances and potential cash flows from operations should satisfy our long-term cash requirements, however, we may elect 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, 2005. For a description of our critical accounting policies, see our Annual Report on Form 10-K for the year ended March 31, 2005 filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959).

Contingencies

We are involved in a dispute with a former consultant relating to the payment of finders fees with respect to certain acquisitions we made in the fiscal years ended March 31, 2000 and March 31, 2001. In October 2004 we initiated arbitration proceedings pursuant to the terms of the finder's fee agreement between us and the former consultant (the "Finder's Fee Agreement"). In June 2005 the former consultant filed a counter claim in the arbitration proceedings alleging we breached the Finder's Fee Agreement. At this time we do not expect the resolution of this dispute to have a material adverse effect on the results of our operations, financial position or liquidity.

On June 22, 2005, Telecheck International Inc. filed a complaint for patent infringement in the United States District Court for the Eastern District of Texas Marshall Division against the Corporation and the Corporation's subsidiary LML Payment Systems Corp., in an action styled Telecheck International Inc. as plaintiff vs. LML Payment Systems Inc. and LML Payment Systems Corp. In the suit, Telecheck International Inc. alleges that the Corporation and its subsidiary, LML Payment Systems Corp., infringe U.S. Patent Nos. 5,679,938 and 5,679,940 and seeks damages, injunctive and other relief. We believe these allegations are without merit and intend to vigorously defend against them. At this time, the likelihood of success of this suit is indeterminate and any amounts likely to be payable cannot be reasonably estimated.

In addition to the legal matters as described herein and previously reported in our Annual Report filed on Form 10-K for the year ended March 31, 2005, as filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959), we are party from time to time to ordinary litigation incidental to our business, none of which is expected to have a material adverse effect on our results of operations, financial position or liquidity.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

From March 31, 2005 until June 30, 2005, 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, 2005, as filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959).

ITEM 4. Controls and Procedures

An evaluation of the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), was carried out by management with the participation of the Chief Executive Officer and Chief Accounting Officer as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Accounting Officer have concluded that such controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q. As required by Exchange Act Rule 13a-15(d), management, with the participation of the Chief Executive Officer and Chief Accounting Officer, also conducted an evaluation of our internal control over financial reporting to determine whether changes occurred during the quarter ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Except for the remediation effort described below as occurring during the first quarter of our fiscal 2006, there were no other changes in our internal control over financial reporting during the first quarter of our fiscal 2006 which have materially affected, or are reasonably likely to materially affect, such internal control over financial reporting.

Management performed an assessment of the effectiveness of our internal controls over financial reporting as of March 31, 2005, using the criteria set forth in the *Internal Control – Integrated Framework* by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Management’s assessment identified the following material weakness as of March 31, 2005:

- Our access controls over our financial application system did not operate to segregate incompatible duties. This lack of segregation was not compensated effectively with other compensating, detective controls. This deficiency was evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. The control deficiency could result in a misstatement to the financial statement accounts, resulting in a material misstatement to annual or interim consolidated financial statements that would not be prevented or detected by our internal control over financial reporting.

As previously reported in our Annual Report on Form 10-K for the year ended March 31, 2005, as filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959) we took the following action to remediate the material weakness identified above:

- We implemented changes to our access controls over our financial application system to appropriately segregate incompatible duties. These changes included the removal of certain rights in our financial application system to certain senior level personnel within the finance and accounting department.

PART II.

OTHER INFORMATION

ITEM 1. Legal Proceedings

On June 22, 2005, Telecheck International Inc. filed a complaint for patent infringement in the United States District Court for the Eastern District of Texas Marshall Division against the Corporation and the Corporation's subsidiary LML Payment Systems Corp., in an action styled Telecheck International Inc. as plaintiff vs. LML Payment Systems Inc. and LML Payment Systems Corp. In the suit, Telecheck International Inc. alleges that the Corporation and its subsidiary, LML Payment Systems Corp., infringe U.S. Patent Nos. 5,679,938 and 5,679,940 and seeks damages, injunctive and other relief. We believe these allegations are without merit and intend to vigorously defend against them. At this time, the likelihood of success of this suit is indeterminate and any amounts likely to be payable cannot be reasonably estimated.

In addition to the legal matters as described herein and as previously reported in our Annual Report on Form 10-K for the year ended March 31, 2005, as filed with the Securities and Exchange Commission on June 14, 2005 (file no. 0-13959), we are party from time to time to ordinary litigation incidental to our business, none of which is expected to have a material adverse effect on our results of operations, financial position or liquidity.

ITEM 6. Exhibits

Exhibits:

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

Exhibit Number	Description of Document
3.1	Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended September 30, 2000, of LML Payment Systems Inc. (File No. 0-13959)).
3.2	Bylaws (incorporated by reference to Exhibit 1.2 to the Annual Report on Form 20-F for the fiscal year ended March 31, 1998, of LML Payment Systems Inc. (File No. 0-13959)).
3.3	Amendment to Bylaws of LML Payment Systems Inc. (incorporated by reference to Exhibit 3.3 to the Quarterly Report on Form 10-Q for the period ended September 30, 2001, of LML Payment Systems Inc. (File No. 0-13959)).
31.1*	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2*	Rule 13a-14(a) Certification of Principal Financial Officer.
32.1*	Section 1350 Certification of Chief Executive Officer and Controller and Chief Accounting Officer.

* filed herewith

LML PAYMENT SYSTEMS INC.

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

LML PAYMENT SYSTEMS INC.

By: /s/ Richard R. Schulz

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

Date: August 4, 2005

RULE 13A-14(A) CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Patrick H. Gaines, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of LML Payment Systems Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information, and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Patrick H. Gaines
Patrick H. Gaines
President and CEO
August 4, 2005

RULE 13A-14(A) CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

I, Richard R. Schulz, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of LML Payment Systems Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information, and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Richard R. Schulz
Richard R. Schulz
Controller and Chief Accounting Officer
August 4, 2005

CERTIFICATION

I, Patrick H. Gaines, President and Chief Executive Officer of LML Payment Systems Inc. (the "Corporation") and I, Richard R. Schulz, Controller and Chief Accounting Officer of the Corporation, certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that:

(1) The Quarterly Report on Form 10Q of the Corporation for the three month fiscal period ended June 30, 2005 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78m); and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Corporation.

/s/ Patrick H. Gaines

Patrick H. Gaines
Chief Executive Officer
August 4, 2005

/s/ Richard R. Schulz

Richard R. Schulz
Chief Accounting Officer
August 4, 2005

A signed original of this written statement required by Section 906 has been provided to the Corporation and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.