QSOUND LABS, INC.

Management Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of the Financial Condition and Results of Operations ("MD&A") is provided to assist readers in understanding QSound Labs, Inc.'s ("QSound" or the "Company") and it's subsidiaries financial performance during the periods presented and significant trends that may impact the future performance of QSound. This discussion should be read in conjunction with the audited consolidated financial statements of QSound Labs, Inc. and the related notes thereto.

All amounts are expressed in United States dollars and in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), except where otherwise noted. For a discussion of the principle differences between QSound's financial results as calculated under U.S. GAAP, see note 17 to the consolidated financial statements of QSound.

Overview

QSound is a developer and provider of software solutions for audio, voice and e-commerce applications. The Company operates its business through three different operating units; QSound Labs, the parent company; its wholly-owned subsidiary QCommerce Inc; and its wholly-owned subsidiary QTelNet Inc.

Audio Business Unit

The Audio business unit develops and licenses audio solutions to the world's leading manufacturers of consumer products as well as semiconductor solution providers for these products. Specifically, these are products for the mobile phone, home theatre, video gaming, portable audio and computer markets. Revenues from this business unit comprised 94%, 90% and 84% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are derived primarily through licensing fees, non-recurring engineering fees and per unit royalty agreements.

E-Commerce Business Unit

The E-Commerce business unit provides electronic commerce services, such as on-line storefront hosting and shopping carts, to small businesses. Revenues from this business unit comprised 6%, 8% and 12% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are comprised primarily of monthly subscription fees.

Telephony Business Unit

The Telephony business unit distributes IP Telephony products which are targeted for the small business environment. Revenues from this business unit comprised 0%, 2% and 4% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are derived from product sales to distributors.

Business Outlook

The Company's business is dependent on continued marketing of its microQ software solutions and establishment of strategic partnerships in the mobile device market, together with the marketing its technology in the home entertainment and Bluetooth audio markets. The Company continues to seek out new licensees from which are derived a combination of: up front licensing fees, non recurring engineering fees (compensation for customization, integration support and specific engineering requirements), annual license fees and per unit royalty agreements.

A. Operating Results

The following table summarizes the consolidated results of operations of the Company for the last three years:

	2007		2006		2005	
	Amount	%	Amount	%	Amount	%
Revenue	2,379,139	100%	1,989,030	100%	1,543,240	100%
Cost of sales	(86,930)	(4%)	(85,673)	(4%)	(179,781)	(12%)
Gross Margin	2,292,209	96%	1,903,357	96%	1,363,459	88%
Marketing, Engineering and Administrative Expenses	(3,261,158)	(137%)	(3,040,859)	(153%)	(3,051,219)	(198%)
Foreign Exchange Loss	(3,751)	–	(25,912)	(1%)	(2,832)	–
EBITDA(1)	(972,700)	(41%)	(1,163,414)	(58%)	(1,690,592)	(110%)
Interest Income	72,559	3%	85,686	4%	56,700	4%
Amortization	(226,509)	(10%)	(331,419)	(17%)	(360,898)	(23%)
Impairment of assets	–		(167,809)	(8%)	(518,207)	(34%)
Interest on convertible debt	(81,240)	(3%)	(61,336)	(3%)	–	–
Accretion of debt discount	(56,278)	(2%)	(45,083)	(2%)	–	–
Gain on sale of property and equipment	586	–	–	–	–	–
Loss before taxes	(1,263,582)	(53%)	(1,683,375)	(84%)	(2,512,997)	(163%)
Taxes	(42,485)	(2%)	(50,849)	(3%)	(37,711)	(2%)
Net loss	(1,306,067)	(55%)	(1,734,224)	(87%)	(2,550,708)	(165%)

(1) EBITDA represents net income before interest, taxes, depreciation and amortization. EBITDA is a supplemental non-GAAP financial measure used by management, as well as industry analysts, to evaluate operations. Management believes that EBITDA, as presented, represents a useful means of assessing the performance of the Company's ongoing operating activities, as it reflects the Company's earnings trends without showing the impact of certain charges. The use of EBITDA by the Company has certain material limitations because it excludes the recurring expenditures of interest, income tax, and amortization expenses. Interest expense is a necessary component of the Company's expenses because the Company borrows money to finance its working capital and capital expenditures. Income tax expense is a necessary component of the Company's expenses because the Company is required to pay cash income taxes. Amortization expense is a necessary component of the Company's expenses because the Company uses property and equipment to generate sales. Management compensates for these limitations to the use of EBITDA by using EBITDA as only a supplementary measure of profitability. EBITDA is not used by management as an alternative to net income as an indicator of the Company's operating performance, as an alternative to any other measure of performance in conformity with generally accepted accounting principles or as an alternative to cash flow from operating activities as a measure of liquidity. A reconciliation of EBITDA to Net Income is provided within the table above. Not all companies calculate EBITDA in the same manner and EBITDA does not have a standardized meaning prescribed by GAAP. Accordingly, EBITDA, as the term is used herein, is unlikely to be comparable to EBITDA as reported by other entities

2007 compared to 2006

The Company's net loss for 2007 narrowed further to $1,306,067 ($0.14 per share) from $1,734,224 ($0.19 per share) in 2006, a reduction of 25%. Revenue increased by 20% due to increasing levels of recurring royalty revenue and annual license fees, while gross margin remained constant at 96%. Marketing, Engineering and Administrative Expenses increased $220,000 (7%) due to increased compensation costs and the impact of a weaker US dollar generally on Canadian dollar denominated expenses. Lower amortization expense can be attributed to the impairment of assets that occurred in both 2006 and 2005. Costs associated with the convertible notes increased 29% in 2007 as the convertible notes were only issued on March 27, 2006.

2006 compared to 2005

The Company's net loss for 2006 decreased to $1,734,224 ($0.19 per share) from $2,550,708 ($0.30 per share) in 2005, a reduction of 32%. Revenue increased by 29% due to receipt of two large license fees from partners, together with an acceleration of recurring royalty revenue and annual license fees. Marketing, Engineering and Administrative Expenses remained fairly consistent with only a $10,360 decrease reported. Impairment of assets declined 68% in 2006 as 2005 included an impairment of $428,453 relating to licensing rights whereas 2006's impairment was against telephony assets. Costs associated with the convertible notes only occur in 2006 as the convertible notes were issued on March 27, 2006.

A more detailed discussion of the Company's annual results from operations is provided below:

Revenue:

Sales for 2007 were $2,379,139 an increase of 20% from $1,989,030 in 2006 principally due to increased recurring royalty revenue and annual license fees reflecting increased levels of product sales with microQ embedded technology by the Company's customers.

	2007		2006		2005	
	$	%	$	%	$	%
Up front license fees	289,217	12%	740,697	37%	649,524	42%
Royalties and recurring license fees	1,853,617	78%	951,972	48%	406,985	26%
Product Sales	236,305	10%	296,361	15%	486,731	32%
	2,379,139	100%	1,989,030	100%	1,543,240	100%

Royalty and recurring license fee revenue for the year ended December 31, 2007 increased 95% to $1,853,617 from $951,972 for the year ended December 31, 2006. This increase reflects the growth in recurring royalty revenue from the microQ technology and results from the Company acquiring new licensees during the year combined with licensees continuing to launch new products and increasing levels of sales throughout the year. This annual increase is indicative of the Company's strategic focus of continuing to grow recurring revenues from licensing of its microQ technology.

Up front license fees for the year ended December 31, 2007 and 2006 were $289,217 and $740,697 respectively, a decrease of 61%. The decrease is attributable to a large fee received from a major video game manufacturer during 2006. As the Company's focus continues to be to build a more stable base of recurring revenue the influence on the Company's total revenue by large up front license or engineering fees that may have been negotiated within license agreements will be less marked, although QSound will continue to negotiate these into its license agreements.

Product sales saw a further decline of 20% in 2007 to $236,305 from $296,361 in 2006 which was attributable to two main factors.

Sales to one of the Company's distribution partners which accounted for 32% and 34% of the product sales revenue in 2007 and 2006 respectively have continued to decline during 2007. The impact on the Company is a reduction in revenue of $26,000 from 2006.

Sales in the Company's telephony division declined further in 2007. Revenues fell by 90% (2006: 44% decline) from $31,000 to $3,000 during 2007. This decline was as expected as the division receives no marketing efforts subsequent to the abandonment of an anticipated product launch scheduled to occur during 2005. The Company expects revenue to remain at this level in 2008 as the Company sells through the remaining inventory.

Expenses:

	2007	2006	2005
Marketing ($000)	1,216	1,112	1,000
Change year over year	9%	11%	(20%)

2007 saw a 9% increase in marketing expenses, totalling $1,216,000 for 2007 compared to $1,112,000 in 2006. The increase primarily occurred as the Company continued to increase the level of marketing support for its microQ software technology in order to establish strategic partnerships in the mobile device market. Marketing expense increased primarily due to compensation costs increasing $23,000, consultant costs increasing $50,000 and travel costs increasing $17,000, as the Company aligned itself with the major platform providers.

	2007	2006	2005
Product Engineering ($000)	787	819	952
Change year over year	(4%)	(14%)	(1%)

For the year ended December 31, 2007 product engineering expenses decreased by 4% to $787,000 from $819,000 in 2006. The decrease is attributable to decreases of $65,000 and $13,000 in compensation expenses and travel expenses respectively being partly offset by an increase in consultant costs of $55,000.

	2007	2006	2005
Administration ($000)	1,117	973	883
Change year over year	15%	10%	10%

Administration costs have increased 15% to $1,117,000 for the year ended December 31, 2007 from $973,000 for the previous year principally due to two factors: an increase in compensation expenses ($84,000) and an increase in audit fees ($76,000). The Company has seen salaries increase over the prior year due to inflationary pressures within Western Canada and a strong Canadian dollar, while audit fees have increased as the Company now undergoes a review of its interim financial statements due to the increasing complexity of Canadian and U.S. accounting standards. The strong Canadian dollar has also contributed to other Canadian based expenses increasing over the course of 2007.

Amortization for the year ended December 31, 2007 decreased 31% to $227,000 from $331,000 in 2006, the decrease occurring as a result of the impairment charge on property and equipment which occurred during 2006.

	2007	2006	2005
($000)			
Impairment of Property and Equipment	–	168	90
Impairment of Intangible Assets	–	–	428

Impairment charges were recorded in 2006 and 2005 as changes in circumstances indicated that the carrying amount of particular groups of assets may not be recoverable. The impairment charges were recorded against the telephony business segment assets in both years. In 2007 there have been no events or changes in circumstances to indicate that the carrying value of the remaining assets is not recoverable.

Interest income was $73,000 in the year ended December 31, 2007 compared to $86,000 for the year ended December 31, 2006. The decrease is resultant from lower levels of surplus cash balances being invested due to the cash requirements of the Company’s operating activities. The Company expects interest income to continue to decrease in the short term due to cash balances being used for operating activities and the expected decrease in US interest rates.

Interest on convertible notes has increased 33% to $81,000 for the year ended December 31, 2007 compared to $61,000 for the year ended December 31, 2006. The increase is as expected and results from the issuance of the convertible notes on March 27, 2006. The Company expects interest on convertible notes to decrease in the short term due to expectations of falling US interest rates.

Accretion expense for the year ended December 31, 2007 increased 24% to $56,000 from $45,000 in the corresponding period in 2006, with the increase attributable to using the Effective Interest Rate within the accretion calculation.

Summary of Quarterly Financial Data

The selected quarterly financial data presented below is presented in United States dollars and in accordance with Canadian GAAP. The information is derived from the Company's unaudited quarterly financial statements.

	2007				2006			
	Dec 31	Sept 30	Jun 30	Mar 31	Dec 31	Sept 30	Jun 30	Mar 31
Revenue	304,455	672,294	796,030	606,360	543,405	341,687	430,168	673,770
Net loss	(516,616)	(234,544)	(158,179)	(396,728)	(509,781)	(533,020)	(491,072)	(200,351)
Loss per share	(0.05)	(0.02)	(0.02)	(0.04)	(0.05)	(0.06)	(0.06)	(0.02)
Total cash	1,232,255	1,507,956	1,832,503	1,824,038	2,316,476	2,307,783	2,464,122	2,223,655
Total assets	2,626,663	3,251,976	3,363,809	3,531,771	3,534,885	4,041,512	4,202,713	4,411,921
Total debt	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000

Sales for the quarter ended December 31, 2007 decreased 44% to $304,455 from $543,405 for quarter ended December 31, 2006 reflecting both a decrease in up front license fees and royalties and recurring license fees. Upfront license fees for the three months ended December 31, 2007 and 2006 were $10,000 and $50,000 respectively, a decrease of 80%, while royalty and recurring license fee revenue decreased 43% to $240,741 for the quarter ended December 31, 2007 compared to $423,694 in the corresponding period in 2006. The reasons for the decline in revenue for the quarter ended December 31, 2007 were threefold:

- recognition of annual license fees in 2006 that were previously amortized over time and are now recognized upfront in accordance with revenue recognition criteria. This resulted in a one-time increase to revenue in 2006 of $200,000.
- one license agreement ended during the quarter ended September 30, 2007. This license was renewed as an annual license fee rather than a royalty per unit agreement as the licensee's products are near to the end of their life cycle. The annual license fee had been recognized in revenue in the quarter ended September 30, 2007, thus no revenue was recorded for this license in the quarter ending December 31, 2007.
- an over estimate of royalties in the quarter ended September 30, 2007 as licensees were late in submitting their royalty statements to QSound. Discussions with these companies led management to estimate the royalties due, however royalties were overestimated by $93,000 and thus revenue in the quarter ended December 31, 2007 was impacted negatively by this adjustment.

Expenses have decreased 21% to $789,829 compared to $1,003,232 in the previous year as a result of lower stock based compensation costs in 2007. Net loss was $516,616 or $0.05 per share (basic and diluted) for the quarter ended December 31, 2007, compared to $509,781 or $0.05 per share for the quarter ended December 31, 2006.

Revenue for the quarter ended December 31, 2007 decreased 55% from $672,294 to $304,455 over the quarter ended September 30, 2007, for the reasons previously discussed. Recurring royalty revenue, when adjusted for the over estimate in the quarter ended September 30, 2007, has declined slightly due to a licensee moving over to an annual license fee. Expenses have remained comparable at $789,829 for the quarter ended December 31, 2007 compared to $859,816 for the previous quarter. Net loss was $516,616 or $0.05 per share (basic and diluted) compared to $234,544 or $0.02 per share for the quarter ended September 30, 2007, the increase being reflective of the decrease in revenue.

B. Liquidity and Capital Resources

The Company has historically financed its operations through the issuance of common shares and debt. As at December 31, 2007 the Company had cash and cash equivalents of $1,232,255 compared to $2,316,476 as at December 31, 2006.

For the year ended December 31, 2007 cash used in operating activities was $1,247,205 compared to $708,651 for the year ended December 31, 2007.

For the years ended December 31, 2007 and 2006 cash provided from financing activities was $156,499 and $1,857,882 respectively. In 2007 exercise of stock options generated all of the cash provided, while 2006 saw 500,000 warrants being exercised for $520,000, issuance of $1,000,000 convertible notes and exercise of stock options for $337,882.

For the year ended December 31, 2007 cash provided from investing activities was $6,485 compared to cash used in investing activities of $55,484 for the year ended December 31, 2006. Cash provided from investing activities resulted primarily from receipt of $36,000 of the outstanding note receivable and receipt of $586 from the Sale of Property and Equipment, offset by investment in Property and Equipment of $18,243 and Intangible Assets of $11,858. Cash used in investing activities for the year ended December 31, 2006 resulted from $39,500 expended on Deferred Development Costs and $42,426 on Property and Equipment, being offset by receipt of $26,442 of the outstanding Note Receivable.

C. Research and Development

Audio Business: QSound carries out sustained research and development activities in the audio business segment, allowing us to maintain our position as a world leader in audio enhancement with cutting edge products and technologies. In 2007, 2006 and 2005 we continued our previous research and development activities of developing new, and refining and upgrading existing, audio synthesis and enhancement technologies. This work is in part carried out through work with our licensees and business partners through integration of our technology into their products and also through joint venture projects. In 2007, 2006 and 2005 continued development and refinement of the Company's microQ scalable software engine was the main "in house" focus. The Company's audio research and development costs were $787,000 in 2007, $819,000 in 2006 and $952,000 in 2005. Also during 2006 and 2005, the Company, through participation in a joint venture, undertook development of a voice chat conferencing system, incurring costs of $39,000 and $353,000 respectively. These costs have been capitalized and from 2006, as this is when commercial production commenced, have been amortized over the useful economic life of the asset. The Company has one patent application, as well as further applications in development. (See "Intellectual Property" under Item 4 of this report.)

E-commerce Business: Research and development expenditures in our e-commerce business segment have steadily decreased, reflecting the performance of our products. There were no research and development activities during 2007 and 2006, with expenditures in 2005 totalling $33,000 respectively relating to upgrading of products.

Internet Telephony Business: Subsequent to the abandoning of a telephony project in 2005 the Company has not incurred any further research and development expenses within its telephony business segment. During 2005 the Company incurred expenditure of $112,000 relating to this project. Due to the abandonment of the project an impairment charge totaling $518,000 was booked as the Company determined that the carrying value of the project assets was not recoverable. However, further to resolution of legal proceedings with the project developer during 2006, the Company now has possession of the assets and fully intends to use these in the future.

Share Capital

The weighted average number of shares (basic and diluted) outstanding during 2007 was 9,420,808, an increase of 246,723 (3%) over the prior year due to the exercise of stock options.

As at December 31, 2007, the following shares and securities convertible into shares, were outstanding:

	December 31, 2007 Shares	December 31, 2006 Shares
Shares outstanding	9,462,985	9,375,585
Stock options	858,500	981,700
Warrants	614,130	614,130
Convertible note	307,693	307,693
Shares outstanding and issuable	11,243,308	11,279,108

Convertible Note

On March 27, 2006, the Company issued a $1,000,000 convertible note and 400,000 related share purchase warrants. The note is due in five years and bears interest at the US prime rate payable quarterly in arrears.

The note is convertible at the option of the holder at any time and from time to time into common stock of the Company at a conversion price of $3.25 per share. Additionally, in the event that the Company issues securities convertible into common stock at a price less than this conversion price, the conversion price shall be immediately adjusted to the price at which such securities were issued.

The warrants issued are each exercisable into one common share at an exercise price of $4.50 per share until March 27, 2011.

The warrants also contain provisions to adjust the exercise price in the event that the Company issues securities convertible into shares at a price less than the then applicable exercise price, in which case the exercise price shall be reduced to the same terms as the convertible securities issued.

Significant Accounting Policies and Application of Critical Accounting Estimates

The significant accounting policies used by the Company are described below. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in these estimates and assumptions may have a material impact on the Company's financial results and condition. The following discusses such accounting policies and is included herein to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. Management reviews its estimates and assumptions regularly. The emergence of new information and changed circumstances may result in changes to estimates and assumptions which could be material and the Company might realize different results from the application of new accounting standards promulgated, from time to time, by various regulatory rule-making bodies. The following assessment of significant accounting polices is not meant to be exhaustive.

<u>Revenue recognition</u>

The Company generates revenue from sale of licenses for software products, royalties, and engineering fees. The Company recognizes revenue, when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery of the software product has occurred or the services have been performed, the price is fixed or determinable, customer acceptance has been received, and collection is reasonably assured. When software sales arrangements contain multiple elements, the Company allocates revenue to each element of accounting based on vendor specific objective evidence of fair value. In the absence of fair value for a delivered element, the Company allocates revenue to the undelivered items based on fair value with the residual amount allocated to the delivered elements. Where the fair value of an undelivered element cannot be determined, the Company would defer revenue for the delivered elements until the undelivered elements are delivered.

Software license fees, royalties, and engineering fees collected on projects in advance of revenue being recognized are recorded as deferred revenue.

The Company also generates revenue from the sale of other products. Revenue from other product sales is recognized when products are shipped pursuant to sales arrangements with customers (which is when title passes), collectibility is reasonably assured, and the Company has no further obligations relating to the product.

<u>Research and development costs</u>

Research costs are expensed as incurred. Development costs are expensed as incurred except if they relate to a specific product or process that management believes is technically and economically feasible and recoverable, in which case these costs are deferred.

Amortization of deferred development costs commences with commercial production / use of the process, and is amortized at a rate of 20% per annum over its useful economic life.

The Company assesses impairment of deferred development costs by determining whether their recoverable amounts are less than their unamortized balance. When a potential impairment is identified, the amount of impairment is calculated by reference to the related net expected future cash flows and charged to period earnings.

Income taxes

The Company uses the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities as a result of a change in tax rates is recognized as part of the provision for income taxes in the period that includes the substantive enactment date.

To the extent that future income tax assets are not considered to be more likely than not realized, a valuation allowance is provided.

Stock based compensation

Stock Options: The fair value of each option granted is estimated on date of grant using the Black Scholes option pricing model. The amount is credited to contributed surplus and expensed over the vesting period. Upon exercise of the options, the exercise proceeds together with amounts credited to contributed surplus are credited to share capital.

Share Awards: The fair value of each award issued is calculated using the closing price on the date of grant.

Recent Accounting Pronouncements

Under revised CICA section 1506 “Accounting Changes” and the Securities and Exchange Commission’s (SEC) Staff Accounting Bulletin 74 (SAB 74), the Company is required to disclose certain information related to recently issued accounting standards. This guidance requires that when a new accounting standard has been issued but not yet adopted, the Company should discuss the effect that the new standard will have on the Company’s financial statements when adopted.

Canadian GAAP pronouncements

(i) Financial Instruments (CICA 1530, 3855, 3861)

Effective January 1, 2007, the Company adopted Section 1530 - Comprehensive Income, Section 3855 - Financial Instrument Recognition and Measurement and Section 3861 - Financial Instruments Disclosure and Presentation, of the Canadian Institute of Chartered Accountants Handbook in accordance with the transitional provisions in each respective section.

The adoption of Sections 1530, 3855 and 3861 did not have a material impact on the financial statements of the Company and did not result in any adjustments for the recognition, de-recognition or measurement of financial instruments as compared to the financial statements for periods prior to the adoption of these sections.

(ii) CICA 1506 – Accounting Changes

Effective January 1, 2007, the Company adopted revised CICA section 1506, “Accounting Changes.” The amendments in the revised standard indicate that voluntary changes in accounting policy are only permitted if they result in financial statements that provide more reliable and relevant information. When a change in accounting policy is made, this change is applied retrospectively unless impractical. Changes in accounting estimates are generally applied prospectively and material prior period errors are corrected retrospectively. This section also outlines additional disclosure requirements when accounting changes are applied including justification for voluntary changes, complete description of the policy, primary source of GAAP and detailed effect on financial statement line items.

(iii) CICA 3031 – Inventories

This section replaces CICA Section 3030 and applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The new section is harmonized with International Accounting Standards and provides additional guidance on the measurement and disclosure requirements for inventories. Specifically, inventories are required to be measured at the lower of cost and net realizable value. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company's financial statements.

(iv) CICA 3862 – Financial Instruments - Disclosure and CICA 3863 – Financial Instruments - Presentation

Both sections establish new levels of disclosure required for financial instruments in the financial statements. The section is effective for annual periods beginning on/after October 1, 2007.

US GAAP pronouncements

(i) FAS 157 – Fair Value Measurements

This statement defines fair value, establishes a framework for measuring fair value within GAAP and expands disclosures about fair value measurements. This is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company's financial statements.

(ii) FAS 159 – The Fair Value Option for Financial Assets and Financial Liabilities

This statement permits entities to choose to measure financial instruments and other certain items at fair value that are not currently required to be measured at fair value. This is effective for fiscal years beginning after November 15, 2007. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company's financial statements.

D. Trends

The continuing growth in the mobile device market and the increasing adoption of audio features for this market has been the single most important trend for audio IP suppliers in recent years. The Company has focused primarily on this market segment. Specifically, the focus has been on the largest segment of this market – mobile phones. High-end phones are now shipping with the capability of offering mobile TV, downloadable music and video game services all of which require audio processing. All phones require the capability to play ring tones.

The mobile device market is driven by consumer growth in Asia, however, QSound continues to enter license agreements with companies that are headquartered in the U.S. but have a worldwide presence. The Company expects that future revenues will continue to be largely derived from the U.S. but that percentage growth will be seen from Asian licensees. The following table presents the geographic segment information:

	2007	2006	2005
U.S.	72%	49%	63%
Asia	21%	50%	32%
Europe	1%	-	3%
Canada	6%	1%	-
Other	-	-	2%
	100%	100%	100%

The Company anticipates that it will continue to acquire new licensees through marketing of existing audio and voice IP, together with development of new technology.

The Company has seen growth in its recurring revenue base (royalties and annual license fees) in recent years and the Company anticipates that this will continue with the acquisition of new licensees, as the new license agreements incorporate per unit royalties.

	2007	2006	2005

Up front license fees	12%	37%	42%
Royalties and recurring license fees	78%	48%	26%
Product Sales	10%	15%	32%
	100%	100%	100%

As the Company will continue to focus its development and marketing efforts on its microQ software technology in 2008 its other business segments, e-commerce and IP telephony, are expected to continue at current performance levels.

With the continued focus on marketing of its microQ software technology, the Company believes that marketing expenditure will increase in 2008. This is directly attributable to increased compensation levels as a result of new hires in the latter part of 2007, together with an increasing presence at international trade shows.

Other costs will not be affected through the increase in revenues as they mostly comprise fixed compensation and travel expenses, although inflationary pressures in Western Canada and a continuing weak US dollar will mean other operating expenses will remain at the levels experienced during 2007.

The Company has no plans for any major capital expenditures.

E. Off-Balance Sheet Arrangements

The Company has not engaged in off-balance sheet financing arrangements through special purpose entities.

F. Tabular Disclosure of Contractual Obligations

Period Due	Long Term Debt	Operating Lease Commitments	Total
(US Dollars)			
2008	63,108	97,744	160,852
2009	60,000	17,183	137,183
2010	60,000	10,023	24,160
2011	14,137	-	-
2012	–	-	-
	197,245	124,950	322,195

The commitment classified as long term debt is the cash interest expense and is calculated assuming that US prime rate remains at 6%.

G. Safe Harbour

This document and other documents filed by the Company with the SEC contain certain forward-looking statements with respect to the business of the Company, including prospective financing arrangements. These forward-looking statements are subject to certain risks and uncertainties, including those mentioned above, which may cause actual results to differ significantly from these forward-looking statement.