

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark One)

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended **December 31, 2006**.

OR

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

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
Date of event requiring this shell company report \_\_\_\_\_

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: 0-17212

**QSOUND LABS, INC.**

(Exact name of registrant as specified in its charter)

**Alberta, Canada**

(Jurisdiction of incorporation or organization)

**#400, 3115 – 12<sup>th</sup> Street N.E.**

**Calgary, Alberta**

**T2E 7J2**

**CANADA**

**Tel (403) 291-2492**

**Fax (403) 250-1521**

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class Common Shares Name of each exchange on which registered The Nasdaq Stock Market LLC

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: \_\_\_\_\_

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: **Common Shares at December 31, 2006: 9,375,585**

Indicate by check mark if the registrant is a well-know seasoned issuer, as defined in Rule 405 of the Securities Act.  Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934.  Yes  No

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 a large accelerated filer, an accelerated filer or a non-accelerated filer.  
Large Accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elect to follow. Item 17  Item 18

If this is an annual report, indicate by the check mark whether the registrant is a shell company.  Yes  No

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**Note: All references to dollar amounts in this Annual Report are stated in United States Dollars under Canadian GAAP unless otherwise stated.**

The terms “QSound”, “our company”, “the Company”, “we”, “us” and “our” as used in this Annual Report on Form 20-F (this “Annual Report”) refer to QSound Labs, Inc. and its subsidiaries, including QSound Ltd., QCommerce Inc. and QTelNet Inc., as a combined entity, except where the context requires otherwise.

### **CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS**

This Annual Report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, reflecting management's current expectations. These statements relate to our future plans, objectives, expectations and intentions. We use words such as “may,” “expect,” “anticipate,” “project,” “believe,” “plan,” “intend,” “future” and other similar expressions to identify forward-looking statements. These forward-looking statements involve inherent risks and uncertainties that may cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that could contribute to differences include, but are not limited to, those discussed in Item 3.D, entitled “Risk Factors”, and elsewhere in this Annual Report.

## **PART I**

### **ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

#### **A. Directors and Senior Management**

Not Applicable.

#### **B. Advisors**

Not Applicable.

#### **C. Auditors**

Not Applicable.

### **ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

#### **A. Offer Statistics**

Not Applicable.

#### **B. Method and Expected Timetable**

Not Applicable.

### **ITEM 3. KEY INFORMATION**

#### **A. Selected Financial Data**

The selected financial data presented below for the five years ended December 31, 2006 is derived from QSound's consolidated financial statements that were examined by the Company's independent auditors. The information set forth below should be read in conjunction with the consolidated financial statements of QSound (including notes thereto) included under item 17 and "Operating and Financial Review and Prospects" included under item 5. The selected financial data presented below is presented in United States dollars and in accordance with Canadian generally accepted accounting principles ("Canadian GAAP").

Selected Financial Data					
Years ended December 31, 2006, 2005, 2004, 2003, and 2002					
Under Canadian GAAP in United States Dollars					
	2006	2005	2004	2003	2002
Revenue	\$ 1,989,030	\$ 1,543,240	\$ 2,213,178	\$ 2,043,088	\$ 4,224,311
Gross Margin	1,948,942	1,363,459	1,793,888	1,617,997	3,952,781
Expenses	3,609,947	3,932,993	3,758,744	3,044,454	2,663,235
Operating (loss) profit	(1,661,005)	(2,569,534)	(1,964,856)	(1,426,457)	1,289,546
Other items	(22,370)	(56,537)	61,414	(2,270,631)	(140,853)
Loss before taxes	(1,683,375)	(2,512,997)	(1,903,442)	(3,697,088)	1,148,693
Foreign withholding tax	(50,849)	(37,711)	(22,504)	(8,543)	(19,741)
Net (loss) income for the year	(1,734,224)	(2,550,708)	(1,925,946)	(3,705,631)	1,128,952
Deficit, beginning					

of year	(46,252,276)	(43,701,568)	(41,775,622)	(38,069,991)	(39,198,943)
Deficit, end of year	<u>\$(47,986,500)</u>	<u>\$(46,252,276)</u>	<u>\$(43,701,568)</u>	<u>\$(41,775,622)</u>	<u>\$(38,069,991)</u>
Income (loss) per common share, basic	\$ (0.19)	\$ (0.30)	\$ (0.25)	\$ (0.52)	\$ 0.16
Income (loss) per common share, diluted	<u>\$ (0.19)</u>	<u>\$ (0.30)</u>	<u>\$ (0.25)</u>	<u>\$ (0.52)</u>	<u>\$ 0.15</u>
Total assets	<u>\$ 3,534,885</u>	<u>\$ 3,002,315</u>	<u>\$ 5,227,834</u>	<u>\$ 3,776,579</u>	<u>\$ 7,271,766</u>
Net assets	<u>\$ 2,831,012</u>	<u>\$ 2,671,518</u>	<u>\$ 4,922,425</u>	<u>\$ 3,446,834</u>	<u>\$ 6,930,361</u>
Capital Stock	\$ 47,208,942	\$ 45,979,055	\$ 45,792,526	\$ 44,108,140	\$ 43,886,036
Shareholders' equity	<u>\$ 2,831,012</u>	<u>\$ 2,671,518</u>	<u>\$ 4,922,425</u>	<u>\$ 3,446,834</u>	<u>\$ 6,930,361</u>
Share capital – common shares issued and outstanding	<u>9,375,585</u>	<u>8,661,985</u>	<u>8,404,085</u>	<u>7,199,244</u>	<u>7,156,074</u>

No dividends have been declared or paid for any of the periods presented.

Net loss, shareholders' equity and other balance sheet amounts as determined in accordance with Canadian GAAP differ from those determined in accordance with United States generally accepted accounting principles ("U.S. GAAP"), due principally to the recording of compensation expense for stock options prior to January 1, 2003, the recording of deferred development costs as an expense rather than capitalized and the recording of a beneficial conversion feature of the convertible notes rather than bifurcating the liability and conversion option. See Note 17 to the December 31, 2006 consolidated financial statements included under Item 17.

	Under U.S. GAAP in United States Dollars				
	2006	2005	2004	2003	2002
Net (loss) income for the year	<u>\$ (1,681,675)</u>	<u>\$ (2,631,579)</u>	<u>\$ (1,925,946)</u>	<u>\$ (3,705,631)</u>	<u>\$ 1,128,952</u>
Income (loss) per common share, basic	\$ (0.20)	\$ (0.31)	\$ (0.25)	\$ (0.52)	\$ 0.16
Income (loss) per common share, diluted	<u>\$ (0.20)</u>	<u>\$ (0.31)</u>	<u>\$ (0.25)</u>	<u>\$ (0.52)</u>	<u>\$ 0.15</u>
Total assets	<u>\$ 3,474,232</u>	<u>\$ 2,921,444</u>	<u>\$ 5,227,834</u>	<u>\$ 3,776,579</u>	<u>\$ 7,271,766</u>
Shareholders' equity	<u>\$ 3,075,272</u>	<u>\$ 2,590,647</u>	<u>\$ 4,922,425</u>	<u>\$ 3,446,834</u>	<u>\$ 6,930,361</u>

At March 1, 2007 the exchange rate was U.S. \$0.856 per CDN. \$1.00.

The high and low exchange rates for each month during the previous six months ended February 28, 2007, and the average rates (average of the exchange rates on the last day of each month during the year) for Canadian dollars for each

of the years in the five year period ended December 31, 2006 based on the closing rates of the Bank of Canada and expressed in U.S. dollars were as follows:

	Month High	Low
February 2007	0.8647	0.8419
January 2007	0.8576	0.8440
December 2006	0.8746	0.8569
November 2006	0.8846	0.8699
October 2006	0.8937	0.8760
September 2006	0.9034	0.8858

	Average
2006 Year	0.8820
2005 Year	0.8259
2004 Year	0.7698
2003 Year	0.7135
2002 Year	0.6368

#### **B. Capitalization and Indebtedness**

Not Applicable

#### **C. Reasons For the Offer and Use of Proceeds**

Not Applicable

#### **D. Risk Factors**

The following is a summary of certain risks and uncertainties which we face in our business. These risk factors should be read in conjunction with other cautionary statements which we make in this Annual Report and in our other public reports, registration statements and public announcements. If any of the following risks actually occur, our business, results of operations and financial condition could suffer significantly.

**We were not profitable in 2006 or in 2005 in any of our business segments. The IP telephony and e-commerce business units have never been profitable. Except for 2002, we have been only marginally profitable in previous years, and we have had to rely on the sale of our common shares, and in the past on debt financing, to fund our business operations.**

With the exception of 2002, we have a history of losses and we have had to fund our operations through a combination of equity and debt financings. In 2006 we had revenues of \$1,989,030 and operating expenses of \$3,650,035, including cost of products sold of \$40,088. The net loss for 2006 was \$1,734,224. In 2005 we had revenues of \$1,543,240 and operating expenses of \$4,112,774, including cost of products sold of \$179,781. The net loss for the year was \$2,550,708. If we are not successful in enhancing revenues through increased sales of our products and technologies or the development and marketing of additional products, or if there is a material increase in our expenses, we may be unable to achieve profitability in the future. As a result, we may have to rely on the sale of shares and on debt financings in the future to fund our operations. If we are unable to raise financing when and in the amount required, we may be required to cease operations.

**Most of our audio industry revenues come from a limited number of accounts and a significant change in the performance or a loss of these accounts would have a material effect on our revenues.**

The sources of our audio industry revenues are limited in number and a reduction in the performance, or expiration or termination, of any of these accounts, would have a material effect on our revenues and consequently, the company's financial condition. In the event that we lose one or more of these accounts, our results of operation would suffer materially.

**Our audio revenues depend primarily on license fees and recurring royalties generated upon the sale of devices that incorporate our technology. As a result, we are highly dependent upon the sales efforts of the manufacturers of these products and market acceptance of their product offering.**

Our primary business in the audio business revolves around entering into license agreements with semiconductor and handset manufacturers who wish to incorporate our microQ audio engine technology into their products. Under most of these agreements, we generate revenue based on the number of units incorporating our microQ audio engine produced by each manufacturer. Factors that contribute to performance of these products include, among others:

- end-user demand;
- timeliness, quality and pricing;
- success or failure of distribution and commercialization efforts;
- competition from similar or substitute products;
- manufacturing uncertainties; and
- general or regional economic conditions.

If these products do not meet the currently anticipated timeline or if these products are not widely accepted by consumers, our revenue stream may be delayed or may not materialize at all. As a consequence of the effect that these and similar factors may have on our licensees, customers and partners, we may from time to time experience significant fluctuations in our revenues.

**To succeed in the audio industry we must be able to identify emerging technological and market trends, to enhance our existing technologies and develop new technologies, and to achieve and maintain wide distribution.**

The audio industry is characterized by a number of factors including:

- rapid technological changes;
- short technology and product life cycles;
- escalating pressure to provide improved audio solutions at increasingly lower prices;
- frequent introduction of new technologies and products; and
- development of audio enhancement technologies in-house by potential customers.

It is important for us to be able to identify emerging trends in the mobile devices, consumer electronics, PC multimedia and Internet audio environments, and to enhance our existing technologies and develop new technologies and products to meet these continually changing market requirements. The development of our products and technologies must continue to focus on technological superiority over the offerings of our competitors while meeting the needs of our customers and potential customers, including competitive pricing and expeditious completion of development. Additionally, there must be sufficient consumer interest in and demand for enhanced audio to motivate our customers to use our products and technologies in their offerings. If we do not continue to develop premium new technologies and products timely and cost effectively, we will not be able to achieve profitability in the audio industry.

**Due to the rapid technological development in our field and changing regulatory and industry standards, our IP telephony technologies may become obsolete quickly.**

The IP telephony industry is characterized by rapid technological advances, evolving industry standards and frequent new product introductions. Unless we continue development and improvement of our technologies to respond to advances in technology and changes in the regulatory landscape, our products may not be accepted by consumers or industry regulators. To keep pace with industry changes, we must continue to incur research and development costs which may not be offset by new and existing revenue streams.

**Our products incorporate technologies licensed from a number of third parties. If we are unable to maintain these licenses on favorable terms or we are unable to effectively integrate these technologies, our revenues will suffer.**

Our products incorporate a number of technologies licensed from third parties. If we are unable to maintain our relationships with these third parties on favorable terms or if we are unable to successfully integrate these technologies into our product line, we may need to revise our products, including by limiting product features or locating substitute technologies. Any modifications of our products would be costly and divert research and development efforts. As a result, our business and results of operations would suffer.

**If we fail to obtain product standard certification in particular countries we will be unable to sell our IP telephony products in such countries. Any such limitations would adversely impact our revenues and business prospects.**

Our IP telephony products must meet certain safety and radio-frequency emission standards. Products that connect to the telephone network must also meet certain standards aimed at protecting the network. Virtually all countries have developed their own sets of standards, which are not uniform. If we do not obtain certifications attesting that our products comply with the standards of the country where our equipment will be used, we will be unable to export our products to that country. Any such failure would adversely impact our revenues and business prospects.

**Telecommunications failures, computer viruses, breaches of security or terrorist attacks could disrupt our IP telephony and e-commerce businesses by reducing consumer confidence in the Internet as a means of communication and commerce.**

Internet communications are susceptible to interruptions resulting from factors including telecommunications failures, computer viruses, capacity limitations, breaches of security, terrorist attacks and vandalism. If one or a combination of these events causes consumers to lose confidence in the Internet as a means for communication or commerce, the growth of use of the Internet and reliance upon the Internet as an alternative to the telephone network would be negatively impacted. Any shift of consumers away from the Internet would adversely impact sales of our IP telephony and e-commerce products.

**Our e-commerce revenues have declined in the past few years and we do not expect growth in this business.**

Our e-commerce revenues have declined in the past few years. Consolidation has become the principal method for acquiring new merchants, and we do not expect organic growth in our merchant base nor do we anticipate adding merchants through acquisition of competitors. Larger service providers may offer their products and services at reduced prices and we may have to adjust our prices accordingly. As new technologies are developed and introduced, our e-commerce products may become less attractive to small business merchants.

**Many of our competitors have greater resources available to them. If we fail to compete effectively with our competitors, our results of operation and viability will be negatively impacted.**

The audio, IP telephony and electronic commerce industries are intensely competitive. We have competitors in these industries who have technologies and products that are similar to ours and compete directly with us. Many of these competitors are large, established companies with significantly greater resources than we have. If we are unable to develop and commercialize products that consumers view as superior to those of our competitors in terms of leading edge technology, performance, features, functions or price, among other elements, our results of operation will suffer.

**Our products and technologies are based on our intellectual property. If we fail to adequately protect our intellectual property our business will suffer, and if we are sued for infringement by a third party we will incur significant legal expenses and may be required to pay substantial fees and/or cease using any such intellectual property.**

Our success depends largely on our ability to protect our proprietary technologies and to keep infringers from using and marketing our technologies. We rely upon U.S. and international patent, copyright, trade secret and trademark laws to protect our intellectual property. We also rely on contractual obligations such as non-disclosure agreements. Third parties may copy our technologies and we may be unable to prevent the sale of infringing products. Also, third parties may successfully develop products which compete with our products and which do not infringe our intellectual property rights. In addition, third parties may successfully assert that our technologies and products infringe their products and that our patents are invalid. Our business will suffer if we are not successful in defending our intellectual property, and we will incur significant legal expenses if we must defend third party infringement claims. In addition, we may be ordered to pay substantial penalties and/or cease using certain intellectual property if we are found to have infringed on the intellectual property rights of a third party.



**New equity financing would dilute current shareholders.**

If we raise funds through future equity financing, it will have a dilutive effect on existing holders of our shares by reducing their percentage ownership. The shares may be sold at a time when the market price is low because we need the funds. This will dilute existing holders more than if our stock price were higher. In addition, private equity financings normally involve shares sold at a discount to the current public market price. Our articles of incorporation allow us to issue an unlimited number of common and preferred stock. Therefore, there is no theoretical cap on the amount of dilution our investors may suffer in subsequent financings.

**The market price of our common shares has been and continues to be volatile.**

The trading price of our common shares on the NASDAQ Capital Market has been and continues to be volatile. During the twelve months ending on March 5, 2007 our stock price has ranged from a high of \$6.09 to a low of \$3.58. The market price may be affected by announcements of, among other things:

- new products by our competitors;
- fluctuations in our operating results;
- assertions of intellectual property infringement made by us against third parties or by third parties against us; and
- changes in our financial position.

In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. A securities class action lawsuit against us, regardless of its merit, could result in substantial costs and divert the attention of our management from other business concerns, which in turn could have a materially adverse impact on our financial results.

**If we experience rapid growth and do not manage it effectively our business and financial results will suffer.**

If our technologies and products achieve wide acceptance we may experience rapid growth. We may have to hire more employees including additional management, improve our financial and control systems, and expand and manage our technical, sales and support services operations. We would need increased revenues and/or additional funding to operate these increased activities. If we do not manage our growth effectively our business and financial results will suffer.

**We depend on key employees and our business may suffer if we are not able to keep these employees or hire and train replacements.**

Our success depends on the skills, experience and performance of our senior management and certain other key personnel. We do not carry key personnel insurance on these employees. Experienced management and highly skilled engineers and software programmers are critical to the success of our business and are in high demand. We would suffer adverse effects if we are unable to successfully retain our key personnel, or hire and train suitable replacements.

**Some of our directors and officers may in the future have potential conflicts of interest between their positions with QSound and their positions as executives or directors of companies that are in the same industries in which we engage.**

Some of our officers and directors may in the future have conflicts of interest due to involvement as shareholders, officers, directors or partners of businesses that are engaged in the audio technology, IP telephony or e-commerce industries. These conflicts could include time and effort devoted to QSound, competition for customers and suppliers and interest in material contracts. Although our by-laws and our corporate legislation require disclosure of conflicts of interest, and our code of ethics prohibits such conflicts, should a conflict arise our business could be adversely affected.

**We are incorporated in Alberta, Canada, some of our directors and officers live in Canada, and most of our assets are in Canada, and investors may have difficulty initiating legal claims and enforcing judgments against us and our directors and officers.**

We are incorporated in the Province of Alberta, Canada. Certain of our directors and officers live in Canada, and most of our assets, and the assets of those officers and directors, are located in Canada. As a result, it may be difficult for investors to effect service of legal process within the United States upon directors and officers who are not United States residents. Also, there is

uncertainty as to the enforceability in Canada, in original actions or for enforcement of judgments of U.S. courts, of civil liabilities predicated upon U.S. federal or state securities laws.

#### ITEM 4. INFORMATION ON THE COMPANY

##### **A. History and Development of the Company**

QSound Labs, Inc. was reincorporated on July 10, 1990 in the province of Alberta, Canada under the Business Corporations Act of Alberta, by way of continuance from the province of British Columbia where QSound was originally incorporated on December 6, 1968. The address of our registered office is Suite 400 – 3115 12<sup>th</sup> Street NE, Calgary, Alberta, Canada T2E 7J2 and the telephone number is (403) 291-2492.

Since 1988 QSound's main focus is development, licensing and distribution of audio enhancement algorithms and software to semiconductor/component and OEM licensees in the mobile devices, consumer electronics and personal computer industries. In 2006 we added eight licensees for microQ™, our audio software engine for portable applications, in the growing mobile and handheld devices market, and six consumer electronics and PC licensees for audio enhancement. Since 2003 we sell Internet telephony technology products through our subsidiary QTelNet Inc. Since 1999 our subsidiary QCommerce Inc. provides e-commerce enabling services to small business merchants.

##### **Capital Expenditures**

Our principal capital expenditures for each of fiscal year 2006, 2005, and 2004 are detailed in the table below:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Sound source and control equipment	\$ 2,895	\$ –	\$ 1,320
Furniture and fixtures	185	2,014	5,092
Computer equipment	39,346	98,481	103,468
Software and production tooling	–	88,393	54,576
Deferred development costs	39,500	352,750	–
Patents and trademarks	–	50,977	46,233
Licensing rights	–	–	428,453
Total	\$ 81,926	\$ 592,615	\$ 639,142

We had no divestitures in either fiscal 2006 or 2005. In fiscal 2004 our divestitures consisted of sound source and control equipment, furniture and fixtures, and computer equipment with a combined net book value of \$20,045.

##### **B. Business Overview**

QSound was engaged in three business segments in 2006:

a) **Audio Business Segment** Since its inception in 1988 QSound has established itself as one of the world's leading audio technology companies, and we derive most of our revenues from this business segment. QSound develops, markets and distributes multimedia software solutions and licenses algorithms based on our patented, proprietary audio technology portfolio. Our strategy is to focus on new products and technologies targeted for high-growth markets where the technical barriers to entry are high, and where we can lever our audio technology expertise to penetrate the market. We generate revenues by licensing to original equipment manufacturers and chip manufacturers in the mobile and handheld devices, consumer electronics, and computer multimedia markets, through sales of QSound-enabled analog chips to consumer electronics manufacturers, and by selling downloadable software products for Internet streaming audio, primarily through third parties and also directly, to consumers over the Internet.

b) **Internet Telephony Business Segment** Our wholly owned Alberta subsidiary QTelNet Inc. has developed and sells Internet telephony products under the brand-name FreeRide™. We target the small to medium sized business and enterprise branch office market, offering Freeride products that enable these businesses to eliminate long distance charges between offices and to expand existing switchboards to encompass remote teleworkers or offices. QTelNet plans to develop new VoIP applications.

c) **E-commerce Business Segment** Our wholly owned Washington subsidiary QCommerce Inc. provides electronic commerce services that enable electronic commerce for small businesses. QCommerce provides our existing client base of Web merchants with all of the tools necessary to set up and operate an on-line store, and with marketing and advertising services to drive targeted traffic to the store.

## Audio Business Segment

QSound is a world leader in the development, marketing and distribution of audio enhancement and audio synthesis technologies, and audio engines. The QSOUND® portfolio of proprietary technologies includes a complete suite of virtual audio, reverberation, synthesis and enhancement algorithms as well as all of the components required to create custom software audio engines, namely, a music synthesiser, a digital audio playback engine, a sample rate converter and a mixer.

QSOUND technologies are currently shipped in:

- mobile phones & PDA's
- DVD players
- home theatre systems, TV's and VCR's
- stereo systems
- amplified and USB speakers
- PC's and PC peripherals including sound cards, speakers and monitors
- video games

### QSOUND Portfolio of Technologies

Our technological efforts concentrate on the development and upgrading of a complete suite of proprietary technologies to cover all aspects of enhanced audio and audio synthesis requirements in the mobile devices, multimedia computer and consumer electronics industries. The QSOUND portfolio consists of:

- Software Engines

microQ™: microQ is a modular and scalable software digital audio engine providing functions such as polyphonic ringtones, game sound, music playback, digital effects and recording for portable and embedded applications in the growing hand-held and mobile devices markets. microQ offers a highly flexible modular architecture, a small memory footprint and support for industry standard (linear and compressed) content formats. microQ's core components consist of a digital audio playback engine, a wavetable synthesis engine with a scalable sample set, a multi-channel stereo mixer and a sample rate convertor.

QVE™: The QSound Virtual Engine ("QVE") is a scalable software audio engine for PCs, soundboards and other digital devices. QVE provides synthesis and digital audio playback for entertainment audio applications, and is a platform for incorporating all of the proprietary algorithms described below.

QMixer™: QMixer is a high-performance audio mixer targeted at game developers. QMixer adds 3D speaker or headphone audio to regular stereo sound cards and also takes advantage of available DirectSound®3D and EAX®-compatible acceleration hardware. QMixer uses low CPU overhead and includes advanced resource management to dynamically distribute the rendering duties between hardware and software.

- 3D Audio Algorithms

Q3D™: Q3D 2.0 is our interactive sound positioning technology, which places multiple individual sounds in specific locations outside of the bounds of stereo speakers and headphones, and positions sound with equal effectiveness via multiple speaker systems. Q3D 2.0 also includes QSound Environmental Modeling® ("QEM"™), a reverberation engine which is compatible with the EAX (Environmental Audio Extensions®) API from Creative Labs, Inc.

QSURROUND®: QSURROUND creates virtual surround sound for audio played back over two speaker and headphone entertainment systems. QSURROUND has been developed by QSound to take advantage of the DVD format and the digital broadcast format, both of which have become standards for music, video game and movie playback. Using QSURROUND, decoded Dolby Digital, Dolby ProLogic® and MPEG2 multi-channel audio streams can be played back over only two speakers, while maintaining the illusion of a multi-speaker system through creation of phantom or "virtual" speakers or headphones, eliminating the need for additional speakers. Dolby Digital and MPEG2 are the current audio standards for DVD-based personal computers and home entertainment systems. QSURROUND has been certified by Dolby Laboratories for use with Dolby Digital and ProLogic.

QXPANDER®: QXPANDER processes existing pre-mixed stereo material to provide 3D enhancement for audio played back over traditional two speaker or headphone stereo.

QMDV™: QSOUND Matrix Surround Decoder/Virtualizer (“QMDV”), a superset of QXPANDER, decodes stereo audio material which has been encoded using matrix surround encoding such as Dolby Surround, and virtualizes the decoded material to create a multiple speaker surround effect when the material is played back over stereo speakers. For three speaker systems, a centre channel output is available.

- Synthesis Algorithms

QSURROUND 5.1/QMSS™: QSURROUND 5.1 and QSOUND Multiple Speaker System (“QMSS”) process stereo audio material including regular stereo content and decoded surround content downmixed to two channels from sources such as Dolby Surround®, Dolby Digital (AC3), DTS® and MPEG2 and “steer” acoustic images to create a distinctly different output for each speaker in multiple-speaker systems.

QIMMERSION™: QIMMERSION is a superset of QMSS (four-channel) optimized for playback over a combination of stereo speakers and headphones.

QSIZZLE™: QSIZZLE is a virtual, adjustable treble feature that allows the listener to adjust the treble level.

QRUMBLE™: QRUMBLE is a virtual, fully adjustable bass boost that creates dynamic bass effects set to the listener's preference.

## **Licensing**

Our primary business model consists of licensing QSOUND technologies to:

- semiconductor/component companies which manufacture and sell QSOUND enhanced chips to original equipment manufacturers (“OEMs”);
- OEM’s for specific products; and
- semiconductor/component companies that include QSOUND as an option for the OEM, who can then, at their choosing, license the technology directly from the company.

Licenses are negotiated on an individual basis. Some of our license agreements provide for per-unit payments and others are on a fixed periodic payment or lump sum payment basis, and in some cases licensees pay engineering fees. Most agreements do not have volume requirements and generally may be terminated by the licensee or by QSound without a prescribed financial penalty.

At the early stages of market adoption, licenses with OEM’s are feasible and desirable since they provide early endorsement of new technology. As markets mature and OEM product margins decrease, there is less opportunity for direct OEM licensing, since the OEM’s are now dependant upon the semiconductor companies to provide them with a cost effective fully featured solution. Semiconductor licenses typically have smaller royalties per unit but can provide potentially much bigger volumes. The mobile and handheld device market is still at an early stage with respect to audio technologies, whereas the PC and DVD markets are at a mature stage.

In 2006 we negotiated and completed license agreements with fourteen semiconductor/component companies and OEM’s. Eight of these licenses were for use of microQ in the mobile and handheld devices market, including with semiconductor manufacturers HiSilicon Technologies, Toshiba and Telechips. We also entered into a strategic collaboration agreement with ARM Limited to provide highly optimized audio software solutions for mobile phone ringtone, music and gaming markets across the ARM CPU architecture family. In addition, we added mobile software solutions providers Trolltech, Inc., and, in January 2007 ACCESS Systems Americas, Inc., to our partner roster. Under previous licenses microQ has been incorporated in handheld and mobile devices from manufacturers including BenQ Corporation, Cellon Communications Technology (Shenzhen) Co., Ltd., Eten Information Systems Co., Ltd., Mitac International Corporation, Shanghai Lenovo Electronic Co., Ltd., UTStarcom Inc., Wistron Neweb Corporation, Yuhua Teltech (Shanghai) Co., Ltd. and ZTE Corporation, and in reference design platforms from Aplix Corporation, Aricent (formerly Emuzed, A Flextronics Company), ATI Technologies, Inc., Broadcom Corporation, CEVA Inc., DSP Group Ltd., Intel Corporation, LSI Logic Corporation, Pulsus Technologies Inc., Qualcomm Incorporated, Samsung Electronics Co., Ltd., Tensilica Inc., and Winbond Electronics Corp. microQ-enabled mobile phones in the marketplace include models by BenQ, Curitel, Eten, i-Mobile, LG, Lenovo, Mitac, Panasonic, Philips, Samsung, UTStarcom and ZTE.

In 2006 we also completed agreements with four licensees for audio enhancement in the consumer electronics market and two licensees for PC audio enhancement. ST Microelectronics, one of the world’s largest semiconductor manufacturer and a global

leader in consumer IC's, will incorporate QSound's audio enhancement into its Sound Terminal IC's for use in flat-panel TV's, active speakers and home-theatre-in a-box systems. Our audio enhancement technologies are incorporated in DVD's, TV's and home-theatre-in a-box systems from, among others, RCA, Sanyo, Sharp, Taiyo and Toshiba, and in the PC multimedia market, in audio controllers and audio codecs from Via Technologies, Inc., in Sony Vaio PC products and in soundcards from Philips. Philips also bundles the Philips SoundAgent2 soft audio engine based on QSound's QVE technology with USB speakers and mini-component stereo systems. During the first quarter of 2006, we completed our first license for our new IP voice chat/conferencing software solution, for which we received a lump sum payment from a major video game manufacturer.

### **Downloadable Software Products**

QSound has several standalone software products as well as plug-in products for most media players and certain authoring tools. The majority of our software product revenues are derived from distribution of our iQfx family by RealNetworks, Inc., a leader in media delivery on the Internet. The iQfx family enhances playback of content over all of RealNetworks' media players. Our third generation iQfx3 plug-in is made exclusively for RealNetworks' RealOne Player®.

QMAX® II is our universal stand-alone Internet streaming audio effects software, and works with any sound source, including Windows Media Player and RealPlayer. QMAX II intercepts the audio player output and applies realtime processing to optimize speaker and headphone audio. We have also developed and distribute custom plug-ins iQms2 plug-in for Windows Media Player 11 Series for Windows XP. We distribute our downloadable consumer software from our Web site [www.qsound.com](http://www.qsound.com).

### **Other**

We also purchase and resell QSOUND enhanced analog chips to OEM's. This is a small part of our business. Our analog chip manufacturer licensees are Mitsumi Electric Co., Ltd., Renesas Technology Corp. (formerly Mitsubishi Electric Corporation) and Nippon Precision Circuits Inc.

### IP Telephony Business Segment

Our wholly-owned subsidiary QTelNet Inc. develops and sells Internet telephony systems under the brand-name FreeRide™. Our FXS and FXO gateways can be combined in a number of different ways to connect remote office locations using VoIP technology. The growing adoption of broadband access is making it easier for smaller sized businesses to utilize VoIP products. Businesses can easily and seamlessly connect office phone systems, and extend their office phone capability to remote offices or home offices that have a broadband connection. Typical applications for FreeRide products are implementations that eliminate long distance charges between offices, extend existing switchboard functionality to encompass remote teleworkers or offices and provide VoIP over broadband wireless.

In April, 2003 QTelNet acquired all of the assets of e-tel Corporation, consisting primarily of Internet telephony-enabling software, hardware inventory and trademark rights, for the purchase price of approximately \$525,000 which was paid by way of cash and an offset of \$500,000 against a secured claim in the principal amount of \$500,000 owed by e-tel to QSound.

Since the acquisition QTelNet has upgraded and added functionalities to our VoIP software, re-designed the internal layout and external features of our gateways, and secured a cost-effective, overseas manufacturing partner.

### E-commerce Business Segment

QCommerce provides electronic commerce enabling services to small businesses. We provide Web merchants with all of the tools necessary to set up and operate an on-line store, including custom design and programming, domain name registration, hosting, merchant credit card account set-up, technical support services and marketing and advertising services to drive targeted traffic to the store.

QCommerce derives its revenues from monthly service subscription fees paid by merchants for on-line storefront hosting and related services.

We offer the following products for use by our online merchants:

QCart™ is a full-featured Internet-based catalog and transaction system that allows a merchant's customers to browse products and purchase them using an optional on-line, real-time secure credit card authorization and verification system, or by manually downloading orders directly from our administration area. QCart's robust database management system gives the merchant full control over administration processes including pricing data, accounting information and detailed customer order records.

emerchantPro™ user-friendly software products help small businesses build e-commerce web sites, catalog and sell their products or services online, process and ship orders, report on their web businesses and initiate live chats with customers to maximize sales. Web sites can be up and running in minutes with professional and interactive results.

### **Revenues by Business Segment**

In fiscal 2006, our revenues were \$1,799,395 from the audio business segment, \$158,269 from the e-commerce business segment, and \$31,366 from the telephony segment. In fiscal 2005, our revenues were \$1,304,832 from the audio business segment, \$182,940 from the e-commerce business segment and \$55,468 from the telephony segment. In fiscal 2004, our revenues were \$1,820,028 from the audio business segment, \$245,238 from the e-commerce business segment and \$147,912 from the telephony segment.

### **Revenues by Geographic Market**

Audio Business: In 2006 product sales revenue came primarily from the United States. Royalties, license and engineering fees came primarily from the United States (43%) and Asia (56%). In 2005 product sales revenue was split between the United States and Asia. Royalties and license fee revenue came primarily from the United States (57%) and Asia (36%). In 2004 product sales revenue was split between the United States and Asia. Royalties and license fee revenue came from the United States (62%) and Asia (28%).

Internet Telephony Business: In 2006 48% of our revenue came from the United States, 44% from Canada, and 8% from other areas. In 2005 75% of our revenue came from the United States, 19% from Canada, and 6% from other areas. In 2004 79% came from the United States, 16% from Canada, and 5% from other areas. The remaining revenue in 2006, 2005 and 2004 was split among Asia, Europe, Africa and Mexico.

E-commerce Business: Revenue for our e-commerce business segment has come primarily from the United States in 2006, 2005 and 2004.

### **Seasonality**

Historically QSound has experienced increased royalty revenues in our audio business segment during the second and third quarters for consumer electronics and PC sales, all related to the Christmas shopping season. These sales activities decrease during the fourth and first quarters. However, both 2006 and 2005 did not experience this seasonality as royalty revenues have increased quarter over quarter since the second quarter of 2005. In 2006 and 2005 we did not experience any seasonal changes in our e-commerce business segment, and all revenue from e-commerce continues to be subscription based. Our IP telephony business is not mature enough to track any seasonality trends. Overall, seasonality does not have a material effect on our business.

### **Marketing Channels**

Audio Business: Our audio business segment sales and marketing activities are carried out by employees, and by representatives and agents in Asia that cover Japan, Hong Kong, China, Taiwan, Singapore, South Korea, Malaysia, Thailand, Philippines, India and Indonesia. In addition, certain of our semiconductor licensees market and promote their QSOUND-enhanced products to third parties worldwide. Our downloadable software products are marketed primarily through RealNetworks, and also by participants in our affiliate marketing program, and from our own web sites.

Internet Telephony Business: Sales and marketing activities of our IP telephony products are directed and carried out by distributors.

E-commerce Business: We are managing our existing client base and we do not actively carry on sales and marketing in this business segment. We effectively manage the costs for this business segment resulting in a net contribution to the Company. We continue to monitor this industry for business opportunities.

### **Intellectual Property**

QSOUND technologies and products are covered by a variety of intellectual property protections which include patent, copyright, trade secret and trademark laws, and contractual obligations. However, there can be no assurance that competitors will not be able to produce non-infringing technologies, products or services, or that third parties will not assert infringement claims against us.

We hold fourteen patents in the United States, including four patents which cover the fundamental technology applicable to our Q3D positional audio, QSURROUND, and stereo enhancement technologies. In addition, one patent covers binaural hearing aid technology previously co-developed by QSound Labs and the House Ear Institute of Los Angeles, California. At the date of this Annual Report, an additional three patent applications for QSOUND complementary and improved technologies have been filed and more applications are in progress. Patent applications have been made in fourteen foreign countries and a number of foreign patents have been granted, including in Japan.

Our key trademarks, including QSOUND, QSURROUND, microQ and the stylized “Q” logo are registered in the United States and in various foreign countries. QSound Labs has filed trademark applications for many of its other trademarks in the United States and internationally, and carries on a trademark protection program on an ongoing basis for new trademarks.

QCommerce’s e-commerce enabling technologies, including software developed for QCart, are covered by copyright and trade secret laws, and contractual obligations.

QTelNet’s VoIP software and technologies are covered by copyright and trade secret laws, and contractual obligations. QTelNet’s products also include technologies that are licensed from third parties.

## **Competition**

Each of the industries in which we engage is intensely competitive. In these industries we have competitors who have technologies and products that are similar to ours and compete directly with us. Some of these competitors are large, established companies with significantly greater resources. These large companies have advantages including greater financial strength, marketing resources and distribution capabilities, and greater ability to hire skilled personnel. In addition, we face competition from new market entrants.

- audio industry: Our competitors in the audio industry have products and technologies that compete with us in the mobile devices market; the consumer electronics market; PC multimedia market; audio enhancement software plug-ins for Internet media players; the headphone audio enhancement area; and the multi-channel home theatre market.
- IP telephony industry: We face significant competition in the IP telephony business. We expect competition to remain intense as existing communications companies enter into and new entrants emerge in this market.
- electronic commerce industry: We face many competitors in the electronic commerce industry and the number of companies providing products and services similar to ours is increasing at a rapid rate. These companies sell products and services similar to those we offer, including building Internet-based electronic storefronts, hosting merchant sites and providing marketing services.

There are no governmental regulations in the audio or e-commerce industries that have a material effect on our business, other than regulations that affect the carrying on of business generally. In the IP telephony industry our products are subject to testing and certification in the United States, Canada and other countries to satisfy a variety of regulatory requirements and protocols, such as for example to avoid interference with radio frequencies and to comply with emission standards.

## **C. Organizational Structure**

QSound Labs, Inc. is the parent of QSound Ltd., a California corporation and wholly owned subsidiary that owns certain assets including several patents, and of QTelNet Inc., an Alberta corporation and wholly owned subsidiary that operates our Internet telephony activities. QSound Ltd. is the parent of wholly owned subsidiary QCommerce Inc., a Washington corporation, which operates our e-commerce business segment.

## **D. Property, Plants and Equipment**

Our head office, including research facilities and a sound studio, is located at 400 – 3115 12<sup>th</sup> Street NE, Calgary, AB, Canada T2E 7J2 where we lease approximately 10,648 square feet of office space until October 31, 2008 at a rental rate of \$7,986.00 Cdn. per month. We have the option to renew the lease for an additional two-year term at then prevailing market rates. Our audio, e-commerce and Internet telephony businesses are operated from our Calgary office.

We own computers, software, electronics equipment, studio and audio equipment, and electronics laboratory and testing equipment, all of which is used by us in the development of our technologies and products. All of this equipment is located at our head office in Calgary. We also own Web servers which are located mainly off-site.

#### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not Applicable.

#### **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

*The following Management's Discussion and Analysis of the Financial Condition and Results of Operations ("MD&A") is provided to assist readers in understanding of QSound and its 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 consolidated financial statements of QSound Labs, Inc. and the related notes thereto.*

*The selected financial data presented below is presented in United States dollars and in accordance with Canadian GAAP. 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 Labs is a developer and provider of software solutions for audio, voice and e-commerce applications. We operate our business through three different operating units; QSound Labs, the parent company; its wholly-owned subsidiary QTelNet Inc; and its wholly-owned subsidiary QCommerce Inc.

##### *Audio Business Unit*

Our 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 90%, 84% and 82% of total consolidated revenues in fiscal 2006, 2005 and 2004 and are derived primarily through licensing fees, non-recurring engineering fees and per unit royalty agreements.

##### *Telephony Business Unit*

Our Telephony business unit develops and distributes IP Telephony products which are targeted for the small business environment. Revenues from this business unit comprised 2%, 4% and 7% of total consolidated revenues in fiscal 2006, 2005 and 2004 and are derived from product sales to distributors.

##### *E-Commerce Business Unit*

Our 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 8%, 12% and 11% of total consolidated revenues in fiscal 2006, 2005 and 2004 and are comprised primarily of monthly subscription fees.

##### **Critical Accounting Estimates**

The preparation of the consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an ongoing basis, based on historical experience and other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions and conditions.

The Company believes the following describes the significant judgments and estimates used in the preparation of its consolidated financial statements.

##### **Stock-based Compensation**

As of January 1, 2003, the Company adopted prospectively the fair value based method of accounting for stock options, which means that the amount expensed in each period for common share options granted to employees, officers and directors is the fair value of the options, calculated using the Black-Scholes option pricing model net of estimated forfeitures amortized over the vesting period of the options. Compensation expense of \$381,000 was recorded in 2006, (2005: \$135,000; 2004 \$320,000).



## Convertible Notes

The fair value of the equity component of the convertible notes and the warrants issued as part of the agreement were calculated using the Black-Scholes option pricing model which incorporated estimates of expected term.

### A. Operating Results

In 2006 the Company's net loss narrowed to \$1,734,224 (\$0.19 per share) compared to \$2,550,708 (\$0.30 per share) and \$1,925,946 (\$0.25 per share) in 2005 and 2004, respectively.

QSound's strategic decision to focus on its audio business segment and more specifically positioning its technology for the mobile device market has led to the narrowing of the loss as the Company is beginning to see increases in its recurring royalty revenues from its licensees. The Company also continues to seek out new licensees from which we derive up front licensing fees and non-recurring engineering fees as compensation for customization, integration support and specific engineering requirements.

This strategic repositioning, which saw revenue decrease to \$1,543,240 in 2005 from \$2,213,178 in 2004, has meant that 2006 has seen both an increase in total revenue to \$1,989,030 and a further departure from the more recent revenue generators, namely product sales. Moving to a more royalty and license fee derived revenue stream has also resulted in the gross margin increasing consistently over the years 2004 through to 2006 (81%, 88% and 98% respectively). The following table sets out the consolidated operating data as a percentage of total revenue for the three years ending December 31, 2006, 2005 and 2004.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Royalty, Licenses and Engineering Fees	85%	68%	53%
Product Sales	<u>15</u>	<u>32</u>	<u>47</u>
Total Revenue	<u>100</u>	<u>100</u>	<u>100</u>
Cost of product sales	<u>2</u>	<u>12</u>	<u>19</u>
Gross Margin	98	88	81
Expenses:			
Marketing	58	62	57
Operations	7	14	11
Product Engineering	41	66	43
Administration	49	57	36
Foreign Exchange Loss	1	-	2
Amortization	<u>16</u>	<u>23</u>	<u>21</u>
Impairment of assets	8	34	-
Total Expenses	<u>180</u>	<u>256</u>	<u>170</u>
Loss before other items	(82)	(168)	(89)
Other Items:			
Interest Income	(4)	(4)	(4)
Interest on convertible debt	3	-	-
Accretion of debt discount	<u>2</u>	<u>-</u>	<u>-</u>
Loss before taxes	<u>(83)</u>	<u>(164)</u>	<u>(85)</u>
Taxes	<u>3</u>	<u>2</u>	<u>1</u>
Net loss	<u>(86)</u>	<u>(166)</u>	<u>(86)</u>

A continuing factor throughout the Company's results for the three years ended December 31 2006, 2005 and 2004 is the continuing weakening (13% over the period 2004 to 2006) of the US dollar. Whilst this has no effect on the reported revenues, as revenue is invoiced and collected in United States Dollars it does, however, impact reported expenses. This is because most of the operations are located in Canada and the majority of expenses are paid in Canadian dollars, and as such reported expenses are affected by the Canadian / United States exchange rate. During fiscal 2006, 2005 and 2004, this had a negative impact on the our total operating expenses.

### **Discussion and analysis**

Below we provide information on the significant line items in our statement of operations for the past three fiscal years, as well as analysis of the changes year-on-year.

## Revenues

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>Royalties, licenses and engineering fees (\$ 000)</i>	\$1,693	\$1,056	\$1,162
<i>Change year-on-year</i>	60%	(9%)	49%

The increase in licensing and royalty revenues from 2005 to 2006 arose from both increasing recurring royalty revenues and license fees resultant from new license agreements. Royalty revenues are derived from licensee's sales of mobile devices incorporating microQ technology. During 2006 royalty revenue increased to \$630,000 (2005: \$345,000, 2004: \$534,000) from 22 licensees compared to 17 in 2005 and 13 in 2004. The royalties in 2004 were uplifted by \$173,000 due to royalties received relating to hearing aid technology. The Company has not received royalties relating to this technology in 2005 or 2006. The Company continued to achieve new license wins which attract license and engineering fees resulting in license and engineering fees totaling \$1,063,000 during 2006 (2005: \$ 711,000, 2004: \$628,000). The increase is reflective of an increase in the negotiated fee level, as the number of licensees attracting license and engineering fees has remained constant throughout the reported periods (2006: 12, 2005: 14, 2004: 13), together with fees received for the new voice chat conferencing system.

## Product Sales

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>Product Sales (\$ 000)</i>	\$296	\$487	\$1,051
<i>Change year-on-year</i>	(39%)	(54%)	(17%)

The continuing decrease between 2005 and 2006 is attributable to a number of factors.

Demand for our analog integrated circuits has further decreased as demand for digital enabled products has increased, to the extent that in 2006 there were no analog chip sales, accounting for \$115,000 of the \$191,000 product sales decline. The move from analog integrated circuits to digital enabled products was first encountered in 2005 when sales of this product fell by 67% (\$216,000) over 2004.

Sales to one of our distribution partners who has accounted for 34%, 27% and 30% of the product sales revenue in 2006, 2005 and 2004 respectively, has continued to see declining sales during 2006. The impact on the Company is a reduction in revenue of \$30,000 in 2006 over 2005.

Sales in our telephony division continued to decline in 2006. Revenues fell by 44% (2005: 62% decline, 2004: 20% decline) from \$55,000 to \$31,000 during 2006. This decline was expected as the anticipated product launch scheduled to occur during 2005 was abandoned.

The final factor in the decrease of product sales has been the continued decrease in revenues from our e-commerce business unit. This business unit continues to receive no investment in marketing activities resulting in a continuing decline in subscriptions. The year on year decline has, however, slowed as a core subscription plateau is reached. Revenues from this business sector for 2006 were \$158,000 (2005: \$183,000, 2004: \$245,000)

## Expenses

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>Marketing (\$000)</i>	\$1,158	\$1,000	\$1,251
<i>Change year-on-year</i>	16%	(20%)	(4%)

As a result of the strategic realignment to focus more on the audio business segment marketing expenditures grew during 2006 as the Company increased the level of marketing support for its microQ software technology. This increased support was mainly through hiring of new personnel in the later part of the year, together with an increased presence at international trade shows, most notably in Asia. The declines shown for 2005 and 2004 relate to cutbacks in marketing support for the telephony business segment, with the large decline in 2005 primarily as a result of the closure of our sales and marketing office.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>Product Engineering (\$ 000)</i>	\$819	\$952	\$964
<i>Change year-on-year</i>	(14%)	17%	16%

Both 2004 and 2005 had increased levels of activity due to introduction of the microQ software technology which is reflected in the expense levels for these two years. During 2006, the Company has seen continued high levels of activity relating to microQ software projects, as reflected with increasing license fee revenue. However, the continuing decline in telephony and e-commerce revenue has meant further reductions in engineering support for these business segments, to the extent where any engineering support for the existing product lines is now minimal, thus accounting for the overall reduction in engineering costs.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>Administration (\$000)</i>	\$972	\$883	\$801
<i>Change year-on-year</i>	10%	10%	38%

Administration costs have increased in 2006 primarily due to an increase in compensation expenses. The Company has seen both its non-cash stock based compensation and salaries and recruitment costs increase over the prior year. This is in addition to the fact that the US Dollar has further weakened during the year making the Canadian cost base more expensive, which contributed to the increase in costs reported in 2005 compared to 2004.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<i>(\$000)</i>			
<i>Impairment of Property and Equipment</i>	\$168	\$ 90	-
<i>Impairment of Intangible Assets</i>	-	\$428	-

At December 31, 2006 management evaluated its Telephony business segment assets for impairment and determined that the carrying value of these assets was not recoverable, resulting in an impairment of \$168,000 being recorded. This impairment was in addition to the \$518,000 recorded in 2005 on specific Internet telephony assets.

### Summary of Quarterly Financial Data

The unaudited selected quarterly financial data presented below is presented in United States dollars and in accordance with Canadian GAAP as is follows:

	2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue	476,744	401,044	262,437	403,015	673,770	430,168	341,687	543,405
Net Loss	(375,147)	(481,160)	(1,219,178)	(475,223)	(200,351)	(491,072)	(533,020)	(509,781)
Loss per share	(0.04)	(0.06)	(0.14)	(0.06)	(0.02)	(0.06)	(0.06)	(0.05)

As the Company's recurring royalty revenue continues to grow quarter over quarter, revenue levels are primarily affected by any large license or non-recurring engineering fees that have been negotiated within the license agreements.

Sales for the quarter ended December 31, 2006 increased 35% to \$543,405 from \$403,015 for quarter ended December 31, 2005 reflecting both an increase in license fees (361%) and recurring royalty revenue (59%). Net loss was \$509,781 or \$0.05 per share (basic) for the quarter ended December 31, 2006, compared to \$475,223 or \$0.06 per share for the quarter ended December 31, 2005. The improvement is driven by increased revenues as expenses remained comparable at \$959,641 with the previous year (\$939,488).

Due to continuing product launches by licensees during 2006, revenues for the quarter ended December 31, 2006 increased 59% from \$341,687 to \$543,405, reflecting both an increase in license fees (119%) and recurring royalty revenue (45%). Net loss was \$509,781 or \$0.05 per share (basic) compared to \$533,020 or \$0.06 per share for the quarter ended September 30, 2006. The narrowing of the loss being driven by the net effect of increased revenues balanced by higher marketing expenses, resultant from hiring new marketing personnel during the quarter ended December 31, 2006.

As part of the year end close and audit process accounting the Company determined, in accordance with Section 3860 of the CICA Handbook, that a component of the convertible notes should have been classified as equity rather than as a liability. The cash proceeds of the notes were allocated to the components based on initial fair values. Accordingly the Company has recorded \$340,826 within equity at December 31, 2006.

## Restatement of “Reconciliation to U.S. GAAP” note for 2006 quarterly financial statements

As described in Note 6 to the Consolidated Financial Statements, the Company entered into a Convertible Promissory Note Agreement on March 27, 2006.

Initially, the Company determined that the conversion feature of the Promissory Note met the criteria of an embedded derivative in accordance with Statement of Financial Accounting Standards No. 133, ‘Accounting for Derivative Instruments and Hedging Activities’, (“SFAS 133”) and paragraphs 12-32 of EITF-0019. Accordingly, the conversion feature of the debt was bifurcated and accounted for as a derivative. As a result the Company recorded the conversion feature as a liability on the balance sheet and incurred a one time interest charge of \$224,633 in the income statement.

During discussions at the year-end audit, it came to management’s attention that reference should be made to all of the discussions within EITF-0019 and on this basis, the conversion feature met the scope exemption requirements of paragraph 11 of SFAS 133 and accordingly should not have been treated as a derivative. As a result, the Company now has recorded the conversion feature as equity and there is no interest charge required.

Over the term of the convertible note, the original accounting would have resulted in a non-cash charge to earnings of \$1,224,633 as compared to a non-cash charge of \$920,000 on a restated basis. The net effect of this restatement for 2006 is an increase in shareholders’ equity of \$369,958.

The tables below present a restatement of the Reconciliation to U.S. GAAP note for the quarters ending March 31, 2006, June 30, 2006 and September 30, 2006.

Three months ended	September 30, 2006	June 30, 2006	March 31, 2006
Net loss for the period as reported in accordance with Canadian GAAP	\$ (533,019)	\$ (491,072)	\$ (200,351)
Amortization of deferred development costs	–	–	20,218
Amortization of debt discount	10,658	10,546	463
<b>Net loss under US GAAP</b>	<b>\$ (522,361)</b>	<b>\$ (480,526)</b>	<b>\$ (179,670)</b>
<b>Loss per share (basic and diluted) under US GAAP</b>	<b>\$ (0.06)</b>	<b>\$ (0.05)</b>	<b>\$ (0.02)</b>

### Excerpts from Balance Sheets:

March 31, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Convertible debt	\$ 345,490	\$ (273,045)	\$ 72,445
Warrants	1,027,114	–	1,027,114
Contributed Surplus	2,365,547	272,582	2,638,129
Deficit	(46,452,627)	(262,248)	(46,714,875)

June 30, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Convertible debt	\$ 360,129	\$ (283,591)	\$ 76,538
Warrants	1,027,114	–	1,027,114
Contributed Surplus	2,478,591	272,582	2,751,173
Deficit	(46,943,699)	(251,702)	(47,195,401)

September 30, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Convertible debt	\$ 374,995	\$ (294,252)	\$ 80,743
Warrants	1,027,114	–	1,027,114

Contributed Surplus	2,555,561	272,582	2,828,143
Deficit	(47,476,718)	(241,041)	(47,717,759)

## **B. Liquidity and Capital Resources**

As at December 31, 2006 we had cash and cash equivalents of \$2,316,476. This is an increase of \$1,093,747 (89%) over the balance at December 31, 2005 of \$1,222,729. \$708,652 (2005: \$1,594,557) of cash was used in operations during the 2006 fiscal year with non-cash working capital decreasing by \$181,317 during the year to \$88,642 from \$269,959 in 2005. Financing activities generated \$1,857,883 in cash during fiscal 2006 (2005: \$165,008) from the exercise of options and the issuance of the convertible loan note.

Cash used in investing activities decreased to \$55,484 in 2006 (2005: \$675,265). The high level in 2005 was attributable to the investment the Company made in the development of software.

At December 31, 2006 we had working capital resources available of \$2,405,118 (2005: \$1,492,688). Management feels that with our current cash on hand and anticipated cash flows from operations we have sufficient capital to carry out our business plan for 2007.

## **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 2006, 2005 and 2004 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 2006 and 2005 continued development and refinement of the Company's microQ scalable software engine was the main "in house" focus. In 2004 the Company's efforts were mainly centred on microQ and the QVE audio engine. The Company's audio research and development costs were \$813,839 in 2006, \$948,580 in 2005 and \$962,340 in 2004. Also during 2006 and 2005, the Company, through participation in a venture arrangement, undertook development of a voice chat conferencing system, incurring costs of \$39,500 and \$352,750 respectively. These costs have been capitalized and from 2006, when commercial production commenced, will be amortized over the useful economic life of the asset. The Company has three patent applications, two of which were filed in 2003 and 2005, in progress, as well as further applications in development. (See "Intellectual Property" under Item 4 of this Annual 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 in 2006, with expenditures in 2005 and 2004 totalling \$32,872 and \$39,032 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 expenditures of \$112,387 (2004: \$561,192) relating to this project. Due to the abandonment of the project an impairment charge totaling \$518,207 was booked as the Company determined that the carrying value of the project assets were 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. In 2004 the Company had further expenditures of \$138,812 for activities consisting of upgrading and adding functionalities to our software, and re-designing the internal layout and external features of our gateways.

## **Share Capital**

During the 2006 fiscal year, our share capital increased from 8,661,985 common shares with a book value of \$45,979,055 to 9,375,585 common shares with a book value of \$47,208,942. The main reason for the increase of 713,600 shares was as a result of 500,000 warrants being exercised for cash of \$520,000, with the remainder of the increase being attributable to the exercise of stock options for cash of \$353,600. Other changes in the book value are from a reclassification from warrants and contributed surplus on the exercise of the warrants and stock options of \$372,005 and the payment of financing costs in cash of \$15,718.

During 2005 fiscal year, our share capital increased from 8,404,085 common shares with a total book value of \$45,792,526 to 8,661,985 common shares with a book value of \$45,979,055. The increase of 257,900 shares was a result of the exercise of stock options for cash of \$201,000.

As at December 31, 2006 the Company had 981,700 options outstanding at exercise prices ranging from \$0.47 to \$5.33 and expiring at various times up to 2015. Further details on stock options outstanding can be found in Note 10 to the financial statements.

Subsequent to the year end and up to February 28, 2007, 20,000 stock options have been exercised for total cash consideration of \$72,300 and reclassification from contributed surplus of \$37,269. This brings the total shares outstanding at the date of this Annual Report to 9,395,585 with a book value of \$47,318,511 and reduces the total options outstanding to 961,700.

During 2006 400,000 common share purchase warrants were issued as part of the convertible loan note transaction (see below). The fair value of the warrants, determined to be \$340,826 using the Black-Scholes Pricing Model, was charged to warrants within shareholder's equity.

As at December 31, 2006, the Company had 614,130 common share purchase warrants outstanding. These warrants entitle the holder to acquire one common share of the Company for \$4.50 to \$9.12 per share. Further details on warrants outstanding can be found in Note 8 to the financial statements.

### **Convertible Note**

On March 27, 2006, the Company issued \$1,000,000 in convertible notes and 400,000 related share purchase warrants (as previously described). The notes are due in five years and bear interest at the US prime rate payable quarterly in arrears.

The notes are convertible at the option of the holders 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. At the date of this Annual Report there are no market related conditions that would automatically cause the conversion price to decrease.

The convertible note is a financial instrument comprising both an equity component and a liability component, which together with the warrants have been fair valued on initial recognition. Fair value of the equity component and the warrants were calculated using the Black-Scholes pricing model, and the fair value of the liability component was calculated as the present value of the principal and interest payments. The total cash proceeds have been allocated to these components on a pro-rata basis using these calculated fair values. The fair value of the warrants and equity component of the convertible note were calculated using the Black-Scholes pricing model.

As a result of the fair value on initial recognition \$340,826 and \$314,396 have been allocated to warrants and the equity component respectively, with the remaining \$344,778 being shown within liabilities. The amounts initially allocated to the convertible notes will be accreted to the notes' fair value over its term of five years.

### **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 during the past three years. The Company has focused primarily on this market segment during this period. 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.

As the mobile device market continues to be driven by Asian growth, the Company derives an increasing percentage of total audio revenue from Asia. To date, the majority of revenue derived from this market segment has been license fees and custom engineering fees. This has continued to be the case during 2006 with revenues from this source totaling \$1,063,000 (2005: \$711,000, 2004: \$628,000) with the split between geographic segments as outlined:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Asia	71%	43%	30%
US	29	48	48

Europe	-	7	11
Canada	-	-	8
Other	-	2	3

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.

Most of the Company's license agreements incorporate per unit royalties. Significant recurring royalty revenue began in the fourth quarter of 2005 and the Company saw quarter on quarter growth throughout 2006 in its recurring royalty revenues from the mobile device market, growing to \$630,000 (2005: \$345,000, 2004: \$362,000). With continuing product launches by our Asian licensees the percentage of recurring royalties received from Asia has had increasing influence on this revenue as a whole.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Asia	43%	42%	37%
US	56	55	60
Other	1	3	3

With the continued signing of new licensees the Company believes that as these licensees introduce new mobile devices to the market it will result in continuing growth in recurring royalty revenues, with an increasing percentage being derived from Asia.

As the Company will continue to focus its development and marketing efforts on providing audio and voice IP to OEMs in 2007, its other business segments, e-commerce and IP telephony, are expected to continue at current performance levels.

With the increased focus on marketing its microQ software technology, the Company believes that marketing expenditure will increase in 2007. This is directly attributable to increased compensation levels as a result of new hires in the latter part of 2006, together with an increased 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.

The Company has no plans for any major capital expenditures.

#### **E. Off-Balance Sheet Arrangements**

We are not a party to and we do not have any off-balance sheet arrangements.

#### **F. Tabular Disclosure of Contractual Obligations**

Contractual Obligations	Total	less than 1 year	1-3 years	3-5 years	more than 5 years
	\$	\$	\$	\$	\$
Long-term Debt Obligations	1,349,438	82,500	165,000	1,101,938	-
Capital (Finance) Lease Obligations	-	-	-	-	-
Operating Lease Obligations	203,131	96,847	106,284	-	-
Purchase Obligations	-	-	-	-	-
Other Long-Term Liabilities	-	-	-	-	-

#### **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.

#### **ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

## **A. Directors and Senior Management**

The following table sets forth certain information with respect to our executive officers and directors as of March 1, 2007. Mr. Doug Drury, formerly Controller, left the Company on October 6, 2006. Mr. Murray Bruce joined QSound as Controller on December 4, 2006. All positions indicated below are with QSound Labs, Inc. only.

<u>Name</u>	<u>Position</u>
David J. Gallagher	President, Chief Executive Officer, Director
Joanna Varvos	Corporate Secretary
Murray Bruce	Controller
Stanley E. MacDougall	Director
M. Patty Chakour	Director
D. Tony Stelliga	Director

David J. Gallagher has served as President and Chief Executive Officer since June, 1992 and as a director since February, 1991. Mr. Gallagher joined our Company in 1989 and has acted as Vice-President, Finance, as Chief Financial Officer and as Chief Operating Officer. Mr. Gallagher has over twenty-one years experience in technology development and commercialization.

Joanna Varvos is Corporate Secretary of QSound. Ms. Varvos is a barrister and solicitor, admitted to the Law Society of Alberta in 1979. Ms. Varvos has provided legal services to QSound Labs since 1989 and was previously in private practice with a emphasis on corporate and securities law.

Murray Bruce, a chartered accountant, joined QSound as our Controller on December, 4, 2006. Mr. Bruce has over eleven years of public and corporate accounting experience, with five years in managing Company-wide financial accounts systems. From September, 2005 to December, 2006 Mr. Bruce was an audit manager with Deloitte and Touche in Calgary, Alberta and prior, from 1999 to 2005 he acted as financial accountant with responsibilities including preparation of accounts, budgets and corporation tax computations for Cambridge Laboratories Limited, U.K.

Stanley E. McDougall was appointed to the board of directors on March 1, 2004. Mr. McDougall is Chairman of Western Crating International Ltd., a Calgary, Alberta based export packaging company. Mr. McDougall has thirty-seven years of business experience in situations ranging from start-up companies to large multi-plant operations, and including leading operations, acquisitions, financings, restructuring and dispositions. Mr. McDougall is a member of the board of directors of Richer Systems Group, a private software Company serving the international transportation and leasing industry. Mr. McDougall has a B.Comm. (Honours) from the University of Saskatchewan.

M. Patty Chakour was appointed to the board of directors on March 10, 2004. Ms. Chakour is Chief Financial Officer of T.P Racing L.L.P., a \$350 million Company that owns and operates Turf Paradise, a Phoenix, Arizona based horse racing track that includes an off-track betting network, and dining and entertainment facilities. Ms. Chakour has over twenty years experience in accounting including S.E.C. reporting, audits, budget preparation, internal accounting control implementation, consolidations, international operations and tax reporting. Ms. Chakour has a B.B.A in accounting from the University of Iowa and a C.P.A. certification in Iowa and Arizona.

D. Tony Stelliga was elected to the board of directors at the meeting of shareholders held on April 29, 2005. Since April, 2003, Mr. Stelliga is Chairman and CEO of Quellan Inc., a California based leading edge communications technology Company that designs and develops integrated circuits for high speed communications equipment. Prior, Mr. Stelliga held various management and strategic positions at Intel Corporation and earned the President's Intel Achievement Award in 2002 for leading Intel's entry into broadband networking following the acquisition of Softcom Microsystems, a developer of network processors, of which he was a founder. Mr Stelliga, who has a B. Sc. in computer science from the University of Ottawa, holds sixteen patents in broadband networking and processing architectures.

There are no family relationships between any directors or officers of QSound. There are no arrangements or understandings between any director or officer of the Company and any other person pursuant to which the director or officer was selected, except for employment agreements between QSound and Messrs. Gallagher and Bruce.



## **B. Compensation**

Remuneration paid or payable to our directors and executive officers during fiscal year 2006 was an aggregate \$375,879 for compensation paid to Messrs. Gallagher, Drury, Bruce and Ms. Varvos. No cash or other bonuses were paid to executive officers in 2006. Mr. Gallagher's salary for 2006 was \$211,314 (\$240,000 Cdn.). In December 2005, the compensation committee determined that certain of Mr. Gallagher's outstanding options be amended by extending the expiry dates by five years. Options to purchase 165,810 common shares at the exercise price of \$0.47 which were to expire on December 2, 2006 are granted under the Company's 1998 Stock Option Plan and the amendment did not require shareholder approval. At the meeting of shareholders held on April 28, 2006 shareholders approved the amendment of options to purchase 235,190 common shares at the exercise price of \$1.04, which were to expire on July 22, 2006.

Mr. Gallagher's contract provides for salary, discretionary bonuses if approved by the board, and participation in any pension and profit sharing plan established from time to time by the board. If terminated without cause, if Mr. Gallagher's employment contract is not renewed for at least one year following expiration, if there is a change in control of the Company and Mr. Gallagher elects not to continue his employment, and in the event of death or disability Mr. Gallagher is entitled to a lump sum payment equal to the greater of salary for the unexpired term of the employment agreement or one year. A lump sum contribution to fund Mr. Gallagher's pension plan is also payable in the foregoing circumstances and in the event of retirement prior to the age of 65. Mr. Gallagher's employment contract was renewed on September 30, 2005 for a further two year term. If there is a change in control of the Company Mr. Gallagher is entitled to vesting of any unvested options.

Mr. Gallagher participates in a registered individual pension plan that was put in place in 2002 to resolve an outstanding contingency relating to his employment contract. In 2006 \$24,153 Cdn. was contributed to the plan for fiscal 2006. In 2005 \$22,749 Cdn. was contributed to the plan for fiscal 2005. Further, \$17,400 Cdn. (of \$23,500 Cdn. which was accrued in 2005 as settlement for past wages that had been deferred by Mr Gallagher prior to 2002) was contributed in 2006 to Mr. Gallagher's RSP. In 2004 \$14,822 Cdn. was contributed to the plan for fiscal 2004.

Our directors were paid cash compensation in the aggregate of \$26,000 for their services in their capacity as directors; in addition, directors are reimbursed for reasonable travel and lodging expenses incurred in the provision of such services and receive stock options.

The following table gives information concerning stock options granted as compensation to outside directors during 2006. These options were approved by shareholders at the annual meeting of shareholders held on April 28, 2006.

<b>Name</b>	<b>Date of Grant</b>	<b>No. of Options Granted</b>	<b>Exercise Price</b>	<b>Market Price on Date of Grant</b>	<b>Expiry Date</b>
M. Patty Chakour	May 1, 2006	10,000	\$5.02 U.S.	\$5.02 U.S.	May 1, 2011
Stanley E. McDougall	May 1, 2006	10,000	\$5.02 U.S.	\$5.02 U.S.	May 1, 2011
D. Tony Stelliga	May 1, 2006	10,000	\$5.02 U.S.	\$5.02 U.S.	May 1, 2011

## **C. Board Practices**

During 2006, the members of our board of directors were David J. Gallagher, Stanley E. McDougall, M. Patty Chakour and D. Tony Stelliga. Directors are elected annually by shareholders at our annual meeting of shareholders, and serve until their successors are elected or appointed.

Our board of directors has two standing committees: an audit committee and a compensation committee. Members of these committees are independent of management and qualify as independent under all relevant Canadian securities, SEC and NASDAQ Stock Market rules and regulations. These independent directors hold regularly scheduled meetings at which only independent directors are present. At the date of this Annual Report the members of these committees are Stanley E. McDougall, M. Patty Chakour and D. Tony Stelliga.

### **Audit Committee**

All audit committee members must be able to read and understand fundamental financial statements and at least one member of the audit committee must have a background in financial reporting, accounting or auditing which results in the member's financial sophistication.

The primary duties and responsibilities of the audit committee are to:

- appoint, compensate and oversee our external auditors;
- review and discuss with our external auditors their independence;
- review and consider with our external auditors significant accounting principles and practices, alternate treatments of financial information and all material written communications between our external auditor and management;
- review our financial statements and disclosures with management and our external auditors;
- meet at least once a year in separate sessions with management, the internal auditor and our external auditors;
- review, monitor and control our information and reporting systems and financial risk exposures; and
- establish procedures for treatment of complaints regarding accounting and auditing matters.

#### Compensation Committee

The primary duties and responsibilities of the compensation committee are:

- development of guidelines for compensation of officers and key executives and evaluation of compensation data for companies that are similar to us in size and scope of business;
- review and approval of corporate goals and objectives relevant to CEO compensation, evaluation of the CEO's performance in light of these goals and objectives, and determination of the CEO's compensation based on this evaluation;
- annual review and approval of the compensation of officers and other key executives of the Company; preparation of a report to shareholders for inclusion in our information circular relating to the annual shareholder meetings; and
- annual reassessment of the adequacy of the charter and recommendation of any proposed changes to the board.

#### **D. Employees**

At December 31, 2006 we had 25 employees and persons engaged by contract on a fulltime basis, of whom 11 were in research, product development and technical support, 6 were in marketing and sales, 2 were in customer support and 6 were in administrative positions. At December 31, 2005 we had 24 employees and persons engaged by contract on a fulltime basis, of whom 11 were in research, product development and technical support, 5 were in marketing and sales, 2 were in customer support and 6 were in administrative positions. One of these employees was located in the United States, one was in the U.K., and the remainder were located in Canada. At December 31, 2004 we had 28 employees and persons engaged by contract on a fulltime basis, of whom 11 were in research, product development and technical support, 8 were in marketing and sales, 3 were in customer support and 6 were in administrative positions. Two of these employees were located in the United States and the remainder were located in Canada.

We are not subject to any collective bargaining agreements and believe our relationship with our employees is satisfactory.

#### **E. Share Ownership**

The following tables show information as to share ownership by directors and executive officers as of March 1, 2007.

##### Shares

<u>Name and Position</u>	<u>Common Shares Owned or Controlled</u>	<u>Percent of Class</u>
David J. Gallagher President and CEO and Director	491,000 <sup>1</sup>	5.2%
Joanna Varvos Corporate Secretary	126,000 <sup>2</sup>	*
Murray Bruce Controller	0	*
Stanley E. McDougall Director	45,000 <sup>3</sup>	*
M. Patty Chakour Director	20,000 <sup>4</sup>	*
D. Tony Stelliga Director	20,000 <sup>4</sup>	*

<sup>1</sup> Includes options to purchase 466,000 common shares.

<sup>2</sup> Options to purchase 126,000 common shares.

<sup>3</sup> Includes options to purchase 10,000 common shares.

<sup>4</sup> Options to purchase 20,000 common shares.

\* represents less than 1%

## Options

The following tables show information as to options granted to directors and executive officers as of March 1, 2007.

<u>Name and Position</u>	<u>Options</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
David J. Gallagher President and CEO and Director	235,190 130,810 100,000	\$1.04 \$0.47 \$1.65	July 22, 2011 December 2, 2011 December 30, 2007
Joanna Varvos Corporate Secretary	25,467 50,533 50,000	\$1.04 \$0.47 \$2.05	July 22, 2011 December 2, 2011 April 1, 2009
Murray Bruce Controller	30,000 <sup>1</sup>	\$4.96	December 3, 2011
Stanley E. McDougall Director	10,000	\$5.02	May 1, 2011
M. Patty Chakour Director	10,000 10,000	\$3.57 \$5.02	June 29, 2010 May 1, 2011
D. Tony Stelliga Director	10,000 10,000	\$3.57 \$5.02	June 29, 2010 May 1, 2011

<sup>1</sup> These options are subject to vesting at the rate of 2500 options per month commencing on June 1, 2007.

The Board of Directors or the compensation committee may in its discretion from time to time grant options and stock awards to officers, directors, key employees and persons or companies providing services for the Company. Pursuant to the NASDAQ Stock Market, all such grants made to officers, directors, employees and consultants require the approval of shareholders, unless the grants are made under an equity compensation plan that has been approved by shareholders. To date we have not granted any stock awards. Under our existing 2006 Stock Option Plan for Outside Directors, 120,000 options remain available for the grant of stock options to outside directors. Under the 2006 Employee Stock Option Plan 10,000 options remain available for grant to employees and consultants that are not officers or directors.

The Board of Directors has approved establishment of an equity compensation plan for officers, employees and consultants which will reserve up to 750,000 shares ("2007 Plan"). Awards consisting of stock options and stock awards may be granted under the 2007 Plan. The 2007 Plan is subject to the approval of shareholders, which we will seek to obtain at the meeting of shareholders scheduled to take place on April 27, 2007.

The Board and the compensation committee administer our equity compensation plans. With respect to awards to employees who are not officers and to consultants, the compensation committee may appoint a committee consisting of one or more persons to determine, among other things, the persons to whom awards will be made, the time or times at which such awards will be granted, the types of awards to be granted and the number of shares subject to such awards, and the specific terms, conditions, performance criteria, restrictions and other provisions applicable to awards, including, but not limited to, the duration, vesting and exercise periods. In determining the size and vesting provisions of option and stock award grants, the factors considered are the individual's performance, achievement of objectives, responsibilities, base salary level, previous option grants and the overall corporate performance of the Company.

The exercise price of an option will not be less than the fair market value per share on the date of grant. Options expire no later than the tenth anniversary of the date of grant to the extent they are not previously exercised or forfeited. Options may be exercised following termination of employment or contractual relationship with the Company, if for cause on the date of termination and if other than for cause for a period of thirty days (twelve months in the event of death or disability) following termination. The foregoing time periods may be extended by the plan administrator.

The 2007 Plan permits the Company to grant awards of shares to participants upon such terms (including vesting), as the plan administrator may determine.

In the event there should be any subdivision or consolidation of our common shares the price and number of shares then subject to each option and stock award is to be adjusted equitably so that the optionee's proportionate interest is maintained without change in the aggregate option price. If we are reorganized or merged with another corporation, provisions shall be made to continue any options then outstanding and to prevent their dilution or enlargement.

## **ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

### **A. Major Shareholders**

The following table discloses information regarding the beneficial ownership of our common shares as of March 1, 2007, by each person or entity known to own beneficially more than 5% of our outstanding common shares based on information provided to us by the holders or disclosed in public filings with the Securities and Exchange Commission

<b>Name</b>	<b>Number of Common Shares Beneficially Owned<sup>1</sup></b>	<b>Percentage of Outstanding Common Shares<sup>2</sup></b>
KBW Partners	707,692 <sup>3</sup>	7.5%
David J. Gallagher	491,000 <sup>4</sup>	5.2%
Fred Kayne <sup>5</sup>	665,346 <sup>6</sup>	7.1%

<sup>1</sup> These shares do not carry voting rights different from the voting rights of our outstanding common shares.

<sup>2</sup> The percentage of outstanding common shares is based on 9,395,585 common shares outstanding as of March 1, 2007.

<sup>3</sup> 307,692 shares are issuable upon conversion of the convertible loan and 400,000 shares are issuable upon the exercise of warrants. (See "Convertible Note" in Item 5. of this Annual Report.)

<sup>4</sup> Includes options to purchase 466,000 shares.

<sup>5</sup> Mr. Kayne is a partner in KBW Partners.

<sup>6</sup> These shares are disclosed in Schedule 13D filed on March 27, 2006.

At March 1, 2007 we had 9,395,585 common shares issued and outstanding. At such date, there were 360 shareholders of record in the United States who collectively held approximately 84% of our outstanding common shares.

We are not directly or indirectly owned or controlled by any other corporation, foreign government or legal person. We know of no arrangements which may result in a change of control of our Company at a future date.

### **B. Related Party Transactions**

We did not have any material transactions with any of our related parties during fiscal year 2006 except for compensation of executive officers as employees or consultants. (See "Compensation" in Item 6. B of this Annual Report).

Except for immaterial advances in the ordinary course of business that may have been outstanding on a short-term basis, no related party was indebted to us during fiscal year 2006.

### **C. Interests of Experts and Counsel**

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### **A. Consolidated Statements and Other Financial Information**

See Item 17.

#### **Export Sales**

In the past three fiscal years we have derived over 97% of our revenues from export sales made to customers outside Canada. In 2006 47% of our export sales were made to the United states, 52% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China, and a further 1% were made to other areas. In 2005 63% of our export sales were made to the United States, 32% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China, and a further 4% were made to other areas. In 2004 64% of our export sales were made to the United States, 39% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China and a further 7% were made to other areas.

## Legal Proceedings

From time to time we may be involved in various disputes and litigation arising in the normal course of business. As of the date of this Annual Report we are not involved in any legal proceedings that are expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

## Dividend Distribution

We have never made a distribution of dividends.

## B. Significant Changes

There have been no significant changes since the date of the financial statements included in this Annual Report.

## ITEM 9. THE OFFER AND LISTING

### A. Offer and Listing Details

#### Price History

Our shares traded during the periods and at the prices set out below on The NASDAQ Capital Market.

The high and low market prices for the last five fiscal years:

<u>Fiscal Year</u>	<u>High</u>	<u>Low</u>
2006	6.45	3.25
2005	8.47	2.15
2004	8.40	1.52
2003	2.65	1.01
2002	2.28	0.53

The high and low market prices for each of the four quarters of 2006 and 2005:

<u>Quarter Ending</u>		<u>High</u>	<u>Low</u>
December	2006	5.47	4.28
September	2006	5.50	3.58
June	2006	6.45	3.65
March	2005	4.74	3.25
December	2005	4.86	2.15
September	2005	4.04	3.05
June	2005	4.50	3.40
March	2005	8.47	4.34

The high and low market prices for each of the last six months:

<u>Month</u>		<u>High</u>	<u>Low</u>
February	2007	6.09	4.50
January	2007	4.90	4.31
December	2006	5.20	4.57
November	2006	5.47	4.79
October	2006	5.47	4.28
September	2006	5.29	3.95

## B. Plan of Distribution

Not Applicable

### **C. Markets**

Our shares trade (since January, 1989) on The NASDAQ Capital Market under the symbol QSND (formerly QSNDF).

### **D. Selling Shareholders**

Not Applicable

### **E. Expenses of the Issue**

Not Applicable

## **ITEM 10. ADDITIONAL INFORMATION**

### **A. Share Capital**

Not Applicable

### **B. Memorandum and Articles of Association**

#### **Objects and Purposes**

Our objects and purposes, which are found in section 6. of our Articles of Continuance, allow us generally to engage in any act or activity that is not prohibited under the laws of the province of Alberta.

#### **Directors**

Our by-laws and the laws of the province of Alberta provide that a director must disclose the nature and extent of his or her interest, or the interest of a party in which the director has a material interest, in a material contract with our Company. The interest must be disclosed at the time the contract is considered or after the interest arises, whichever occurs first. A director may not approve a contract in which the director or the related party has a material interest unless the contract is an arrangement by way of security for money lent to or obligations undertaken by the director, or relates to his remuneration, or is for indemnity insurance or with an affiliate. A material contract in which a director has an interest is not void or voidable by reason only of the interest, or because the director is counted to determine the presence of a quorum at the meeting where the contract is considered. A director or former director to whom a profit accrues as a result of the material contract is not liable to us for the profit only by reason of the interest if the interest of the director was disclosed, the contract was approved by the directors or shareholders and the contract was reasonable and fair to us when approved.

Our by-laws and the laws of the province of Alberta provide that our directors may fix the remuneration of our directors, officers and employees. Under our by-laws the directors may also by resolution award special remuneration to any director that provides services to us other than routine work ordinarily required of a director. Directors, officers and employees are entitled to be paid their work-related travelling and other expenses.

Under Alberta law and our by-laws, our directors, or a delegated director, managing director or committee of directors, may borrow money, issue debt obligations, give a guarantee or mortgage or otherwise create a security interest in the property of our Company.

We do not have an age limit requirement for retirement of directors, and our directors are not required to hold our shares in order to be members of the board of directors.

#### **Shares**

We are authorized to issue an unlimited number of common shares, an unlimited number of first preferred shares, and an unlimited number of second preferred shares. At the date of this Annual Report there are 9,395,585 common shares, and no preferred shares, outstanding.

#### **Dividends**

Our directors may declare dividends on issued shares. Dividends may consist of shares, money or property. No dividends may be declared if we have reasonable grounds to believe that we are, or would be after payment of the dividend, unable to pay our debts as they become due, or if the realizable value of our assets would be less than our aggregate liabilities and stated capital. Our directors may attach preferential dividend rights to first or second preferred shares. Dividends are paid to preferred shareholders, if their preferred shares carry the right to a preferential dividend, before they are paid to common shareholders.

## **Voting**

Holders of common shares are entitled to one vote for each share they own on any matter that is submitted to a shareholder vote, unless only a different class of shareholders, for example holders of preferred shares, is entitled to vote on that matter. Our board of directors may attach various voting rights and restrictions to preferred shares. Shareholders elect our directors to hold office until the next annual meeting of shareholders, or until their successors are elected or appointed. Our Articles of Continuance do not provide for cumulative voting for the election of directors.

## **Other Rights of Shareholders**

If we are dissolved or liquidated, we must use our assets to pay liabilities and any remaining assets would be distributed first to preferred shareholders if their preferred shares carry the right to distribution of assets in priority to distribution of assets to common shareholders, and second to the holders of common shares, in proportion to the number of shares they own. Our common shares do not have any redemption or sinking fund provisions. There is no liability on the part of any shareholder to further capital calls and there are no provisions discriminating against any existing or prospective shareholder as a result of owning a substantial number of shares.

Shareholders may by special resolution change the rights of holders of our shares. A special resolution means a resolution passed by a majority of not less than two-thirds of the votes cast by shareholders who voted on the resolution, or signed by all shareholders entitled to vote on that resolution.

We are required by Alberta law and our by-laws to hold an annual meeting of shareholders in each year not later than fifteen months following the last annual meeting. A notice in writing stating the time and place of the meeting, the nature of any special business to be transacted and the text of the related proposed special resolution must be given to shareholders of record not less than 21 days and not more than 50 days prior to the meeting. In addition, Canadian securities regulatory policy requires us to deliver these shareholder meeting materials to brokers and intermediaries who hold shares on behalf of beneficial shareholders who do not hold their shares of record. The brokers and intermediaries must seek voting instructions from the beneficial shareholders. Holders of five percent or more of issued voting shares may requisition the directors to call a meeting for the purpose stated in the requisition. If the directors do not call a meeting within twenty-one days of the requisition, any shareholder who signed the requisition may call the meeting. Shareholders may vote at meetings in person or by proxy.

At meetings of shareholders two persons present and each holding or representing by proxy at least one common share constitute a quorum for purposes of selecting a chairman for the meeting or adjourning the meeting. For transacting any business at a shareholders meeting, two persons present and holding or representing by proxy at least five percent of the shares entitled to vote at the meeting must be present. We have received an exemption from The NASDAQ Stock Market, stating that we are not required to comply with NASDAQ's quorum requirement which calls for a quorum of not less than thirty-three and one-third percent of the shares entitled to vote at the meeting.

There are no limitations on rights to hold our shares or to exercise voting rights imposed by Alberta law or by our articles or by-laws. There are no provisions in our articles or by-laws that would have the effect of delaying, deferring or preventing a change in control of our Company and that would operate only with respect to a merger, acquisition or corporate restructuring of our Company or subsidiaries. Our by-laws do not contain any provision governing the threshold above which share ownership must be disclosed.

## **C. Material Contracts**

We have not entered into any contracts other than agreements entered into in the ordinary course of business.

## **D. Exchange Controls**

There are no government laws, decrees or regulations in Canada which restrict the export or import of capital or which affect the remittance of dividends, interest or other payments to non-resident holders of our common shares. However, any such remittance to a resident of the United States is generally subject to Canadian withholding tax pursuant to the Income Tax Act

(Canada) (the “Act”). (For further information concerning such non-resident withholding tax, see Item 10 E. “Taxation” of this Annual Report.)

## **E. Taxation**

The following is not intended to be, nor should it be considered to be, legal or income tax advice to any particular QSound shareholder or relied upon for tax planning purposes. Accordingly each shareholder should consult their own independent tax advisors for advice with respect to the income tax consequences to them having regard to their own particular circumstances.

### **U.S. Federal Income Tax Consequences**

The following is a summary of the anticipated material U.S. federal income tax consequences to a U.S. Holder (as defined below) arising from and relating to the acquisition, ownership, and disposition of common shares of QSound (“Common Shares”).

This summary is for general information purposes only and does not purport to be a complete analysis or listing of all potential U.S. federal income tax consequences that may apply to a U.S. Holder as a result of the acquisition, ownership, and disposition of Common Shares. In addition, this summary does not take into account the individual facts and circumstances of any particular U.S. Holder that may affect the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares. Accordingly, this summary is not intended to be, and should not be construed as, legal or U.S. federal income tax advice with respect to any U.S. Holder. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. federal income, U.S. state and local, and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares.

### **Scope of this Summary**

#### **Authorities**

This summary is based on the Internal Revenue Code of 1986, as amended (the “Code”), Treasury Regulations (whether final, temporary, or proposed), published rulings of the Internal Revenue Service (the “IRS”), published administrative positions of the IRS, the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed September 26, 1980, as amended (the “Canada-U.S. Tax Convention”), and U.S. court decisions that are applicable and, in each case, as in effect and available, as of the date of this Annual Report. Any of the authorities on which this summary is based could be changed in a material and adverse manner at any time, and any such change could be applied on a retroactive basis. This summary does not discuss the potential effects, whether adverse or beneficial, of any proposed legislation that, if enacted, could be applied on a retroactive basis.

#### **U.S. Holders**

For purposes of this summary, a “U.S. Holder” is a beneficial owner of Common Shares that, for U.S. federal income tax purposes, is (a) an individual who is a citizen or resident of the U.S., (b) a corporation, or any other entity classified as a corporation for U.S. federal income tax purposes, that is created or organized in or under the laws of the U.S. or any state in the U.S., including the District of Columbia, (c) an estate if the income of such estate is subject to U.S. federal income tax regardless of the source of such income, or (d) a trust if (i) such trust has validly elected to be treated as a U.S. person for U.S. federal income tax purposes or (ii) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of such trust.

#### **Non-U.S. Holders**

For purposes of this summary, a “non-U.S. Holder” is a beneficial owner of Common Shares other than a U.S. Holder. This summary does not address the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares to non-U.S. Holders. Accordingly, a non-U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. federal income, U.S. state and local, and foreign tax consequences (including the potential application of and operation of any tax treaties) of the acquisition, ownership, and disposition of Common Shares.

#### **U.S. Holders Subject to Special U.S. Federal Income Tax Rules Not Addressed**

This summary does not address the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares to U.S. Holders that are subject to special provisions under the Code, including the following U.S. Holders: (a) U.S. Holders that are tax-exempt organizations, qualified retirement plans, individual retirement accounts, or other tax-deferred accounts; (b) U.S. Holders that are financial institutions, insurance companies, real estate investment trusts, or regulated



investment companies; (c) U.S. Holders that are dealers in securities or currencies or U.S. Holders that are traders in securities that elect to apply a mark-to-market accounting method; (d) U.S. Holders that have a “functional currency” other than the U.S. dollar; (e) U.S. Holders that are liable for the alternative minimum tax under the Code; (f) U.S. Holders that own Common Shares as part of a straddle, hedging transaction, conversion transaction, constructive sale, or other arrangement involving more than one position; (g) U.S. Holders that acquired Common Shares in connection with the exercise of employee stock options or otherwise as compensation for services; (h) U.S. Holders that hold Common Shares other than as a capital asset within the meaning of Section 1221 of the Code; (i) U.S. Holders who are U.S. expatriates; or (j) U.S. Holders that own (directly, indirectly, or constructively) 10% or more of the total combined voting power of the outstanding shares of QSound. U.S. Holders that are subject to special provisions under the Code, including U.S. Holders described immediately above, should consult their own financial advisor, legal counsel or accountant regarding the U.S. federal income, U.S. state and local, and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares.

If an entity that is classified as a partnership (or “pass-through” entity) for U.S. federal income tax purposes holds Common Shares, the U.S. federal income tax consequences to such partnership (or “pass-through” entity) and the partners of such partnership (or owners of such “pass-through” entity) generally will depend on the activities of the partnership (or “pass-through” entity) and the status of such partners (or owners). Partners of entities that are classified as partnerships (or owners of “pass-through” entities) for U.S. federal income tax purposes should consult their own financial advisor, legal counsel or accountant regarding the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares.

#### Tax Consequences Other than U.S. Federal Income Tax Consequences Not Addressed

This summary does not address the U.S. state and local, U.S. federal estate and gift, or foreign tax consequences to U.S. Holders of the acquisition, ownership, and disposition of Common Shares. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. state and local, U.S. federal estate and gift, and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares. (See “Taxation—Canadian Federal Income Tax Consequences” above).

### **U.S. Federal Income Tax Consequences of the Acquisition, Ownership, and Disposition of Common Shares**

#### Distributions on Common Shares

##### *General Taxation of Distributions*

A U.S. Holder that receives a distribution, including a constructive distribution, with respect to the Common Shares will be required to include the amount of such distribution in gross income as a dividend (without reduction for any Canadian income tax withheld from such distribution) to the extent of the current or accumulated “earnings and profits” of QSound. To the extent that a distribution exceeds the current and accumulated “earnings and profits” of QSound, such distribution will be treated (a) first, as a tax-free return of capital to the extent of a U.S. Holder’s tax basis in the Common Shares and, (b) thereafter, as gain from the sale or exchange of such Common Shares. (See more detailed discussion at “Disposition of Common Shares” below).

##### *Reduced Tax Rates for Certain Dividends*

For taxable years beginning before January 1, 2011, a dividend paid by QSound generally will be taxed at the preferential tax rates applicable to long-term capital gains if (a) QSound is a “qualified foreign corporation” (as defined below), (b) the U.S. Holder receiving such dividend is an individual, estate, or trust, and (c) such dividend is paid on Common Shares that have been held by such U.S. Holder for at least 61 days during the 121-day period beginning 60 days before the “ex-dividend date.”

QSound generally will be a “qualified foreign corporation” under Section 1(h)(11) of the Code (a “QFC”) if (a) QSound is eligible for the benefits of the Canada-U.S. Tax Convention, or (b) the Common Shares are readily tradable on an established securities market in the U.S. However, even if QSound satisfies one or more of such requirements, QSound will not be treated as a QFC if QSound is a “passive foreign investment Company” (as defined below) for the taxable year during which QSound pays a dividend or for the preceding taxable year.

As discussed below, QSound does not believe that it was a “passive foreign investment Company” for the taxable year ended December 31, 2006, and does not expect that it will be a “passive foreign investment Company” for the taxable year ending December 31, 2007. (See more detailed discussion at “Additional Rules that May Apply to U.S. Holders” below). However, there can be no assurance that the IRS will not challenge the determination made by QSound concerning its “passive foreign investment Company” status or that QSound will not be a “passive foreign investment Company” for the current taxable year or any subsequent taxable year. Accordingly, although QSound expects that it may be a QFC for the taxable year ending December 31, 2007, there can be no assurances that the IRS will not challenge the determination made by QSound concerning its QFC

status, that QSound will be a QFC for the taxable year ending December 31, 2007 or any subsequent taxable year, or that QSound will be able to certify that it is a QFC in accordance with the certification procedures issued by the Treasury and the IRS.

If QSound is not a QFC, a dividend paid by QSound to a U.S. Holder, including a U.S. Holder that is an individual, estate, or trust, generally will be taxed at ordinary income tax rates (and not at the preferential tax rates applicable to long-term capital gains). The dividend rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the dividend rules.

#### *Distributions Paid in Foreign Currency*

The amount of a distribution paid to a U.S. Holder in foreign currency generally will be equal to the U.S. dollar value of such distribution based on the exchange rate applicable on the date of receipt. A U.S. Holder that does not convert foreign currency received as a distribution into U.S. dollars on the date of receipt generally will have a tax basis in such foreign currency equal to the U.S. dollar value of such foreign currency on the date of receipt. Such a U.S. Holder generally will recognize ordinary income or loss on the subsequent sale or other taxable disposition of such foreign currency (including an exchange for U.S. dollars).

#### *Dividends Received Deduction*

Dividends paid on the Common Shares generally will not be eligible for the “dividends received deduction.” The availability of the dividends received deduction is subject to complex limitations that are beyond the scope of this discussion, and a U.S. Holder that is a corporation should consult its own financial advisor, legal counsel, or accountant regarding the dividends received deduction.

#### Disposition of Common Shares

A U.S. Holder will recognize gain or loss on the sale or other taxable disposition of Common Shares in an amount equal to the difference, if any, between (a) the amount of cash plus the fair market value of any property received and (b) such U.S. Holder’s tax basis in the Common Shares sold or otherwise disposed of. Any such gain or loss generally will be capital gain or loss, which will be long-term capital gain or loss if the Common Shares are held for more than one year. Gain or loss recognized by a U.S. Holder on the sale or other taxable disposition of Common Shares generally will be treated as “U.S. source” for purposes of applying the U.S. foreign tax credit rules. (See more detailed discussion at “Foreign Tax Credit” below).

Preferential tax rates apply to long-term capital gains of a U.S. Holder that is an individual, estate, or trust. There are currently no preferential tax rates for long-term capital gains of a U.S. Holder that is a corporation. Deductions for capital losses are subject to significant limitations under the Code.

#### Foreign Tax Credit

A U.S. Holder that pays (whether directly or through withholding) Canadian income tax with respect to dividends paid on the Common Shares generally will be entitled, at the election of such U.S. Holder, to receive either a deduction or a credit for such Canadian income tax paid. Generally, a credit will reduce a U.S. Holder’s U.S. federal income tax liability on a dollar-for-dollar basis, whereas a deduction will reduce a U.S. Holder’s income subject to U.S. federal income tax. This election is made on a year-by-year basis and applies to all foreign taxes paid (whether directly or through withholding) by a U.S. Holder during a year.

Complex limitations apply to the foreign tax credit, including the general limitation that the credit cannot exceed the proportionate share of a U.S. Holder’s U.S. federal income tax liability that such U.S. Holder’s “foreign source” taxable income bears to such U.S. Holder’s worldwide taxable income. In applying this limitation, a U.S. Holder’s various items of income and deduction must be classified, under complex rules, as either “foreign source” or “U.S. source.” In addition, this limitation is calculated separately with respect to specific categories of income. Dividends paid by QSound generally will constitute “foreign source” income and generally will be categorized as “passive income.” The foreign tax credit rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the foreign tax credit rules.

#### Information Reporting; Backup Withholding Tax

Payments made within the U.S., or by a U.S. payor or U.S. middleman, of dividends on, or proceeds arising from the sale or other taxable disposition of, Common Shares generally will be subject to information reporting and backup withholding tax, at the rate of 28%, if a U.S. Holder (a) fails to furnish such U.S. Holder’s correct U.S. taxpayer identification number (generally on Form W-9), (b) furnishes an incorrect U.S. taxpayer identification number, (c) is notified by the IRS that such U.S. Holder has previously failed to properly report items subject to backup withholding tax, or (d) fails to certify, under penalty of perjury, that such U.S. Holder has furnished its correct U.S. taxpayer identification number and that the IRS has not notified such U.S. Holder that it is

subject to backup withholding tax. However, U.S. Holders that are corporations generally are excluded from these information reporting and backup withholding tax rules. Any amounts withheld under the U.S. backup withholding tax rules will be allowed as a credit against a U.S. Holder's U.S. federal income tax liability, if any, or will be refunded, if such U.S. Holder furnishes required information to the IRS. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the information reporting and backup withholding tax rules.

### **Additional Rules that May Apply to U.S. Holders**

If QSound is a "controlled foreign corporation" or a "passive foreign investment Company" (each as defined below), the preceding sections of this summary may not describe the U.S. federal income tax consequences to U.S. Holders of the acquisition, ownership, and disposition of Common Shares.

#### Controlled Foreign Corporation

QSound generally will be a "controlled foreign corporation" under Section 957 of the Code (a "CFC") if more than 50% of the total voting power or the total value of the outstanding shares of QSound is owned, directly or indirectly, by citizens or residents of the U.S., domestic partnerships, domestic corporations, domestic estates, or domestic trusts (each as defined in Section 7701(a)(30) of the Code), each of which own, directly or indirectly, 10% or more of the total voting power of the outstanding shares of QSound (a "10% Shareholder").

If QSound is a CFC, a 10% Shareholder generally will be subject to current U.S. federal income tax with respect to (a) such 10% Shareholder's pro rata share of the "subpart F income" (as defined in Section 952 of the Code) of QSound and (b) such 10% Shareholder's pro rata share of the earnings of QSound invested in "United States property" (as defined in Section 956 of the Code). In addition, under Section 1248 of the Code, any gain recognized on the sale or other taxable disposition of Common Shares by a U.S. Holder that was a 10% Shareholder at any time during the five-year period ending with such sale or other taxable disposition generally will be treated as a dividend to the extent of the "earnings and profits" of QSound that are attributable to such Common Shares. If QSound is both a CFC and a "passive foreign investment Company" (as defined below), QSound generally will be treated as a CFC (and not as a "passive foreign investment Company") with respect to any 10% Shareholder.

QSound does not believe that it has previously been, or currently is, a CFC. However, there can be no assurance that QSound will not be a CFC for the current or any subsequent taxable year.

#### Passive Foreign Investment Company

QSound generally will be a "passive foreign investment Company" under Section 1297 of the Code (a "PFIC") if, for a taxable year, (a) 75% or more of the gross income of QSound for such taxable year is passive income or (b) 50% or more of the assets held by QSound either produce passive income or are held for the production of passive income, based on the fair market value of such assets (or on the adjusted tax basis of such assets, if QSound is not publicly traded and either is a "controlled foreign corporation" or makes an election). "Passive income" includes, for example, dividends, interest, certain rents and royalties, certain gains from the sale of stock and securities, and certain gains from commodities transactions.

For purposes of the PFIC income test and asset test described above, if QSound owns, directly or indirectly, 25% or more of the total value of the outstanding shares of another foreign corporation, QSound will be treated as if it (a) held a proportionate share of the assets of such other foreign corporation and (b) received directly a proportionate share of the income of such other foreign corporation. In addition, for purposes of the PFIC income test and asset test described above, "passive income" does not include any interest, dividends, rents, or royalties that are received or accrued by QSound from a "related person" (as defined in Section 954(d)(3) of the Code), to the extent such items are properly allocable to the income of such related person that is not passive income.

In addition, if QSound is a PFIC and owns shares of another foreign corporation that also is a PFIC, under certain indirect ownership rules, a disposition of the shares of such other foreign corporation or a distribution received from such other foreign corporation generally will be treated as an indirect disposition by a U.S. Holder or an indirect distribution received by a U.S. Holder, subject to the rules of Section 1291 of the Code discussed below. To the extent that gain recognized on the actual disposition by a U.S. Holder of Common shares or income recognized by a U.S. Holder on an actual distribution received on Common Shares was previously subject to U.S. federal income tax under these indirect ownership rules, such amount generally should not be subject to U.S. federal income tax.

If QSound is a PFIC, the U.S. federal income tax consequences to a U.S. Holder of the acquisition, ownership, and disposition of Common Shares will depend on whether such U.S. Holder makes an election to treat QSound as a "qualified electing fund" or "QEF" under Section 1295 of the Code (a "QEF Election") or a mark-to-market election under Section 1296 of the Code (a

“Mark-to-Market Election”). A U.S. Holder that does not make either a QEF Election or a Mark-to-Market Election will be referred to in this summary as a “Non-Electing U.S. Holder.”

Under Section 1291 of the Code, any gain recognized on the sale or other taxable disposition of Common Shares, and any “excess distribution” (as defined in Section 1291(b) of the Code) paid on the Common Shares, must be ratably allocated to each day in a Non-Electing U.S. Holder’s holding period for the Common Shares. The amount of any such gain or excess distribution allocated to prior years of such Non-Electing U.S. Holder’s holding period for the Common Shares generally will be subject to U.S. federal income tax at the highest tax applicable to ordinary income in each such prior year. A Non-Electing U.S. Holder will be required to pay interest on the resulting tax liability for each such prior year, calculated as if such tax liability had been due in each such prior year.

A U.S. Holder that makes a QEF Election generally will not be subject to the rules of Section 1291 of the Code discussed above. However, a U.S. Holder that makes a QEF Election generally will be subject to U.S. federal income tax on such U.S. Holder’s pro rata share of (a) the “net capital gain” of QSound, which will be taxed as long-term capital gain to such U.S. Holder, and (b) and the “ordinary earnings” of QSound, which will be taxed as ordinary income to such U.S. Holder. A U.S. Holder that makes a QEF Election will be subject to U.S. federal income tax on such amounts for each taxable year in which QSound is a PFIC, regardless of whether such amounts are actually distributed to such U.S. Holder by QSound.

A U.S. Holder that makes a Mark-to-Market Election generally will not be subject to the rules of Section 1291 of the Code discussed above. A U.S. Holder may make a Mark-to-Market Election only if the Common Shares are “marketable stock” (as defined in Section 1296(e) of the Code). A U.S. Holder that makes a Mark-to-Market Election will include in gross income, for each taxable year in which QSound is a PFIC, an amount equal to the excess, if any, of (a) the fair market value of the Common Shares as of the close of such taxable year over (b) such U.S. Holder’s tax basis in such Common Shares. A U.S. Holder that makes a Mark-to-Market Election will, subject to certain limitations, be allowed a deduction in an amount equal to the excess, if any, of (a) such U.S. Holder’s adjusted tax basis in the Common Shares over (b) the fair market value of such Common Shares as of the close of such taxable year.

QSound does not believe that it was a PFIC for the taxable year ended December 31, 2006, and does not expect that it will be a PFIC for the taxable year ending December 31, 2007. The determination of whether QSound was, or will be, a PFIC for a taxable year depends, in part, on the application of complex U.S. federal income tax rules, which are subject to differing interpretations. In addition, whether QSound will be a PFIC for the taxable year ending December 31, 2007 and each subsequent taxable year depends on the assets and income of QSound over the course of each such taxable year and, as a result, cannot be predicted with certainty as of the date of this Annual Report. Accordingly, there can be no assurance that the IRS will not challenge the determination made by QSound concerning its PFIC status or that QSound was not, or will not be, a PFIC for any taxable year.

The PFIC rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the PFIC rules and how the PFIC rules may affect the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares.

### **Canadian Federal Income Tax Considerations**

The following is a general summary of certain Canadian federal income tax considerations generally applicable to a holder of QSound common shares that is not a resident of Canada and holds such common shares as capital property, both for the purposes of the Income Tax Act (Canada) (the “Act”). The discussion does not address all of the potentially relevant Canadian federal income tax matters and it does not address consequences peculiar to persons subject to special provisions of Canadian federal income tax law including a “financial institution” as defined in the Act subject to the “mark-to-market rules” or a shareholder an interest in which would be a “tax shelter” as defined in the Act.

This summary is based upon the current provisions of the Act and the Regulations promulgated thereunder and our understanding of the current administrative practices published by the Canada Revenue Agency. This summary takes into account proposals to amend the Act and Regulations announced prior to the date hereof (although no assurances can be given that such changes will be enacted in the form presented or at all), but does not otherwise take into account or anticipate any other changes in law, whether by judicial, governmental or legislative action or decision nor does it take into account any provincial, territorial, local or foreign tax considerations which may vary significantly from those discussed herein. Accordingly, holders and prospective holders of our shares should consult their own tax advisors about the federal, provincial, territorial, local and foreign tax consequences to them of purchasing, owning and disposing of such shares having regard to their particular circumstances.

The Act provides that dividends and other distributions which are deemed to be dividends and which are paid or credited, or are deemed to be paid or credited by a corporation resident in Canada, to a person who is not resident of Canada for purposes of the Act shall be subject to withholding tax equal to 25 percent of the gross amount of the dividend. This rate of withholding tax is

subject to reduction if the provisions of a tax treaty between Canada and the country in which the recipient is resident provides for a lesser rate of withholding tax.

Shareholders who are residents of the United States for purposes of the Canada-United States Income Tax Convention (1980) (the "1980 Convention") will generally be entitled to the benefits of the 1980 Convention.

Article X of the 1980 Convention generally provides that the rate of Canadian withholding tax on dividends paid or deemed to be paid by a corporation resident in Canada to a corporation resident in the United States that beneficially owns at least 10 percent of the voting stock of the corporation paying the dividend shall not exceed 5 percent. Otherwise, for persons that are resident in the United States for the purposes of the 1980 Convention, and except as described below, the rate of non-resident withholding shall not exceed 15 percent of the dividend. Where the dividends are received by a resident of the United States carrying on business in Canada through a permanent establishment in Canada or by a person who performs independent personal services in Canada from a fixed base situated in Canada, and the holding of the shares in respect of which the dividends are paid is effectively connected with that permanent establishment, the dividends are generally subject to Canadian tax as business profits or income from rendering such services and the 1980 Convention does not limit the Canadian tax payable on such income under the Act.

Generally a non-resident person is not subject to income tax in Canada on any capital gain arising on the disposition of shares of a corporation which are listed on a prescribed stock exchange unless such shares constitute "taxable Canadian property" to such holder. Generally, shares will be taxable Canadian property to a non-resident person only if, at any time during the five year period immediately preceding the disposition, the non-resident person, either alone or together with persons with whom such non-resident did not deal at arm's length, owned 25 percent or more of the issued shares of any class of the capital stock of the corporation, or the non-resident's shares were acquired in a tax deferred exchange in consideration for property that was itself taxable Canadian property.

Article XIII of the 1980 Convention generally provides that gains realized on the disposition of shares of a corporation that is a resident of Canada by a resident of the United States for purposes of the 1980 Convention, may not be taxed in Canada unless the value of those shares is derived principally from real property situated in Canada or the shares form part of the business property of a permanent establishment which the resident of the United States has or had in Canada within the 12 month period preceding the date of disposition or if the shares pertain to a fixed base in Canada which is or was available within the 12 month period preceding the date of disposition for the purpose of performing independent personal services. However, Article XIII permits Canada to tax gains on shares of other corporations (including substituted shares), if the United States resident was a resident of Canada for 120 months during any prior 20-consecutive-year period and at any time during the preceding 10 years and owned our common shares at the time the person emigrated from Canada.

In situations where our common shares constitute taxable Canadian property, and the treaty benefits under the 1980 Convention discussed above or treaty benefits under any other applicable tax convention, are not applicable, one-half of any capital gain (a "taxable capital gain") realized by a shareholder in a taxation year must be included in the shareholder's income for the year for Canadian tax purposes, and one-half of any capital loss (an "allowable capital loss") realized by a shareholder in a taxation year from the disposition of taxable Canadian property may be deducted from taxable capital gains realized by the shareholder in that year. Allowable capital losses for a taxation year in excess of taxable capital gains for that year generally may be carried back and deducted in any of the three preceding taxation years or carried forward and deducted in any subsequent taxation year against net taxable capital gains realized in such years, to the extent and under the circumstances described in the Act.

#### **F. Dividends and Paying Agents**

Not applicable.

#### **G. Statements by Experts**

Not Applicable

#### **H. Documents on display**

We are subject to the informational requirements of the Securities Exchange Act of 1934 and of Canadian provincial securities laws and regulations in Alberta, Ontario and British Columbia. We file reports, registration statements and other information with the SEC and with Canadian provincial securities regulators. Our reports, registration statements and other information can be found on the SEC website [www.sec.gov](http://www.sec.gov), on the Canadian System for Electronic Document Analysis and Retrieval website [www.sedar.com](http://www.sedar.com), and may be inspected and copied at the public reference facilities maintained by the SEC:

Washington, D.C. 20549.

Copies of these materials can also be obtained by mail at prescribed rates from the Public Reference Section of the SEC at the same address, or by calling the SEC at 1-800-SEC-0330.

## **I. Subsidiary Information**

Not Applicable

### **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **Foreign Currency**

The Company uses the U.S. dollar as the currency of measurement and display. The Company is exposed to foreign currency fluctuation on Canadian dollar denominated cash, receivables, and payables. Canadian dollar denominated accounts receivables are nominal. Canadian dollar denominated payables are all trade payables arising out of the normal course of business. Foreign currency risk arising from a decline or increase in the relative value of the Canadian dollar is managed to the extent that the estimated requirement for Canadian dollar denominated cash is kept equal to the amount of Canadian dollar cash on hand. The majority of overseas transactions are conducted in U.S. dollars.

The Company has not entered into any foreign currency contracts to hedge this risk.

#### **Interest Rates**

The Company's exposure to market risk includes changes in interest rates, which relates to both our invested balances of cash and cash equivalents, and convertible loan notes.

The Company invests excess funds in a manner that preserves capital, provides liquidity and generates the highest available after-tax return. To limit exposure to market risk, the Company places its cash in banks and cash not required for immediate operations is placed in bank term deposits. At December 31, 2006 this amounted to \$2,055,166 (2005: \$1,189,887). The fair value of QSound's cash and cash equivalents would not be significantly impacted by a decrease in interest rates. All cash and cash equivalents are carried at fair value, which approximates cost.

The Company's convertible loan notes are for the principal amount of \$1,000,000 and are repayable on March 27, 2011. The notes bear interest at US prime rate, based on the prime rate in effect on the last day of the immediately preceding calendar quarter, and is payable quarterly in arrears. The US prime rate at December 31, 2006 was 8.25%. The weighted average interest rate as at December 31, 2006 was 8.08%. The Company has exposure to interest rate fluctuations on its convertible loan notes but the Company would not be significantly impacted by an increase in interest rates. The convertible loan notes are carried at fair value, with the components being allocated a fair value at date of initial recognition liabilities (\$344,778), equity (\$314,396) and warrants (\$340,826).

The Company has not entered into any contracts to hedge its interest rate risk during 2006.

### **ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not Applicable.

## **PART II**

### **ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

We are not in default on any of our obligations relating to indebtedness. We have not declared any dividends and are not delinquent with respect to the payment of dividends.

### **ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS**

During our last fiscal year, we have not materially modified any of the rights or instruments defining the rights of our security holders. We do not have any registered securities which are secured by our assets. We do not have trustees or paying agents for our securities.

## **ITEM 15. CONTROLS AND PROCEDURES**

Based on their evaluation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) as of December 31, 2006, our Chief Executive and Financial Officer has concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that 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, and are operating in an effective manner.

This Annual Report does not include management’s report on internal control over financial reporting pursuant to current SEC rules which do not require such a report to be included.

There were no changes in our internal control over financial reporting that occurred during the period covered by this Annual Report that materially affected or were reasonably likely to have materially affected our internal control over financial reporting for the fiscal year ended December 31, 2006.

## **ITEM 16. [RESERVED]**

### **ITEM 16A. Audit Committee Financial Expert**

M. Patty Chakour, who became a director on March 1, 2004, serves as the audit committee financial expert.

### **ITEM 16B. Code of Ethics**

We have adopted a Code of Ethics which applies to all of our officers, directors and employees. The Code of Ethics may be viewed on our Web site [www.qsound.com](http://www.qsound.com). We will mail a copy of the Code of Ethics to you without charge upon request.

### **ITEM 16C. Principal Accountant Fees and Services**

#### **Audit Fees**

Grant Thornton, who acted as our accountants from April 29, 2005 to October 6, 2006, billed \$96,000 in 2006 and \$11,500 in 2005 for audit services and services related to statutory filings. KPMG, our external accountants prior to April 29, 2005 and after October 6, 2006, billed \$9,520 in 2006, \$67,065 in 2005 and \$89,000 in 2004 for audit services and services related to statutory filings.

#### **Audit-Related Fees, Tax Fees and All Other Fees**

Grant Thornton and KPMG did not bill any audit-related, tax or other fees in 2006 or 2005.

#### **Audit Committee Approval**

The audit committee approves the engagement of our external auditors for all services on an engagement by engagement basis.

### **ITEM 16D. Exemptions from Listing Standards for Audit Committees**

Not Applicable.

### **ITEM 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

Not Applicable.

## **PART III**

## **ITEM 17. FINANCIAL STATEMENTS**

Consolidated Financial Statements of QSound Labs, Inc.  
Report of Independent Registered Public Accounting Firm to the Shareholders.

Consolidated Balance Sheets – December 31, 2006 and 2005.

Consolidated Statements of Operations and Deficit – Years ended December 31, 2006, 2005 and 2004.

Consolidated Cash Flows – Years ended December 31, 2006, 2005 and 2004.

Notes to Consolidated Financial Statements – Years ended December 31, 2006, 2005 and 2004.

#### **ITEM 18. FINANCIAL STATEMENTS**

Not Applicable.

#### **ITEM 19. EXHIBITS**

1.1 Articles of Continuance of QSound Labs, Inc. (formerly called Archer Communications Inc.). (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.2 By-law No. 1 dated July 2, 2002. (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)

1.3 By-law No. 2 dated May 14, 1991. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.4 Articles of Amendment dated September 3, 1991. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.5 Articles of Amendment dated July 8, 1992. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.6 Articles of Amendment dated June 25, 1993. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.7 Articles of Amendment dated November 26, 1996. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.8 Articles of Amendment dated January 8, 1997. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

2.1 Not Applicable

3.1 Not Applicable

4.1 Form of Stock Option Agreement (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)

4.2 QSound Labs, Inc. 1998 Stock Option Plan (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)

4.3 Employment Agreement dated September 30, 2002 between David J. Gallagher and QSound Labs, Inc. (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)

4.4 Employment Agreement dated April 19, 1999 between Francis Munoz and QSound Labs, Inc. (Incorporated by reference to our Annual Report on Form 20-F filed March 21, 2005.)

4.5 Employment Agreement dated June 17, 2002 between Robert Starr and QSound Labs, Inc. (Incorporated by reference to our Annual Report on Form 20-F filed March 21, 2005.)

5.1 Not Applicable.

6.1 Not Applicable.

7.1 Not Applicable.



- 8.1 List of Subsidiaries (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)
- 9.1 Not Applicable.
- 10.1 Not Applicable
- 11.1 Code of Ethics (Incorporated by reference to our Annual Report on Form 20-F filed March 31, 2004.)
- 12.1 Certification of President and Chief Executive Officer under section 302 of the Sarbanes-Oxley Act of 2002.
- 12.2 Certification of Chief Financial Officer under section 302 of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification of President and Chief Executive Officer under section 906 of the Sarbanes-Oxley Act of 2002.
- 13.2 Certification of Chief Financial Officer under section 906 of the Sarbanes-Oxley Act of 2002.
- 14.1 KPMG Consent of Auditors.
- 14.2 Grant Thornton Consent of Auditors.
- 15.1 Audit Committee Charter (Incorporated by reference to our Annual Report on Form 20-F filed March 21, 2005.)
- 15.2 Audit Committee Charter dated August 2, 2006.

**SIGNATURE**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Annual Report on its behalf.

QSound Labs, Inc.

/s/ David J. Gallagher  
David J. Gallagher  
President and Chief Executive Officer

March 23, 2007

## EXHIBITS INDEX

Exhibit No.	Description of Document
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**Consolidated Financial Statements**



**KPMG LLP**  
**Chartered Accountants**  
2700 205 - 5th Avenue SW  
Calgary AB T2P 4B9

Telephone (403) 691-8000  
Fax (403) 691-8008  
Internet www.kpmg.ca

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheet of QSound Labs, Inc. as at December 31, 2006 and the consolidated statements of operations and deficit and cash flows for the year then ended. We have also audited the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and the results of its operations and its cash flows for the year then ended and the year ended December 31, 2004, in accordance with Canadian generally accepted accounting principles.

Accounting principles generally accepted in Canada vary in certain significant respects from accounting principles generally accepted in the United States. Application of accounting principles generally accepted in the United States would have affected results of operations for the year ended December 31, 2006 and year ended December 31, 2004 and total assets and shareholders' equity as at December 31, 2006 to the extent summarized in note 17 to the consolidated financial statements.

The consolidated financial statements as at December 31, 2005 and for the year then ended were audited by other auditors, who expressed an opinion without reservation on those statements in their report, dated March 29, 2006.

*KPMG LLP*

Chartered Accountants

Calgary, Canada  
March 7, 2007

# Consolidated Balance sheets

December 31, 2006 and 2005  
(Expressed in United States dollars)

	2006	2005
<b>ASSETS</b>		
<i>Current assets</i>		
Cash and cash equivalents	\$ 2,316,476	\$ 1,222,729
Accounts receivable (net) and accrued revenue	316,298	401,524
Note receivable	6,000	82,648
Inventory	19,422	40,438
Deposits and prepaid expenses	60,933	76,146
	2,719,129	1,823,485
Note receivable	55,325	—
Property and equipment (note 3)	348,280	670,635
Deferred development costs (note 4)	313,800	352,750
Intangible assets (note 5)	98,351	155,445
	\$ 3,534,885	\$ 3,002,315
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<i>Current liabilities</i>		
Accounts payable and accrued liabilities	\$ 268,439	\$ 285,786
Deferred revenue	45,572	45,011
	314,011	330,797
Convertible notes (note 6)	389,862	—
<i>Shareholders' equity</i>		
Share capital (note 7)	47,208,942	45,979,055
Warrants (note 8)	1,027,114	903,738
Contributed surplus (note 9)	2,581,456	2,041,001
Deficit	(47,986,500)	(46,252,276)
	2,831,012	2,671,518
	\$ 3,534,885	\$ 3,002,315

See accompanying notes to consolidated financial statements.

Approved by the Board:

David Gallagher: Director

Patty Chakour: Director

# Consolidated Statements of Operations and Deficit

Years ended December 31, 2006, 2005 and 2004  
(Expressed in United States dollars)

	2006	2005	2004
<b>REVENUE</b>			
Royalties, license and engineering fees	\$ 1,692,669	\$ 1,056,509	\$ 1,162,303
Product sales	296,361	486,731	1,050,875
	1,989,030	1,543,240	2,213,178
Cost of product sales	40,088	179,781	419,290
	1,948,942	1,363,459	1,793,888
<b>EXPENSES</b>			
Marketing	1,157,573	999,875	1,251,695
Operations	136,386	216,409	242,531
Product engineering	819,277	952,050	964,380
Administration	971,571	882,722	800,611
Foreign exchange loss	25,912	2,832	41,955
Amortization	331,419	360,898	457,572
Impairment of property and equipment (note 3)	167,809	89,754	–
Impairment of intangible assets (note 5)	–	428,453	–
	3,609,947	3,932,993	3,758,744
Loss before other items	(1,661,005)	(2,569,534)	(1,964,856)
<b>OTHER ITEMS</b>			
Interest income	85,686	56,700	78,727
Interest on convertible notes	(61,336)	–	–
Accretion expense	(45,083)	–	–
Loss on sale of property and equipment	–	–	(15,616)
Other	(1,637)	(163)	(1,697)
	(22,370)	56,537	61,414
Loss before taxes	(1,683,375)	(2,512,997)	(1,903,442)
Foreign withholding tax	(50,849)	(37,711)	(22,504)
Net loss	(1,734,224)	(2,550,708)	(1,925,946)
Deficit, beginning of year	(46,252,276)	(43,701,568)	(41,775,622)
Deficit, end of year	\$ (47,986,500)	\$ (46,252,276)	\$ (43,701,568)
Loss per common share (basic and diluted)	\$ (0.19)	\$ (0.30)	\$ (0.25)

See accompanying notes to consolidated financial statements

# Consolidated Statements of Cash Flows

Years ended December 31, 2006, 2005 and 2004  
(Expressed in United States dollars)

	2006	2005	2004
Cash provided by (used in):			
<b>OPERATIONS</b>			
Loss for the year	\$ (1,734,224)	\$ (2,550,708)	\$ (1,925,946)
Items not requiring (providing) cash:			
Amortization	331,419	360,898	457,572
Stock based compensation	380,614	134,793	320,432
Accretion expense	45,083	–	–
Loss on sale of property and equipment	–	–	15,616
Impairment of property and equipment	167,809	89,754	–
Impairment of intangible assets	–	428,453	–
Other	(4,022)	–	–
Changes in non-cash working capital balances (note 12)	104,669	(57,747)	(47,817)
	(708,652)	(1,594,557)	(1,180,143)
<b>FINANCING</b>			
Issuance of common shares, net	857,883	165,008	2,120,657
Issuance of warrants	–	–	904,019
Proceeds on issuance of convertible notes	1,000,000	–	–
	1,857,883	165,008	3,024,676
<b>INVESTMENTS</b>			
Note receivable	26,442	(82,648)	–
Purchase of property and equipment	(42,426)	(188,890)	(164,457)
Deferred development costs	(39,500)	(352,750)	–
Purchase of intangible assets	–	(50,977)	(418,056)
Proceeds from sale of property and equipment	–	–	4,430
	(55,484)	(675,265)	(578,083)
Increase (decrease) in cash and cash equivalents	1,093,747	(2,104,814)	1,266,450
Cash and cash equivalents, beginning of year	1,222,729	3,327,543	2,061,093
Cash and cash equivalents, end of year	\$ 2,316,476	\$ 1,222,729	\$ 3,327,543

Supplementary information (note 12)

# Notes

## to Consolidated Financial Statements

Years Ended December 31, 2006, 2005, and 2004  
(Expressed in United States dollars)

### 1. Financial statement presentation

The consolidated financial statements include the accounts of QSound Labs, Inc., a company organized under the laws of the Province of Alberta, and its subsidiaries (collectively "QSound" or the "Company") and are presented in accordance with Canadian generally accepted accounting principles. These accounting principles, in the case of the Company, conform in all material respects with those in the United States, except as outlined in note 17. All amounts are expressed in United States Dollars

QSound Labs, Inc. is an audio technology company which develops proprietary audio solutions, including virtual surround sound, positional audio and stereo enhancement for mobile devices, consumer electronics, PC/multimedia and Internet markets. Its subsidiaries QCommerce Inc. and QTelNet Inc. provide e-commerce solutions for small and medium sized businesses and Voice Over IP solutions respectively.

### 2. Significant accounting policies:

#### Cash and cash equivalents:

Cash and cash equivalents include short term deposits with initial maturities of three months or less at the date of acquisition.

#### Inventory:

Inventory is stated at the lower of cost, being determined by the first-in, first-out method, and net realizable value.

#### Foreign currency translation:

The Company's functional currency is United States Dollars. The Company translates its foreign denominated monetary assets and liabilities at the exchange rate prevailing at the year end. Non-monetary assets, liabilities and depreciation are translated at historic rates. Revenues and expenses are translated at the average rate of exchange for the year and any resulting foreign exchange gains or losses are included in determination of net income or loss for the year.

#### Property and equipment:

Property and equipment is recorded at cost and is depreciated over the expected useful life of the assets as follows:

Assets	Basis	Rate
Sound source and control equipment	Declining balance	20%
Real time systems	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Computer equipment	Declining balance	30%
Software and production tooling	Declining balance	30%

The carrying value of property and equipment is assessed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

#### Research and development costs:

Research costs are expensed as incurred. Development costs are expensed as incurred except if they relate to a specific product or process that meet certain criteria and are fully recoverable, in which case these costs are deferred.

Amortization of deferred development costs commences with commercial production or use of the process, and are amortized at an annual rate of 20% over its estimated 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.

#### Intangible assets:

Patents and trademarks and purchased customer lists are recorded at cost and are amortized over the expected useful life of the assets, which has been estimated to be 5 years. Their carrying value is assessed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.



**Revenue recognition:**

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 their 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.

**Income taxes:**

The Company uses the asset and 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 to be realized, a valuation allowance is provided.

**Per share amounts:**

Basic per share amounts are calculated using the weighted average number of common shares outstanding for the year. The Company applies the treasury stock method to calculate diluted per share amounts. The treasury stock method assumes that any proceeds from the exercise of in-the-money stock options and other dilutive instruments would be used to purchase common shares at the average market price during the period.

**Stock based compensation:**

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.

**Measurement uncertainty:**

The timely preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires that management make estimates and assumptions and use judgment regarding the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Such estimates primarily relate to unsettled transactions and events as of the date of the consolidated financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur. Amounts recorded for depreciation, accretion of debt discount and income taxes (which are subject to re-assessment by tax authorities) are based on management estimates and assumptions.

**3. Property and equipment:**

	2006		2005	
	Cost	Accumulated amortization	Net book value	
Sound source and control equipment	\$ 550,664	\$ 536,591	\$ 14,073	
Real time systems	905,534	902,608	2,926	
Furniture and fixtures	230,853	211,714	19,139	
Computer equipment	1,132,745	891,337	241,408	
Software and production tooling	1,632,281	1,561,547	70,734	
	\$ 4,452,077	\$ 4,103,797	\$ 348,280	
Sound source and control equipment	\$ 545,463	\$ 529,346	\$ 16,117	
Real time systems	905,534	901,354	4,180	
Furniture and fixtures	230,668	207,750	22,918	
Computer equipment	1,095,705	809,061	286,644	
Software and production tooling	1,632,281	1,291,505	340,776	
	\$ 4,409,651	\$ 3,739,016	\$ 670,635	

In accordance with the Company's accounting policy, an analysis of property and equipment was completed in 2006 on the telephony assets, as changes in this market indicated that the carrying amount may not be recoverable. Included in accumulated amortization above are asset impairment charges of \$167,809 (2005: \$88,392) relating to software and production tooling and of \$nil (2005: \$1,362) relating to computer equipment.

#### 4. Deferred development costs:

	2006	2005
Software development costs	\$ 844,064	\$ 804,564
Accumulated amortization	530,264	451,814
Net book value	\$ 313,800	\$ 352,750

In 2006, amortization of \$78,450 (2005: \$64,974; 2004: \$112,711) was recorded and included in amortization expense.

#### 5. Intangible assets:

	Cost	Accumulated amortization	Net book value
<b>2006</b>			
Patents and trademarks	\$ 927,811	\$ 829,460	\$ 98,351
Purchased customer list	34,418	34,418	-
Licensing rights	428,453	428,453	-
	\$ 1,390,682	\$ 1,292,331	\$ 98,351
<b>2005</b>			
Patents and trademarks	\$ 928,906	\$ 780,344	\$ 148,562
Purchased customer list	34,418	27,535	6,883
Licensing rights	428,453	428,453	-
	\$ 1,391,777	\$ 1,236,332	\$ 155,445

In accordance with its accounting policy the Company has determined that there were no events or circumstances in the current year that indicate possible impairment of these assets. An analysis of intangible assets was completed in 2005 resulting in an impairment charge of \$428,453 relating to licensing rights. This charge is included in accumulated amortization.

#### 6. Convertible notes:

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

The notes are convertible at the option of the holders 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 provide for an adjustment to 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 exercise price as that of the convertible securities subsequently issued.

The convertible notes are a financial instrument comprising both an equity component and a liability component, which together with the warrants have been fair valued on initial recognition. Fair value of the equity component and the warrants were calculated using the Black Scholes pricing model, and the fair value of the liability component was calculated as the present value of the principal and interest payments. The total cash proceeds have been allocated to these components on a pro-rata basis using these calculated fair values resulting in \$344,778, \$314,396 and \$340,826 being allocated to the liability component, equity component and warrants respectively. The fair value of the warrants and equity component of the convertible notes were calculated with the assumptions stated below:

Risk free interest rate	4.83%
Volatility	71%
Expected Life	3 Years
Dividend yield	0%

The present value of the principal and interest payments have been calculated using a discount factor of 15% and a US prime rate of 7.75%. The proceeds allocated to the debt component of the convertible note, \$344,778, will be accreted to the face value of the note of \$1,000,000 over its term of five years. During the year, \$45,083 has been charged as accretion expense relating to these items.

#### At December 31, 2006

Face value of loan	\$ 1,000,000
Accretion expense to be recognized in future periods	610,138
	\$ 389,862

## 7. Share capital:

### Authorized:

The Company is authorized to issue an unlimited number of common shares without par value and an unlimited number of first and second preferred shares. No preferred shares are outstanding.

### Common shares issued and outstanding:

	Number of Shares	Consideration
Balance December 31, 2003	7,199,244	\$ 43,801,245
Issued upon exercise of options	857,015	1,425,703
Issued for cash by private placement	347,826	2,000,000
Assigned value of warrants issued as part of private placement costs (note 8)	—	(380,862)
Deemed allocation to warrants	—	(904,019)
Share issue costs	—	(149,541)
Balance December 31, 2004	8,404,085	45,792,526
Issued upon exercise of options	257,900	222,521
Share issue costs	—	(35,992)
Balance December 31, 2005	8,661,985	45,979,055
Issued upon exercise of options	213,600	508,155
Issued upon exercise of warrants	500,000	737,450
Share issue costs	—	(15,718)
Balance December 31, 2006	9,375,585	\$ 47,208,942

## 8. Warrants:

	Number of Warrants	Consideration
Balance December 31, 2003	500,000	\$ 217,450
Issued	735,869	1,284,881
Balance December 31, 2004	1,235,869	1,502,331
Expired	(521,739)	(598,593)
Balance December 31, 2005	714,130	903,738
Exercised	(500,000)	(217,450)
Issued	400,000	340,826
Balance December 31, 2006	614,130	\$ 1,027,114

The balance at December 31, 2005 has been adjusted to reflect the expiration of warrants in 2005 and the transfer within shareholders' equity from warrants to contributed surplus.

The amount of \$340,826 allocated to the warrants issued was calculated taking the total cash proceeds of the convertible note (note 6) on a pro-rata basis using the estimated fair value of the warrants issued and the fair value of the convertible note.

Each warrant outstanding at December 31, 2006 is exercisable into one common share of the Company as follows:

Warrants Outstanding and Exercisable	Exercise Price	Remaining Term (years)
75,000	\$ 7.77	3.0
139,130	9.12	3.0
400,000	4.50	4.2
614,130	\$ 5.95	3.8

## 9. Contributed surplus:

Balance December 31, 2003	\$	1,203,760
Stock – based compensation		376,861
Options exercised		(251,485)
Balance December 31, 2004		1,329,136
Stock – based compensation		134,793
Options exercised		(21,521)
Expired warrants		598,593
Balance December 31, 2005		2,041,001
Stock – based compensation		380,614
Options exercised		(154,555)
Value of equity component of convertible notes (note 6)		314,396
Balance December 31, 2006	\$	2,581,456

The balance at December 31, 2005 has been adjusted to reflect the expiration of warrants in 2005 and the transfer within shareholders' equity from warrants to contributed surplus.

## 10. Stock option plan:

A summary of the Company's outstanding stock options at December 31, 2006, 2005 and 2004 and changes during those years is presented below:

	Number of Shares	Weighted average exercise price
Balance at December 31, 2003	1,738,765	\$ 0.87
Granted	630,720	2.58
Exercised	(857,015)	1.37
Cancelled or expired	(354,970)	1.36
Balance at December 31, 2004	1,157,500	1.29
Granted	180,933	2.59
Exercised	(257,900)	0.78
Cancelled or expired	(53,000)	4.56
Balance December 31, 2005	1,027,533	1.48
Granted	170,000	4.69
Exercised	(213,600)	1.66
Cancelled or expired	(2,233)	2.40
Balance December 31, 2006	981,700	\$ 1.99

All stock options granted have expiry dates between 2007 and 2015. Of the 170,000 stock options granted in 2006, 63,500 stock options vested in 2006, 84,000 stock options vest in 2007 and 22,500 stock options vest in 2008. No options were granted to non-employees in 2006 (2005: Nil, 2004: 60,000) in connection with services to be performed. The non employee options granted in 2004 have either vested or been cancelled. The table below summarizes unexercised stock options:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted- Average Remaining Term (Years)	Weighted- Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.47 to 1.65	551,500	4.0	\$ 0.97	551,500	\$ 0.97
2.05 to 2.40	229,200	4.8	2.22	139,200	2.10
3.50 to 3.57	45,000	2.7	3.55	45,000	3.55
3.57 to 5.33	156,000	4.4	4.81	52,500	4.47
	981,700	4.1	\$ 1.99	788,200	\$ 1.55

In 2006, a non cash expense of \$380,614 (2005: \$134,793; 2004: \$320,432) was recorded reflecting the fair value of employee and directors stock options granted and vesting during the year. Of the \$380,614 expense, \$45,848 related to modification of 485,500 existing stock options. These fully vested stock options had their expiry date extended through to 2011. In 2006, no compensation cost (2005: \$nil; 2004: \$56,429) has been recognized as compensation cost related to options issued to non-employees.

No compensation cost was recorded in the Company's statement of operations and deficit for options granted in 2002 to employees, directors and officers. Had compensation cost for stock options granted in 2002 been determined based on the fair value method, the Company's net loss for the current year would not have changed while the net loss for 2005 would have been increased by \$21,982 to \$2,572,690, and the pro-forma net loss for 2004 would have increased by \$81,620 to \$2,007,566. Net loss per common share (basic and diluted) would not have changed for 2006 and 2005 while 2004 would have increased by \$0.01 to \$0.26.

The fair value of the options granted during 2006, 2005 and 2004 is estimated on the day of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2006	2005	2004
Risk free interest rate	4.8%	4.5%	4.5%
Volatility	64%	66%	94%
Expected life	2 years	3.4 years	3.5 years
Dividend yield	0%	0%	0%
Forfeitures	10%	28%	0%

#### 11. Defined benefit pension plan:

The Company has established an individual pension plan for the President to resolve an outstanding compensation contingency. The Company does not have a pension plan for other employees.

Under the terms of the plan, the Company makes yearly contributions to the plan up to the date of retirement of the individual. All contributions to the plan are expected to return 7.5% per annum. Should the plan not achieve the 7.5% expected return, the Company will be responsible for any shortfall.

Information regarding the individual pension plan is outlined below:

	2006	2005	2004
Fair value of plan assets	\$ 352,507	\$ 302,827	\$ 255,628
Accrued benefit obligation	(322,372)	(283,799)	(236,744)
Funded status:			
Plan assets in excess of benefit obligation	30,135	19,028	18,884
Unamortized net actuarial gain	(12,465)	(8,124)	(14,403)
Accrued benefit asset	\$ 17,670	\$ 10,904	\$ 4,481

The financial statements presented do not reflect the accrued benefit asset shown above, since it is considered insignificant. The economic assumptions used to determine benefit obligation and periodic expense were:

	2006	2005	2004
Discount rate	5.5%	5.5%	5.75%
Expected rate of return on assets	7.5%	7.5%	7.5%
Rate of compensation increase	5.5%	5.5%	5.5%
Average remaining service period of covered employee	11	12	13

Actuarial evaluations are required every three years, the next evaluation being January 1, 2009.

Pension expense, included in marketing expense, is as follows:

	2006	2005	2004
Current service cost	\$ 21,001	\$ 18,551	\$ 16,063
Interest on accrued benefit obligation	24,329	20,743	15,667
Expected return on plan assets	(24,079)	(19,734)	(15,560)
Pension expense	\$ 21,251	\$ 19,560	\$ 16,170

The Company expects to contribute \$21,980 to the plan in 2007.

## 12. Supplementary information:

### (a) Per share amounts

The following table summarizes the common shares used in per share calculations

	2006	2005	2004
Weighted average common shares outstanding (basic and diluted)	9,156,085	8,497,201	7,628,238

### (b) Net change in non-cash working capital

	2006	2005	2004
Accounts receivable	\$ 85,226	\$ (190,557)	\$ 10,227
Inventory	21,016	122,130	(55,191)
Deposits and prepaid expenses	15,213	(14,708)	21,483
Accounts payable and accrued liabilities	(17,347)	40,122	12,466
Deferred revenue	561	(14,734)	(36,802)
	\$ 104,669	\$ (57,747)	\$ (47,817)

### (c) Supplementary cash flow information

Interest received in cash	\$ 75,291	\$ 55,981	\$ 85,546
Interest paid in cash	\$ 19,747	\$ -	\$ -
Taxes paid in cash	\$ 50,849	\$ 37,711	\$ 22,504

## 13. Income taxes:

Income tax expense differs from the amount that would be computed by applying the basic combined Canadian federal and provincial statutory income tax rate to the loss for the year. The reasons for the differences are as follows:

	2006	2005	2004
Loss before taxes	\$ (1,683,375)	\$ (2,512,997)	\$ (1,903,442)
Combined Canadian Federal and Provincial statutory rate	32.49%	33.62%	33.87%
Computed tax (recovery)	(546,926)	(844,870)	(644,696)
Increase (decrease) resulting from:			
Change in valuation allowance	(968,000)	172,000	(53,000)
Reduction of unrealized future tax assets for enacted changes in income tax rates	561,386	34,467	331,584
Stock based compensation	140,307	45,317	108,530
Reduction due to expired Canadian tax losses	296,148	424,220	218,582
Reduction due to expired US tax losses	876,607	514,500	549,548
Impact of strengthening exchange rate	(322,557)	(321,878)	(302,505)
Other permanent differences	13,884	13,955	(185,539)
Actual expense	\$ 50,849	\$ 37,711	\$ 22,504

The tax effects of temporary differences that give rise to significant portions of future income tax assets are as follows:

	Canada	United States	2006	2005
Future income tax assets:				
Property and equipment	\$ 1,436,000	\$ -	\$ 1,436,000	\$ 1,361,000
Share issue costs	27,000	-	27,000	35,000
Loss and SRED carry-forwards	3,083,000	2,756,000	5,839,000	6,702,000
Intangible assets	173,000	77,000	250,000	264,000
Investments	-	-	-	158,000
	4,719,000	2,833,000	7,552,000	8,520,000
Less: valuation allowance	(4,719,000)	(2,833,000)	(7,552,000)	(8,520,000)
Net future tax assets	\$ -	\$ -	\$ -	\$ -

The Company has Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of \$5,101,000 which have no expiry. The Company also has Canadian non-capital loss carry-forwards and United States net operating loss carry-forwards which expire in the following years:

	Canada	United States
2007	\$ 88	\$ –
2008	88	776,287
2009	–	373,177
2010	1,471,256	412,789
2011	–	107,980
2012	–	59,918
2014	1,216,947	–
2015	1,452,096	–
2018	–	1,966,743
2019	–	164,364
2020	–	1,295,294
2021	–	1,422,885
2022	–	188,145
2023	–	716,280
2024	–	149,172
2025	–	241,877
2026	1,036,054	84
	\$ 5,176,529	\$ 7,874,995

#### 14. Segmented information:

The Company has three operating segments consisting of Audio Products (“Audio”), E-Commerce Products (“E-Commerce”), and Voice Over Internet Protocol Products (“Telephony”). Audio involves the development and marketing of sound enhancement technology for use in various industries. E-Commerce involves the development and marketing of internet business services. Telephony involves the development and marketing of telecommunication over internet equipment and software.

2006	Audio	E-Commerce	Telephony	Total
Revenue	\$ 1,799,395	\$ 158,269	\$ 31,366	\$ 1,989,030
Amortization	217,004	28,554	85,861	331,419
Impairment of property and equipment	–	–	167,809	167,809
Loss before other items	(1,260,215)	(97,991)	(302,799)	(1,661,005)
Interest income	81,329	19	4,338	85,686
Segment Assets	3,294,716	75,977	164,192	3,534,885
Expenditures for property and equipment	42,111	315	–	42,426

2005	Audio	E-Commerce	Telephony	Total
Revenue	\$ 1,304,832	\$ 182,940	\$ 55,468	\$ 1,543,240
Amortization	211,464	27,045	122,389	360,898
Impairment of property and equipment	1,362	–	88,392	89,754
Impairment of intangible assets	–	–	428,453	428,453
Loss before other items	(1,281,763)	(234,456)	(1,053,315)	(2,569,534)
Interest income	54,470	12	2,218	56,700
Segment Assets	2,495,997	84,574	421,744	3,002,315
Expenditures for property and equipment	73,881	25,201	89,808	188,890
Expenditures for intangible assets	50,563	414	–	50,977

2004	Audio	E-Commerce	Telephony	Total
Revenue	\$ 1,820,028	\$ 245,238	\$ 147,912	\$ 2,213,178
Amortization	251,362	35,273	170,937	457,572
Loss before other items	(655,750)	(140,209)	(1,168,897)	(1,964,856)
Interest income	78,254	12	461	78,727
Segment Assets	4,037,007	109,600	1,081,227	5,227,834
Expenditures for property and equipment	154,884	811	8,762	164,457
Expenditures for intangible assets	46,032	–	372,024	418,056

#### 14. Segmented information (continued):

Geographic information	2006 Revenue	2005 Revenue	2004 Revenue
Canada	\$ 13,769	\$ 10,472	\$ 73,294
United States	938,586	966,980	1,418,029
Asia	1,027,959	489,625	644,503
Europe	—	49,026	72,102
Other	8,716	27,137	5,250
	\$ 1,989,030	\$ 1,543,240	\$ 2,213,178

As at December 31, 2006, 2005, and 2004, substantially all of the Company's product assets and employees were located in Canada.

#### 15. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 2006 due to their short term to maturity.

The Company is exposed to foreign currency fluctuations on its Canadian dollar denominated cash, receivables and payables. Foreign currency risk arising from a decline in the relative value of the Canadian dollar is managed to the extent that Canadian dollar denominated cash and receivables are equal to or exceed Canadian dollar payables. The Company has not, at December 31, 2006, entered into foreign currency derivatives to hedge its exposure to foreign exchange risk.

The Company is exposed to credit risk on its accounts receivable, royalties receivable and accrued revenue. As at December 31, 2006, there were outstanding accounts receivable, royalties receivable and accrued revenue balances from five entities which comprised 66% of the total balance. These entities are located in the United States and Asia. Since the year end two entities have fully paid the outstanding amounts, whilst management believes that the remainder are fully collectable.

As at December 31, 2005, there were outstanding accounts receivable balances from two entities which comprised 49% of the total balance. These entities are located in the United States and Asia. These amounts have been collected subsequent to the 2005 year end.

During 2006, three customers, within the Audio segment, contributed 52% of the total revenues, each providing greater than 10% of the total revenues. For 2005, two customers within the audio segment contributed 23% of the total revenues, each providing greater than 10% of the total revenues whilst in 2004 no one individual customer provided greater than 10% of total revenues.

#### 16. Commitments and contingencies:

Under the terms of its lease agreements for office space and equipment, the Company is obligated at December 31, 2006 to make the following minimum lease payments over the next five years and in total:

2007	\$ 96,847
2008	83,142
2009	14,616
2010	8,526
2011	—
	\$ 203,131

Minimum lease payments of \$98,872 (2005: \$92,756; 2004: \$88,458) are included in the calculation of the loss for the year.

#### 17. United States accounting principles:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). Any differences in United States generally accepted accounting principles ("US GAAP") as they pertain to the Company's financial statements are not material except as follows:

- The Company follows Statement of Financial Accounting Standards ("SFAS") 130 regarding comprehensive income for purposes of reconciliation to US GAAP. Under US GAAP, items defined as other comprehensive income are separately classified in the financial statements and the accumulated balance of other comprehensive income (loss) is reported separately in shareholders' equity on the balance sheet. For all periods presented, comprehensive income (loss) equals net income (loss).
- From 2003 through 2005, the Company accounted for its stock based awards in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation", which required the use of a fair value-based method of accounting for stock-based compensation plans. Prior to 2003, under US GAAP, \$202,058 of stock based compensation costs for stock options issued to third parties were expensed. No entry was made under Canadian GAAP.

Effective January 1, 2006, the Company has adopted SFAS 123(R), "Stock Based Payment". As the Company previously applied the fair value based method prescribed by SFAS 123 for US GAAP purposes, the impact of the adoption on the Company's financial statements is limited. Under SFAS 123(R), the Company now estimates forfeitures at the date of grant as opposed to accounting for forfeitures as they occur. In applying the modified prospective approach on adoption, there is no impact on the current year relating to previously granted stock options as all have vested or been forfeited before December 31, 2006. This is consistent with the accounting under Canadian GAAP.



- (c) The Company has applied SFAS 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" in accounting for its production costs of software. Accordingly, \$80,871 was expensed to product engineering until May 17, 2005 when technological feasibility was established. Costs subsequent to this date were capitalized as they related to the production of 'product masters'. In 2006 amortization of these costs commenced on a straight line basis over the remaining estimated useful economic life of the product which is 5 years. Resultant from \$80,871 of the costs being expensed rather than capitalized during 2005, the amortization recorded for 2006 is \$20,218 lower under US GAAP.
- (d) The Company has also determined that the conversion feature of the convertible notes meet the embedded derivative scope exemption requirements of SFAS 133. As such, the conversion option has not been separated under US GAAP. However, the Company has separated the beneficial conversion feature associated with the conversion price being less than the market price at the transaction date. The Company determined that the intrinsic value of the beneficial conversion feature was \$586,978, which reduces the initial carrying value of the notes to \$72,196, for US GAAP purposes, with a corresponding entry made to equity.

The effect on the loss for each of the years in the three year period ended December 31, 2006 of the differences between Canadian and United States generally accepted accounting principles is summarized as follows:

Years ended December 31,	2006	2005	2004
Net loss for the year as reported in accordance with Canadian GAAP	\$ (1,734,224)	\$ (2,550,708)	\$ (1,925,946)
Development expense	–	(80,871)	–
Amortization of deferred development costs	20,218	–	–
Accretion of debt discount	32,331	–	–
Net loss under US GAAP	\$ (1,681,675)	\$ (2,631,579)	\$ (1,925,946)
Net loss per share (basic and diluted) under US GAAP	\$ (0.18)	\$ (0.31)	\$ (0.25)

The effect on the consolidated balance sheets of the difference between Canadian and United States generally accepted accounting principles is as follows:

December 31, 2006,	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	\$ 2,719,129	\$ –	\$ 2,719,129
Note Receivable	55,325	–	55,325
Property and equipment	348,280	–	348,280
Deferred development costs	313,800	(60,653)	253,147
Intangible assets	98,351	–	98,351
	\$ 3,534,885	\$ (60,653)	\$ 3,474,232
Current liabilities	\$ 314,011	\$ –	\$ 314,011
Convertible notes	389,862	(304,913)	84,949
Shareholder's equity:			
Common shares	47,208,942	202,058	47,411,000
Warrants	1,027,114	–	1,027,114
Contributed Surplus	2,581,456	272,582	2,854,038
Deficit	(47,986,500)	(230,380)	(48,216,880)
	\$ 3,534,885	\$ (60,653)	\$ 3,474,232
<b>December 31, 2005</b>			
Current assets	\$ 1,823,485	\$ –	\$ 1,823,485
Property and equipment	670,635	–	670,635
Deferred development costs	352,750	(80,871)	271,879
Intangible assets	155,445	–	155,445
	\$ 3,002,315	\$ (80,871)	\$ 2,921,444
Current liabilities	\$ 330,797	\$ –	\$ 330,797
Shareholder's equity:			
Common shares	45,979,055	202,058	46,181,113
Warrants	903,738	–	903,738
Contributed Surplus	2,041,001	–	2,041,001
Deficit	(46,252,276)	(282,929)	(46,535,205)
	\$ 3,002,315	\$ (80,871)	\$ 2,921,444

Included in the current liabilities above are accrued liabilities of \$144,645 in 2006 and \$138,731 in 2005.

## CERTIFICATION

I, David J. Gallagher, President and Chief Executive Officer of QSound Labs, Inc. certify that:

1. I have reviewed this annual report on Form 20-F for 2006 of QSound Labs, 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 company as of, and for, the periods presented in this report;
4. The registrant's other certifying officers 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)) for the company and we 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 company, 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) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosures and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent function):
  - 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 company'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 company's internal control over financial reporting.

/s/ David J. Gallagher  
David J. Gallagher  
President and Chief Executive Officer

March 23, 2007

## CERTIFICATION

I, David J. Gallagher, Chief Financial Officer of QSound Labs, Inc. certify that:

1. I have reviewed this annual report on Form 20-F for 2006 of QSound Labs, 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 company as of, and for, the periods presented in this report;
4. The registrant's other certifying officers 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)) for the company and we 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 company, 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) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosures and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent function):
  - 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 company'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 company's internal control over financial reporting.

/s/ David J. Gallagher  
David J. Gallagher  
Chief Financial Officer

March 23, 2007

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, David J. Gallagher, President and Chief Executive Officer of QSound Labs, Inc., do hereby certify that, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the information contained in the Annual Report on Form 20-F for the year ended December 31, 2006 of QSound Labs, Inc. and filed with the Securities and Exchange Commission, fully complies with the requirements of Section 13 (a) or 15 (d) of the Securities Act of 1934 and the information contained in such report fairly presents, in all material respects, the financial condition and results of operations on QSound Labs, Inc.

/s/ David J. Gallagher \_\_\_\_\_

David J. Gallagher  
President and Chief Executive Officer

March 23, 2007

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, David J. Gallagher, Chief Financial Officer of QSound Labs, Inc., do hereby certify that, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the information contained in the Annual Report on Form 20-F for the year ended December 31, 2006 of QSound Labs, Inc. and filed with the Securities and Exchange Commission, fully complies with the requirements of Section 13 (a) or 15 (d) of the Securities Act of 1934 and the information contained in such report fairly presents, in all material respects, the financial condition and results of operations on QSound Labs, Inc.

/s/ David J. Gallagher \_\_\_\_\_

David J. Gallagher  
Chief Financial Officer

March 23, 2007



KPMG LLP  
Chartered Accountants  
2700-205 5 Avenue SW  
Calgary AB T2P 4B9

Telephone (403) 691-8000  
Fax (403) 691-8008  
Internet [www.kpmg.ca](http://www.kpmg.ca)

### CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors  
QSound Labs, Inc.

We consent to the incorporation by reference in the registration statements on Form S-8 (No. 333-09228, 333-117165, and 333-133714) and on Form F-3 (No. 333-121871 and 333-133290) of QSound Labs, Inc. of our report dated March 7, 2007, with respect to the consolidated balance sheet of QSound Labs, Inc. as of December 31, 2006, and the related consolidated statements of operations and deficit and cash flows for the year then ended and the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2004, which report appears in the December 31, 2006, annual report on Form 20-F of QSound Labs, Inc.

*KPMG LLP*

Chartered Accountants

Calgary, Canada  
March 23, 2007

Grant Thornton LLP  
Chartered Accountants  
Management Consultants

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors  
QSound Labs, Inc.

We have issued our report dated March 29, 2006, accompanying the consolidated financial statements included in the Annual Report of QSound Labs, Inc. on the Form 20-F for the year ended December 31, 2006. We hereby consent to the incorporation by reference of said report in the Registration Statements of QSound Labs, Inc. on Forms S-8 (File Nos. 333-09228, effective August 8, 1998, 333-117165, effective July 2, 2004 and 333-133714, effective May 1, 2006), on Form F-3/A (File No. 333-121871, effective April 7, 2005) and on Form F-3 (File No. 333-133290, effective May 4, 2006).



Chartered Accountants  
Calgary, Canada  
March 23, 2007

Sun Life Plaza, East Tower  
Suite 1000, 112 – 4<sup>th</sup> Avenue SW  
Calgary, Alberta  
T2P 0H3  
T (403) 260-2500  
F (403) 260-2571  
E [Calgary@GrantThornton.ca](mailto:Calgary@GrantThornton.ca)  
W [www.GrantThornton.ca](http://www.GrantThornton.ca)

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