QSoundLabs

2005 First Quarter Report

Management's
Discussion and Analysis
First Quarter ended March 31, 2005

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the quarter ended March 31, 2005 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarter ended March 31, 2005, and the annual audited financial statements of the company for the fiscal year ended December 31, 2004. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2004.

The company reports its unaudited consolidated financial statements in United States dollars and in accordance with Canadian Generally Accepted Accounting Principles (GAAP).

Operations

Below we provide information on the significant line items in our statement of operations for the first quarter of 2005 and 2004, as well as analysis of the changes period to period.

	Q1 2005	Q1 2004
Royalties & license fees revenues:	$ 337,648	$ 205,467
Product sales revenues:		
Audio segment	$ 72,828	$ 164,202
E-Commerce segment	52,644	68,845
Telephony segment	13,624	71,734
Total	$ 139,096	$ 304,781

The increase in licensing and royalty revenues from 2004 to 2005 is directly attributable to the introduction of microQ software and the design wins realized with this product. Revenue from our legacy licenses declined throughout 2004 and will continue to decline through 2005.

The audio segment experienced a decrease in product sales of 56% in Q1 2005 from Q1 2004 primarily due to a decline in integrated circuit chip sales. As the integrated circuit chips are of an analog design, we expect these sales to continue to decline as digital technology expands as the leading design in the market place.

The telephony segment showed a decrease of 81% in product sales when compared to the same period in 2004 due to the maturation of our product line. We are focusing our efforts on developing a new VoIP product line for the small business market and expect to conclude regulatory testing in time for a product launch later this year.

	Q1 2005	Q1 2004
Marketing expenses	$ 230,974	$ 350,476
Operating expenses	$ 43,230	$ 71,536

We experienced an increase in marketing and operating expenses in 2003 when we established our IP Telephony business unit. We cut back on these expenditures in March 2004 and again in January 2005 so as to bring them more into line with revenues being generated from the IP Telephony business unit. This is reflected in the decreased marketing and operating expenses in Q1 2005.

	Q1 2005	Q1 2004
Product engineering expenses	$ 227,025	$ 224,517

While the product engineering expense for Q1 2005 is consistent with Q1, 2004, the makeup of engineering staff has changed. The engineering staff in the audio business unit has increased while the telephony business unit has seen a decrease in staff.

	Q1 2005	Q1 2004
Administration & foreign exchange	$ 194,572	$ 255,617

The difference between Q1 2005 and Q4 2004 can be directly attributable to two factors, foreign exchange and stock based compensation cost. The increase in value of the United States dollar against the Canadian dollar has lowered our expenses as the majority of administrative expenses are incurred in Canadian Dollars. A larger amount of compensation cost of options issued to directors and employees was incurred in Q1 2004 than in Q1 2005.

Financial Condition

The company had a working capital surplus of $3,111,104 at March 31, 2005 as compared to $3,457,107 as at December 31, 2004.

Cash resources at the end of the first quarter of 2005 were $2,746,529 as compared to $3,327,543 at December 31, 2004. Liabilities at the end of the first quarter of 2005 were $354,593, which consisted of $285,897 in accounts payable and accrued liabilities and $68,696 in deferred revenue. Liabilities at December 31, 2004 were $305,409 which consisted of $245,664 in accounts payable and accrued liabilities and $59,745 in deferred revenue. Management feels that with our current cash on hand and cash flows from operations, the company has sufficient capital to carry out its business plan for the remainder of 2005.

Capital Expenditures

The company continues to take steps to ensure that its technology is current and up to date. To facilitate that goal and ongoing research and development, as well as protecting its technology through the registration of trademarks and patents, the company invested $66,188 in the quarter in new computer equipment and software, trademarks and patents. In addition the company invested and capitalized $31,356 in software and production tooling in the development of our new IP Telephony product.

This report contains forward-looking statements as defined in U.S. federal securities laws. Our actual results or industry results could differ materially from those in the forward-looking statements. Investors are advised to read the risks and uncertainties filed with the Securities and Exchange Commission. Forward-looking statements are based on the current expectations and opinions of QSound management.

Consolidated

Balance Sheets

As at March 31, 2005 and December 31, 2004
(Expressed in United States dollars)

		March 31, 2005		December 31,2004
ASSETS		**(unaudited)**		
Current assets				
Cash and cash equivalents	$	2,746,529	$	3,327,543
Accounts receivable		462,677		210,967
Inventory		121,012		162,568
Deposits and prepaid expenses		135,479		61,438
		3,465,697		3,762,516
Capital assets (note 2)		1,298,159		1,302,598
Other intangible assets (note 3)		163,019		162,720
	$	4,926,875	$	5,227,834
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities				
Accounts payable and accrued liabilities	$	285,897	$	245,664
Deferred revenue		68,696		59,745
		354,593		305,409
Shareholders' equity				
Share capital (note 4)		45,815,039		45,792,526
Warrants		1,502,331		1,502,331
Contributed surplus		1,331,627		1,329,136
Deficit		(44,076,715)		(43,701,568)
		4,572,282		4,922,425
	$	4,926,875	$	5,227,834

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Operations and Deficit

For the three month periods ended March 31, 2005 and 2004
(Expressed in United States dollars)

	2005	2004
	(unaudited)	(unaudited)
REVENUE		
Royalties and license fees	$ 337,648	$ 205,467
Product sales	139,096	304,781
	476,744	510,248
Cost of product sales	46,806	138,663
	429,938	371,585
EXPENSES		
Marketing	230,974	350,476
Operations	43,230	71,536
Product engineering	227,025	224,517
Administration	192,601	255,467
Foreign exchange loss	1,971	150
Depreciation and amortization	101,684	107,629
	797,485	1,009,775
Operating loss	(367,547)	(638,190)
OTHER ITEMS		
Interest and other income	11,453	1,139
Other	(19,053)	(5,527)
	(7,600)	(4,388)
Net loss for period	(375,147)	(642,578)
Deficit, beginning of period	(43,701,568)	(41,775,622)
Deficit, end of period	$ (44,076,715)	$ (42,418,200)
Loss per common share	$ (0.04)	$ (0.09)

See accompanying notes to consolidated financial statements.

Consolidated
Statements of Cash Flows

For the three month periods ended March 31, 2005 and 2004
(Expressed in United States dollars)

	2005	2004
	(unaudited)	(unaudited)
Cash provided by (used in)		
Operations		
Loss for the period	$ (375,147)	$ (642,578)
Items not requiring cash:		
Depreciation and amortization	101,684	107,629
Compensation cost of options issued	22,037	108,307
Changes in working capital balances (note 6)	(249,903)	(263,361)
	(501,329)	(690,003)
Financing		
Issuance of common shares, net	17,859	35,070
	17,859	35,070
Investments		
Purchase of capital assets	(82,654)	(31,666)
Purchase of intangible assets	(14,890)	(15,861)
	(97,544)	(47,527)
Decrease in cash and cash equivalents	(581,014)	(702,460)
Cash and cash equivalents, beginning of period	3,327,543	2,061,093
Cash and cash equivalents, end of period	$ 2,746,529	$ 1,358,633

See accompanying notes to consolidated financial statements.

(Expressed in United States dollars under Canadian GAAP)

1. Basis of presentation:

These consolidated financial statements include the accounts of QSound Labs, Inc. a public company organized under the laws of the Province of Alberta, Canada and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated.

The statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles for interim financial statements. These financial statements follow the same accounting policies and methods of applications as the most recent annual financial statements dated December 31, 2004. These interim financial statements should be read in conjunction with the Company's December 31, 2004 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

2. Capital assets:

March 31, 2005	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 545,463	$ 524,872	$ 20,591
Real time systems	905,534	900,011	5,523
Furniture and fixtures	230,668	207,189	23,479
Computer equipment	1,046,507	750,077	296,430
Software and production tooling	2,455,512	1,503,376	952,136
	$ 5,183,684	$ 3,885,525	$ 1,298,159

3. Other intangible assets:

March 31, 2005	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 892,819	$ 741,846	$ 150,973
Purchased customer list	34,418	22,372	12,046
	$ 927,237	$ 764,218	$ 163,019

4. Share capital:

	Number of Shares	Consideration
Balance at December 31, 2004	8,404,085	$ 45,792,526
Issued for cash on exercise of options	33,500	33,985
Financing costs	—	(16,126)
Additional paid-in capital stock options	—	4,654
Balance at March 31, 2005	8,437,585	$ 45,815,039

5. Stock option plan:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at December 31, 2004	1,157,500	$ 0.47 – 4.56	$ 1.29
Exercised	(33,500)	$ 0.47 – 4.56	1.01
Balance at March 31, 2005	1,124,000	$ 0.47 – 4.56	$ 1.29

5. Stock option plan (continued):

The following table summarizes the information about stock options outstanding at March 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at March 31, 2005	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at March 31, 2005	Weighted-Average Exercise Price
$ 0.47 - 0.62	409,307	1.9	$ 0.54	387,073	$ 0.54
1.04 - 1.75	441,693	1.7	1.22	433,193	1.21
1.88 - 2.05	215,000	3.4	2.01	141,900	1.99
4.56	58,000	4.5	4.56	5,000	4.56
	1,124,000	2.3	$ 1.29	967,166	$ 1.07

6. Changes in non-cash working capital balances:

	March 31, 2005	March 31, 2004
Accounts receivable	$ (251,710)	$ (185,803)
Inventory	41,556	(47,330)
Deposits and prepaid expenses	(74,041)	(64,662)
Accounts payable and accrued liabilities	25,341	47,012
Deferred revenue	8,951	(12,578)
	$ (249,903)	$ (263,361)

7. Segmented information:

For the three month period ended March 31, 2005	Audio	E-Commerce	Telephony	Total
Revenues	$ 410,476	$ 52,644	$ 13,624	$ 476,744
Interest revenue	11,022	—	431	11,453
Amortization of capital assets	39,360	5,003	42,730	87,093
Segment operating loss	(96,829)	(34,750)	(235,968)	(367,547)
Segment assets	3,758,535	117,035	1,051,305	4,926,875
Expenditures for segment capital assets	49,769	256	32,629	82,654

For the three month period ended March 31, 2004				
Revenues	$ 369,669	$ 68,845	$ 71,734	$ 510,248
Interest revenue	1,098	—	41	1,139
Amortization of capital assets	41,245	7,060	42,732	91,037
Segment operating income	(263,851)	(24,372)	(349,967)	(638,190)
Segment assets	2,300,751	118,030	893,031	3,311,812
Expenditures for segment capital assets	37,883	—	5,000	42,883

Geographic Information	2005 Revenue	2004 Revenue
Canada	$ 689	$ 8,935
United States	326,467	294,176
Asia	115,562	140,470
Europe	34,026	66,667
	$ 476,744	$ 510,248

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