
Smartphone
QSOUND
QSoundLabs
FirstQuarter2006

Management's Discussion and Analysis

Three month period ended March 31, 2006

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the Company) for the quarter ended March 31, 2006 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarter ended March 31, 2006, and the annual audited financial statements of the company for the fiscal year ended December 31, 2005. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2005.

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 2006 and 2005, as well as analysis of the changes period to period.

	Q1 2006	Q1 2005
Royalties and license fees revenues	$ 592,717	$ 337,648
Product sales revenues		
Audio segment	$ 29,101	$ 72,828
E-Commerce segment	42,802	52,644
Telephony segment	9,150	13,624
Total	$ 81,053	$ 139,096

The increase in licensing and royalty revenues from 2005 to 2006 is directly attributable to the first license of the company's new voice chat/conferencing software solution to a major video game manufacturer. We have achieved several design wins with our microQ software, and the revenue from these design wins is starting to be realized. Our legacy licenses however continued to decline, and we expect these to continue to decline through 2006.

The audio segment experienced a decrease in product sales of 60% in Q1 2006 from Q1 2005 primarily due to a decline in integrated circuit chip sales.

	Q1 2006	Q1 2005
Marketing expenses	$ 201,565	$ 230,974
Operating expenses	$ 35,877	$ 43,230

We have concentrated our efforts primarily on the mobile device market for the past four years. As a result, we have cut back on expenditures in the telephony and e-commerce segments of our business. Expenses in the Audio segment for Q1, 2006 have remained consistent with Q1 2005.

	Q1 2006	Q1 2005
Product engineering expenses	$ 215,632	$ 227,025

The majority of product engineering expense is made up of salaries. As our needs in audio and telephony change, so does our staffing mix to satisfy those needs. The audio segment has seen a general increase in staff, while the e-commerce and telephony business units have both seen a decrease in staff.

	Q1 2006	Q1 2005
Administration and foreign exchange	$ 231,657	$ 194,572

The difference between 2006 and 2005 can be directly attributable to two factors, foreign exchange and stock based compensation cost. The decrease in value of the United States dollar against the Canadian dollar has increased 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 2006 than in 2005.

	Q1 2006	Q1 2005
Amortization	$ 183,506	$ 101,684

The increase in amortization from 2005 to 2006 is directly attributable to the amount of deferred development cost amortized as a result of our first license of the company's new voice chat/conferencing software solution.

Financial Condition

The company had a working capital surplus of $3,091,040 at March 31, 2006 as compared to $1,492,688 as at December 31, 2005.

During the first quarter of 2006 the company entered into a convertible loan agreement for $1,000,000. Details of the loan and its accounting can be found in note 7 of the March 31, 2006 financial statements.

Also during the quarter, in addition to options being exercised, 500,000 warrants were exercised for proceeds of $520,000.

Cash resources at the end of the first quarter of 2006 were $2,223,655 as compared to $1,222,729 at December 31, 2005. Current liabilities at the end of the first quarter of 2006 were $221,646, which consisted of $181,163 in accounts payable and accrued liabilities and $40,483 in deferred revenue. Liabilities at December 31, 2005 were $330,797 which consisted of $285,786 in accounts payable and accrued liabilities and $45,011 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 2006.

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 $23,047 in the first quarter of 2006 ($97,544 in the first quarter of 2005) in new computer equipment and software, trademarks and patents. In addition the company invested $23,080 in deferred development costs in the completion of our new voice chat/conferencing software solution.

Consolidated
Balance sheets
March 31, 2006 and December 31, 2005
(Expressed in United States dollars)

	March 31, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,223,655	$ 1,222,729
Accounts receivable (net) and accrued revenue	912,933	401,524
Note receivable (note 3)	26,442	82,648
Inventory	37,252	40,438
Deposits and prepaid expenses	112,404	76,146
	3,312,686	1,823,485
Note receivable (note 3)	57,784	–
Property and equipment (note 4)	588,860	670,635
Deferred development costs (note 5)	297,518	352,750
Intangible assets (note 6)	155,073	155,445
	$ 4,411,921	$ 3,002,315

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 181,163	$ 285,786
Deferred revenue	40,483	45,011
	221,646	330,797
Convertible loan (net)(note 7)	504,088	–
	725,734	330,797
Shareholders' equity		
Share capital (note 8)	46,904,751	45,979,055
Warrants (note 9)	1,781,336	1,502,331
Contributed surplus (note 10)	1,452,558	1,442,408
Deficit	(46,452,458)	(46,252,276)
	3,686,187	2,671,518
	$ 4,411,921	$ 3,002,315

See accompanying notes to consolidated financial statements.

Consolidated
Statements of Operations and Deficit
For the three month periods ended March 31, 2006 and 2005
(Expressed in United States dollars)

		2006		2005
		(unaudited)		(unaudited)
REVENUE				
Royalties, licenses and engineering fees	$	592,717	$	337,648
Product sales		81,053		139,096
		673,770		476,744
Cost of product sales		8,074		46,806
		665,696		429,938
EXPENSES				
Marketing		201,565		230,974
Operations		35,877		43,230
Product engineering		215,632		227,025
Administration		222,970		192,601
Foreign exchange loss		8,687		1,971
Amortization		183,506		101,684
		868,237		797,485

Loss before other items	(202,541)	(367,547)
OTHER ITEMS		
Interest income	7,662	11,453
Interest on convertible loan	(425)	–
Amortization of debt issue costs	(543)	–
Other	–	(3,168)
	6,694	8,285
Loss before taxes	(195,847)	(359,262)
Foreign withholding tax	(4,335)	(15,885)
Net loss for the period	(200,182)	(375,147)
Deficit, beginning of period	(46,252,276)	(43,701,568)
Deficit, end of period	$ (46,452,458)	$ (44,076,715)
Loss per common share (basic and diluted) (note 12)	$ (0.02)	$ (0.04)

See accompanying notes to consolidated financial statements

Consolidated

Statements of Cash Flows

For the three month periods ended March 31, 2006 and 2005
(Expressed in United States dollars)

		2006		2005
		(unaudited)		(unaudited)
Cash provided by (used in)				
OPERATIONS				
Loss for the period	$	(200,182)	$	(375,147)
Items not requiring (providing) cash:				
Amortization		183,506		101,684
Stock based compensation		71,981		22,037
Amortization of debt issue costs		543		–
Changes in non-cash working capital balances (note 13)		(653,632)		(249,903)
		(597,784)		(501,329)

FINANCING		
Issuance of common shares (net)	646,415	17,859
Issuance of warrants	496,455	–
Convertible loan (net)	503,545	–
	1,646,415	17,859
INVESTMENTS		
Note receivable	(1,578)	–
Purchase of property and equipment	(9,422)	(82,654)
Purchase of deferred development costs	(23,080)	–
Purchase of intangible assets	(13,625)	(14,890)
	(47,705)	(97,544)
Increase (decrease) in cash and cash equivalents	1,000,926	(581,014)
Cash and cash equivalents, beginning of period	1,222,729	3,327,543
Cash and cash equivalents, end of period	$ 2,223,655	$ 2,746,529

See accompanying notes to consolidated financial statements

Notes
to Consolidated Financial Statements
For the three month periods ended March 31, 2006 and 2005
(Expressed in United States dollars)

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, 2005. These interim financial statements should be read in conjunction with the Company’s December 31, 2005 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

The statements have been prepared by management and have not been reviewed the Company’s auditors.

2. Joint venture:

At March 31, 2006, the company entered into an agreement with its' joint venture partners to acquire 100% of the joint venture and thus effectively terminate the joint venture. As such, 100% of the joint venture assets, liabilities, revenues and expenses less those portions earned by the joint venture partners during the quarter have been included in these financial statements. The assets, liabilities, revenues and expenses of the joint venture included are as follows:

Accounts receivable	$	429,600
Deferred development costs		297,518
Net joint venture equity		(727,118)
Revenue		420,569
Expenses		78,313

During the first three months of 2006, the Company provided the joint venture net financing in the amount of $31,357. These amounts were paid to a joint venture partner to facilitate the software development.

3. Note receivable:

The note receivable is unsecured and bears interest at 8% per annum. Payments of $26,442 are due in 2006, $6,000 in 2007, and the balance in 2008.

4. Property and equipment:

March 31, 2006		Cost		Accumulated amortization		Net book value
Sound source and control equipment	$	545,463	$	530,581	$	14,882
Real time systems		905,534		901,668		3,866
Furniture and fixtures		230,668		210,685		19,983
Computer equipment		1,105,126		830,206		274,920
Software and production tooling		2,011,463		1,736,254		275,209
	$	4,798,254	$	4,209,394	$	588,860

5. Deferred development costs:

March 31, 2006		Cost		Accumulated amortization		Net book value
Software development costs	$	827,644	$	530,126	$	297,518

6. Intangible assets:

March 31, 2006		Cost		Accumulated amortization		Net book value
Patents and trademarks	$	942,534	$	792,623	$	149,911
Purchased customer list		34,418		29,256		5,162
Licensing rights		428,453		428,453		–
	$	1,405,405	$	1,250,332	$	155,073

7. Convertible loan:

The Company entered into a convertible loan agreement for $1,000,000. The loan bears interest at US prime rate, payable quarterly. The term of the loan is the shorter of 5 years or the date of conversion. The amount owed can be converted for $3.25 per share at any time at the option of the lender. Conversion may take place in whole or in part, however a minimum of 25,000 shares ($81,250) is to be converted each time. As part of the transaction, 400,000 warrants, exercisable at $4.50 with a 5 year term were issued.

The amount contributed to the warrants was calculated taking the total cash proceeds of the convertible loan on a pro-rata basis with the fair value of the warrants and the total amount of the face value of the convertible loan. The amount deducted as the value of the warrants will be amortized over 5 years and charged to income.

7. Convertible loan (continued):

Cash received	$	1,000,000
Less warrants valued under Black-Scholes (note 9)		(496,455)
		503,545
Amortization of debt issue costs		543
	$	504,088

8. Share capital:

	Number of Shares		Consideration
Balance at December 31, 2005	8,661,985	$	45,979,055
Issued for cash on exercise of options	67,800		126,415
Reclassification from contributed surplus on exercise of stock options	–		61,831
Issued for cash on exercise of warrants	500,000		520,000
Reclassification from warrants on exercise of warrants	–		217,450
Balance March 31, 2006	9,229,785		46,904,751

9. Warrants:

	Number of Warrants	Consideration
Balance December 31, 2005	714,130	$ 1,502,331
Issued for cash	400,000	496,455
Exercised	(500,000)	(217,450)
Balance March 31, 2006	614,130	$ 1,781,336

The amount contributed to the warrants was calculated taking the total cash proceeds of the convertible loan on a pro-rata basis with the fair value of the warrants and the total amount of the face value of the convertible loan. The fair value of the warrants issued was calculated using the Black-Scholes pricing model using the assumptions stated below:

Risk free interest rate	5.5%
Volatility	71%
Life of the warrant	5 Years
Dividend yield	0%

9. Warrants (continued):

The following table summarizes the information about warrants outstanding at March 31, 2006:

Warrants Outstanding and Exercisable		Exercise Price	Remaining Term (years)
400,000	$	4.50	5.0
75,000		7.77	3.7
139,130		9.12	3.7
614,130	$	5.95	4.5

Each warrant is exercisable for one common share of the Company.

10. Contributed surplus

Balance December 31, 2005	$	1,442,408
Increase due to stock based compensation		71,981
Decrease due to stock options exercised		(61,831)
Balance March 31, 2006	$	1,452,558

11. Stock option plan:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at December 31, 2005	977,533	$ 0.47 – 4.56	$ 1.45
Granted	15,000	3.50 – 3.50	3.50
Exercised	(67,800)	1.04 – 2.40	1.86
Balance at March 31, 2006	924,733	$ 0.47 – 4.56	$ 1.45

The following table summarizes the information about stock options outstanding at March 31, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at March 31, 2006	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at March 31, 2006	Weighted Average Exercise Price
$ 0.47	219,307	0.7	$ 0.47	219,307	$ 0.47
1.04 to 1.75	394,193	0.7	1.21	394,193	1.21
1.88 to 2.40	261,233	5.4	2.21	151,300	2.08
3.50 to 4.56	50,000	3.5	3.65	5,000	4.56
	924,733	2.2	$ 1.45	769,800	$ 1.19

12. Loss per share

Basic loss per share		**March 31, 2006**		**March 31, 2005**
Net loss	$	(200,182)	$	(375,147)
Weighted average number of shares outstanding		8,695,166		8,414,013
Loss per share	$	(0.02)	$	(0.04)

Diluted loss per share		**March 31, 2006**		**March 31, 2005**
Net loss	$	(200,182)	$	(375,147)
Weighted average number of shares outstanding		8,695,166		8,414,013
Weighted average number of stock options potentially exercisable		562,071		813,961
Weighted average number of warrants potentially exercisable		–		488,498
Weighted average number of diluted shares outstanding		9,257,237		9,716,472
Diluted loss per share	$	(0.02)	$	(0.04)

In calculating the weighted average number of diluted shares above, the Company excluded 5,000 stock options (2005 – nil) and 614,130 warrants (2005 – 214,130) because the exercise price was greater than the average market price for the period.

13. Supplementary cash flow information:

Changes in non-cash working capital balances	March 31, 2006	March 31, 2005
Accounts receivable	$ (511,409)	$ (251,710)
Inventory	3,186	41,556
Deposits and prepaid expenses	(36,258)	(74,041)
Accounts payable and accrued liabilities	(104,623)	25,341
Deferred revenue	(4,528)	8,951
	$ (653,632)	$ (249,903)
Interest received in cash	$ 11,124	$ 13,380
Withholding taxes paid in cash	$ 4,335	$ 15,885

14. Segmented information:

For the three month period ended March 31, 2006	Audio	E-Commerce	Telephony	Total
Revenues	$ 621,818	$ 42,802	$ 9,150	$ 673,770
Interest revenue	6,746	–	916	7,662
Amortization	112,952	7,137	63,417	183,506
Segment loss before other items	(109,233)	(17,678)	(75,630)	(202,541)
Segment assets	3,921,832	131,744	358,345	4,411,921
Expenditures for property and equipment	9,107	315	–	9,422
Expenditures for intangible assets	13,625	–	–	13,625

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	52,192	6,760	42,732	101,684
Segment loss before other items	(96,829)	(34,750)	(235,968)	(367,547)
Segment assets	3,758,535	117,035	1,051,305	4,926,875
Expenditures for property and equipment	49,769	256	32,629	82,654
Expenditures for intangible assets	14,890	–	–	14,890

14. Segmented information (continued):

Geographic information	March 31, 2006 Revenue	March 31, 2005 Revenue
Canada	$ 2,511	$ 689
United States	179,794	326,467
Asia	488,965	115,562
Europe	–	34,026
Other	2,500	–
	$ 673,770	$ 476,744

15. Reconciliation to United States accounting principles:

Three month periods ending March 31,	2006	2005
Net loss for the year as reported in accordance with Canadian GAAP	$ (200,182)	$ (375,147)
Amortization	20,218	–
Net loss under US GAAP	$ (179,964)	$ (375,147)
Net loss per share (basic and diluted) under US GAAP	$ (0.02)	$ (0.04)

15. Reconciliation to United States accounting principles (continued):

March 31, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,312,686	$ –	$ 3,312,686
Note receivable	57,784	–	57,784
Property and equipment	588,860	–	588,860
Deferred development costs	297,518	(60,653)	236,865
Intangible assets	155,073	–	155,073
	$ 4,411,921	$ (60,653)	$ 4,351,268
Current liabilities	$ 221,646	$ –	$ 221,646
Convertible loan	504,088	–	504,088
Shareholder's equity:			
Common shares	46,904,751	202,058	47,106,809
Warrants	1,781,336	–	1,781,336
Contributed Surplus	1,452,558	–	1,452,558
Deficit	(46,452,458)	(262,711)	(46,715,169)
	$ 4,411,921	$ (60,653)	$ 4,351,268

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