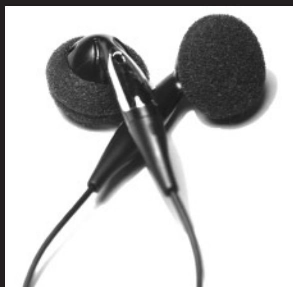

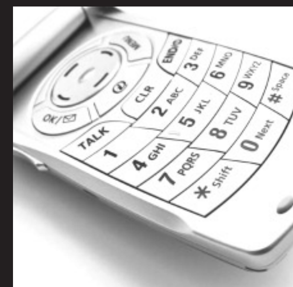

QSOUND

QSoundLabs

Third Quarter Report 2004

President's Message

During the quarter, we continued to make progress in penetrating the mobile market with our microQ product suite. The Company added two more design wins to the previously announced microQ design wins with Broadcom and Qualcomm. Specifically, the Company completed license agreements with Vodafone for the inclusion of our 3D positional audio solution in their VFX reference design and, subsequent to the quarter ending, with PacketVideo for both the ringtone player and 3D positional audio components of microQ. These agreements reflect our strategy of addressing multiple distribution channels; namely chip manufacturers, OEM handset manufacturers and video software partners.

With all of these agreements, the target for product delivery to the market place is throughout 2005. At this stage, management expects that recurring revenues from some of these contracts will commence in early 2005. The mobile market is in the early stages of multimedia adoption and usage. Advanced markets in Japan and Korea indicate that consumers are willing to pay for multimedia data services. Industry analysts are predicting the same consumer pattern to occur in the rest of the world thus providing a growth market for several years to come. Management believes the Company is currently well situated to take advantage of this opportunity. Competition will, of course, be fierce and it is critical that the Company continues to capitalize on its first to market advantage by closing more license agreements over the next few months.

Revenues from our PC audio software solution, QVE, remained flat. The Company has continued to seek out new licensees to complement our main licensee, Philips Sound Solutions.

VoIP product sales were also flat and will continue as such until new products with a wider application, are available. This is still expected to occur in early FY2005.

David Gallagher

David Gallagher
President and Chief Executive Officer

Forward-looking statements concerning expectation of revenues from customers in the mobile device and IP telephony markets involve risk and uncertainties including loss of relationships with companies that do business with QSound, continued growth of mobile devices and Internet telephony products, successful product development, introduction and acceptance, QSound's ability to carry out its business strategy and marketing plans, dependence on intellectual property, rapid technological change,competition, general economic and business conditions, and other risks detailed from time to time in QSound's periodic reports filed with the Securities and Exchange Commission.

Management's Discussion and Analysis

Third Quarter ended September 30, 2004

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the quarter ended September 30, 2004 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarters ended March 31, 2004 and June 30, 2004, and the annual audited financial statements of the company for the fiscal year ended December 31, 2003. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2003 and the quarters ended March 31, 2004 and June 30, 2004.

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

Operations

Revenues for the three months ended September 30, 2004 were $600,277 as compared to $465,667 for the same period in 2003. The audio segment had revenues of $505,972 for the quarter as compared to $284,579 for the same period in 2003. The increase was due primarily to increased license fees and royalties. The e-commerce segment had revenues of $59,027 as compared to $83,231 for 2003. The decrease was due to a decrease in the number of subscribers for the e-commerce services. The telephony segment had revenues of $35,278 as compared to $97,857 for 2003.

The operating loss for three months ended September 30, 2004 was $218,141 as compared to an operating loss of $382,774 for the same period last year. The audio segment had an operating loss of $39,309 for the quarter as compared to an operating loss of $284,573 for the same period in 2003. Included in the loss for the three month period ended September 30, 2004 is $33,704 of compensation costs of options issued. The reason for the decrease in loss was due primarily to increased licensing fee and royalty revenue. The e-commerce segment had an operating loss of $21,487 for the quarter as compared to an operating profit of $38,213 for the same period in 2003. The reason for the decrease was due to the decrease in revenue being larger than the decrease in operating costs. The telephony segment had an operating loss of $157,345 as compared to an operating loss of $136,414 for the same period in 2003. This increase in the operating loss was due mainly to increased marketing costs as we research and develop new marketing opportunities for our products.

Administration expenses increased to $201,422 for the three months ended September 30, 2004 from $133,723 for the same period in 2003. The increase is due mainly because of two items, the compensation costs of options issued as detailed above, and the fluctation of the Canadian dollar against the United States dollar. With the decrease in value of the United States dollar, our administration costs increase.

Net loss for the quarter ended September 30, 2004 was $336,854 or $0.04 per share as compared to net loss of $463,516 or $0.06 per share for the same period in 2003. The net loss for the quarter ended September 30, 2004 is also $161,653 less than the loss for the quarter ended June 30, 2004.

Cash Flow and Financial Condition

The company experienced a net decrease in cash for the quarter ended September 30, 2004 of $250,885 as compared to a net decrease in cash of $593,788 for the same period in 2003.

Cash used in operations was $61,823 for the quarter ended September 30, 2004, as compared to $542,900 for the same period in 2003.

Cash provided by financing for the quarter ended September 30, 2004 was $68,099 as compared to $1,645 for the same period in 2003. The cash was provided in the quarter ended September 30, 2004 through the exercise of 58,250 stock options.

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 patents and trademarks, the company invested $49,921 in the quarter ended September 2004 in new computer equipment and software, patents and trademarks as compared to $52,712 in the same period in 2003. In addition, the company invested with a third party $207,380 in cash and stock options in the development of a new telephony product which will be released for market in 2005. This development cost has been capitalized and added to the capital assets as part of software and production tooling in the quarter.

The company had a working capital surplus of $1,766,369 at September 30, 2004 as compared to $2,142,840 as at December 31, 2003.

Cash resources at September 30, 2004 were $1,502,746 as compared to $2,061,093 at December 31, 2003. Liabilities at September 30, 2004 were $361,338, which consisted of $229,178 in accounts payable and accrued liabilities and $132,160 in deferred revenue. Liabilities at December 31, 2003 were $329,745 which consisted of $233,198 in accounts payable and accrued liabilities and $96,547 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 2004.

Consolidated

Balance Sheets

As at September 30, 2004 and December 31, 2003
(Expressed in United States dollars)

	September 30, 2004 (unaudited)	December 31,2003
ASSETS		
Current assets		
Cash and cash equivalents	$ 1,502,746	$ 2,061,093
Accounts receivable	449,466	221,194
Inventory	99,656	107,377
Deposits and prepaid expenses	75,839	82,921
	2,127,707	2,472,585
Capital assets (note 2)	1,349,070	1,114,992
Other intangible assets (note 3)	176,083	189,002
	$ 3,652,860	$ 3,776,579
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 229,178	$ 233,198
Deferred revenue	132,160	96,547
	361,338	329,745
Shareholders' equity		
Share capital (note 4)	45,430,767	44,108,140
Contributed surplus	1,114,316	1,114,316
Deficit	(43,253,561)	(41,775,622)
	3,291,522	3,446,834
	$ 3,652,860	$ 3,776,579

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Operations and Deficit

For the periods ended September 30, 2004 and 2003
(Expressed in United States dollars)

	For three months ended Sept. 30, 2004	For three months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2004	For the nine months ended Sept. 30, 2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
REVENUE				
Royalties and license fees	$ 383,773	$ 114,879	$ 977,794	$ 691,287
Product sales	216,504	350,788	741,169	988,538
	600,277	465,667	1,718,963	1,679,825
Cost of product sales	93,320	136,749	380,677	283,762
	506,957	328,918	1,338,286	1,396,063
EXPENSES				
Marketing	265,281	287,549	982,889	866,796
Operations	30,184	45,667	171,725	121,921
Product engineering	228,211	244,753	698,798	598,703
Administration	201,422	133,723	630,226	414,190
	725,098	711,692	2,483,638	2,001,610
Operating (loss) profit	(218,141)	(382,774)	(1,145,352)	(605,547)
OTHER ITEMS				
Depreciation and amortization	(101,433)	(74,904)	(311,085)	(237,628)
Interest and other income	2,843	11,031	7,068	34,153
Gain (loss) on sale of capital assets	(13,236)	179	(13,236)	(1,729)
Other	(6,887)	(17,048)	(15,334)	108,193
	(118,713)	(80,742)	(332,587)	(97,011)
Net (loss) income for period	(336,854)	(463,516)	(1,477,939)	(702,558)
Deficit, beginning of period	(42,916,707)	(38,309,033)	(41,775,622)	(38,069,991)
Deficit, end of period	$ (43,253,561)	$ (38,772,549)	$ (43,253,561)	$ (38,772,549)
Income (loss) per common share	$ (0.04)	$ (0.06)	$ (0.20)	$ (0.10)

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Cash Flows

For the periods ended September 30, 2004 and 2003
(Expressed in United States dollars)

	For three months ended Sept. 30, 2004	For three months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2004	For the nine months ended Sept. 30, 2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Cash provided by (used in)				
OPERATIONS				
(Loss) income for the period	$ (336,854)	$ (463,516)	$ (1,477,939)	$ (702,558)
Items not requiring (providing) cash:				
Depreciation and amortization	101,433	74,904	311,085	237,628
Provision for inventory	—	—	60,000	—
Compensation cost of options issued	44,230	—	262,233	5,864
Loss (gain) on sale of capital assets	13,236	(179)	13,236	1,729
Changes in working capital balances (note 6)	116,132	(154,109)	(241,876)	394,536
	(61,823)	(542,900)	(1,073,261)	(62,801)
FINANCING				
Issuance of common shares, net	68,099	1,645	1,022,775	11,642
	68,099	1,645	1,022,775	11,642
INVESTMENTS				
Purchase of capital assets	(227,704)	(40,810)	(468,792)	(51,219)
Purchase of intangible assets	(29,597)	(11,902)	(39,261)	(36,179)
Proceeds from sale of capital assets	140	179	192	5,801
	(257,161)	(52,533)	(507,861)	(81,597)
Increase (decrease) in cash	(250,885)	(593,788)	(558,347)	(132,756)
Cash and cash equivalents beginning of period	1,753,631	3,082,237	2,061,093	2,621,205
Cash and cash equivalents end of period	$ 1,502,746	$ 2,488,449	$ 1,502,746	$ 2,488,449

See accompanying notes to consolidated financial statements.

(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, 2003. These interim financial statements should be read in conjunction with the Company's December 31, 2003 audited annual financial statements. These statements have not been reviewed by the company's auditors. The disclosures provided below are incremental to those included in the annual financial statements.

2. Capital assets:

September 30, 2004	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 554,850	$ 526,416	$ 28,434
Real time systems	905,534	898,923	6,611
Furniture and fixtures	229,102	214,392	14,710
Computer equipment	935,261	714,401	220,860
Software and production tooling	2,405,346	1,326,891	1,078,455
	$ 5,030,093	$ 3,681,023	$ 1,349,070

3. Other intangible assets:

September 30, 2004	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 871,157	$ 710,562	$ 160,595
Purchased customer list	34,418	18,930	15,488
	$ 905,575	$ 729,492	$ 176,083

4. Share capital:

	Number of Shares	Consideration
Balance at June 30, 2004	7,827,574	$ 45,299,629
Issued for cash on exercise of options	58,250	68,100
Additional paid-in capital stock options	—	63,038
Balance at September 30, 2004	7,885,824	$ 45,430,767

5. Stock option plan:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at June 30, 2004	1,326,185	$ 0.47 – 2.05	$ 1.08
Exercised	(58,250)	0.47 – 1.65	1.17
Balance at September 30, 2004	1,267,935	$ 0.47 – 2.05	$ 1.08

5. Stock option plan (continued):

The following table summarizes the information about stock options outstanding at September 30, 2004:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at Sept. 30, 2004	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at Sept. 30, 2004	Weighted-Average Exercise Price
$ 0.47	241,307	2.1	$ 0.47	241,307	$ 0.47
0.57 - 0.62	275,000	3.0	0.61	219,436	0.61
1.04 - 1.04	380,628	1.5	1.04	380,628	1.04
1.34 - 2.05	371,000	4.1	1.86	214,996	1.66
	1,267,935			1,056,367	

6. Changes in non-cash working capital balances:

	For the three months ended Sept. 30, 2004	For the three months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2004	For the nine months ended Sept. 30, 2003
Accounts receivable	$ 17,650	$ (57,686)	$ (228,272)	$ 623,060
Inventory	(7,557)	(1,925)	(52,279)	(95,870)
Deposits and prepaid expenses	23,848	(50,539)	7,082	(65,948)
Accounts payable and accrued liabilities	80,244	(42,317)	(4,020)	(44,031)
Deferred revenue	1,947	(1,642)	35,613	(22,675)
	$ 116,132	$ (154,109)	$ (241,876)	$ 394,536

7. Segmented information:

For the three month period ended September 30, 2004	Audio	E-Commerce	Telephony	Total
Revenues	$ 505,972	$ 59,027	$ 35,278	$ 600,277
Interest revenue	2,819	1	23	2,843
Amortization of capital assets	34,248	7,059	42,732	84,039
Segment operating (loss) income	(39,309)	(21,487)	(157,345)	(218,141)
Segment assets	2,482,411	109,171	1,061,278	3,652,860
Expenditures for segment capital assets	39,132	—	207,381	246,513

For the three month period ended September 30, 2003				
Revenues	$ 284,579	$ 83,231	$ 97,857	$ 465,667
Interest revenue	11,031	—	—	11,031
Amortization of capital assets	45,192	9,992	—	55,184
Segment operating (loss) income	(284,573)	38,213	(136,414)	(382,774)
Segment assets	3,549,909	2,346,904	731,919	6,628,732
Goodwill	—	2,184,589	—	2,184,589
Expenditures for segment capital assets	10,280	—	28,486	38,766

For the nine month period ended September 30, 2004	Audio	E-Commerce	Telephony	Total
Revenues	$ 1,389,439	$ 193,782	$ 135,742	$ 1,718,963
Interest revenue	6,973	1	94	7,068
Amortization of capital assets	109,530	21,179	128,196	258,905
Segment operating (loss) income	(287,065)	(61,959)	(796,328)	(1,145,352)
Expenditures for segment capital assets	89,366	—	417,044	506,410

For the nine month period ended September 30, 2003	Audio	E-Commerce	Telephony	Total
Revenues	$ 1,268,655	$ 276,039	$ 135,131	$ 1,679,825
Interest revenue	34,153	—	—	34,153
Amortization of capital assets	148,489	29,977	—	178,466
Segment operating (loss) income	(443,618)	125,191	(287,120)	(605,547)
Expenditures for segment capital assets	121,016	867	511,576	633,459

7. Segmented information (continued):

Geographic Information		For the three months ended Sept. 30, 2004		For the three months ended Sept. 30, 2003		For the nine months ended Sept. 30, 2004		For the nine months ended Sept. 30, 2003
Canada	$	62,175	$	50,884	$	70,822	$	60,489
United States		224,721		273,140		982,038		1,251,990
Africa		26,150		20,000		26,150		20,000
Asia		281,754		121,643		567,809		347,346
Europe		5,477		—		72,144		—
	$	600,277	$	465,667	$	1,718,963	$	1,679,825

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