QSoundLabs

ThirdQuarter2006

Management's Discussion and Analysis

Three and nine month periods ended September 30, 2006

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the three and nine month periods ended September 30, 2006 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarters ended March 31, 2006; June 20, 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 and the quarters ended March 31, 2006 and June 30, 2006.

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 three and nine month periods ended September 30, 2006 and 2005, as well as analysis of the changes period to period.

		Q3 2006		YTD 2006		Q3 2005		YTD 2005
Royalties and license fees revenues	$	262,307	$	1,219,078	$	167,087	$	758,591
Product sales revenues								
Audio segment	$	25,805	$	73,314	$	37,264	$	194,922
E-Commerce segment		41,668		124,789		44,724		145,557
Telephony segment		11,907		28,444		13,362		41,155
Total	$	79,380	$	226,547	$	95,350	$	381,634

The increase in royalties and license fee revenues is attributable to increased activity in the mobile device market as shipments of our MicroQ product start to ramp up. Typically, each license includes an upfront license fee and per unit royalties payable as the related products are shipped.

The audio segment experienced a decrease in product sales of 65% in Q3 2006 from Q3 2005 primarily due to a decline in analog chip sales. We expect these sales to continue to decline as digital technology continues to become the more cost effective solution.

		Q3 2006		YTD 2006		Q3 2005		YTD 2005
Marketing expenses	$	270,591	$	698,576	$	256,592	$	754,891
Operating expenses	$	35,427	$	105,237	$	53,305	$	150,951

Marketing expenses in the Audio segment comprise the majority of this category. We have concentrated our efforts primarily on the mobile device market for the past four years and as a result, we have cut back on expenditures in the telephony and e-commerce segments of our business. The increase for Q3, 2006 over Q3, 2005 is due primarily to stock based compensation expense totaling $42,599.

		Q3 2006		YTD 2006		Q3 2005		YTD 2005
Product engineering expenses	$	194,244	$	627,074	$	226,433	$	710,807

The majority of product engineering expenses is made up of salaries. As our needs in audio and telephony change, so does our staffing mix to satisfy those needs. During the third quarter of 2006 the audio segment has seen a relatively constant level of staff when compared to the third quarter of 2005, while the telephony business unit has seen a decrease in staff.

		Q3 2006		YTD 2006		Q3 2005		YTD 2005
Administration and foreign exchange	$	213,751	$	667,164	$	236,714	$	620,847

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.

Financial Condition

The company had a working capital surplus of $2,636,804 at September 30, 2006 as compared to $1,492,688 as at December 31, 2005.

Cash resources at the end of the third quarter of 2006 were $2,307,783 as compared to $1,222,729 at December 31, 2005. Current liabilities at the end of the third quarter of 2006 were $466,300, which consisted of $220,971 in accounts payable and accrued liabilities and $245,329 in deferred revenue. Current 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 at least the next twelve months.

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 $8,611 in the quarter in new computer equipment and software, trademarks and patents.

Consolidated

Balance sheets

As at September 30, 2006 and December 31, 2005
(Expressed in United States dollars)

	September 30, 2006	December 31, 2005
	(unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,307,783	$ 1,222,729
Accounts receivable	637,609	401,524
Note receivable (note 2)	6,000	82,648
Inventory	44,162	40,438
Deposits and prepaid expenses	107,550	76,146
	3,103,104	1,823,485
Note receivable (note 2)	53,893	–
Property and equipment (note 3)	423,131	670,635
Deferred development costs (note 4)	313,938	352,750
Other intangible assets (note 5)	147,446	155,445
	$ 4,041,512	$ 3,002,315

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 220,971	$ 285,786
Deferred revenue	245,329	45,011
	466,300	330,797
Convertible debt (net) (note 6)	608,501	–
	1,074,801	330,797
Shareholders' equity		
Share capital (note 7)	47,094,261	45,979,055
Warrants	1,720,489	1,502,331
Contributed surplus (note 8)	1,520,152	1,442,408
Deficit	(47,368,191)	(46,252,276)
	2,966,711	2,671,518
	$ 4,041,512	$ 3,002,315

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Operations and Deficit

For the periods ended September 30, 2006 and 2005
(Expressed in United States dollars)

	For the three months ended September 30, 2006	For the three months ended September 30, 2005	For the nine months ended September 30, 2006	For the nine months ended September 30, 2005
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
REVENUE				
Royalties, licenses, and engineering fees	$ 262,307	$ 167,087	$ 1,219,078	758,591
Product sales	79,380	95,350	226,547	381,634
	341,687	262,437	1,445,625	1,140,225
Cost of product sales	8,065	14,605	12,888	82,295
	333,622	247,832	1,432,737	1,057,930
EXPENSES				
Marketing	270,591	256,592	698,576	754,891
Operations	35,427	53,305	105,237	150,951
Product engineering	194,244	226,433	627,074	710,807
Administration	222,094	230,812	666,600	617,514
Foreign exchange loss (gain)	(8,343)	5,902	564	3,333
Amortization	100,303	71,080	382,443	277,293
	814,316	844,124	2,480,494	2,514,789
Loss before other items	(480,694)	(596,292)	(1,047,757)	(1,456,859)

OTHER ITEMS								
Interest income		23,722		11,939		55,998		40,958
Interest on convertible debt		(20,794)		–		(40,541)		–
Accretion of debt discount		(21,935)		–		(44,109)		–
Other		(5,438)		(623,278)		(7,075)		(626,484)
		(24,445)		(611,339)		(35,727)		(585,526)
Loss before taxes		(505,139)		(1,207,631)		(1,083,484)		(2,042,385)
Foreign withholding tax		(18,954)		(11,547)		(32,431)		(33,100)
Net loss for period		(524,093)		(1,219,178)		(1,115,915)		(2,075,485)
Deficit, beginning of period		(46,844,098)		(44,557,875)		(46,252,276)		(43,701,568)
Deficit, end of period	$	(47,368,191)	$	(45,777,053)	$	(47,368,191)	$	(45,777,053)
Loss per common share (basic and diluted)	$	(0.06)	$	(0.14)	$	(0.12)	$	(0.25)

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Cash Flows

For the periods ended September 30, 2006 and 2005
(Expressed in United States dollars)

	For the three months ended September 30, 2006	For the three months ended September 30, 2005	For the nine months ended September 30, 2006	For the nine months ended September 30, 2005
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Cash provided by (used in)				
OPERATIONS				
Loss for the period	$ (524,093)	$ (1,219,178)	(1,115,915)	(2,075,485)
Items not requiring (providing) cash:				
Amortization	100,303	71,080	382,443	277,293
Stock based compensation	70,505	28,086	193,717	97,814
Amortization of debt discount	21,935	–	44,109	–
Impairment of assets	–	556,332	–	556,332
Changes in non-cash working capital balances (note 10)	140,530	122,567	(135,710)	(405,736)
	(190,820)	(441,113)	(631,356)	(1,549,782)
FINANCING				
Issuance of common shares, net	43,820	14,664	781,782	53,713
Proceeds from convertible debt	–	–	1,000,000	–
	43,820	14,664	1,781,782	53,713

INVESTMENTS				
Note receivable	(728)	–	22,755	–
Purchase of property and equipment	(2,070)	(3,191)	(26,080)	(135,432)
Purchase of deferred development costs	–	–	(39,500)	–
Purchase of other intangible assets	(6,541)	(16,953)	(22,547)	(38,806)
	(9,339)	(20,144)	(65,372)	(174,238)
Increase (decrease) in cash and cash equivalents	(156,339)	(446,593)	1,085,054	(1,670,307)
Cash and cash equivalents, beginning of period	2,464,122	2,103,829	1,222,729	3,327,543
Cash and cash equivalents, end of period	$ 2,307,783	$ 1,657,236	$ 2,307,783	$ 1,657,236

See accompanying notes to consolidated financial statements

Notes

to Consolidated Financial Statements

For the Periods Ended September 30, 2006 and 2005
Unaudited
(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, 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 by the Company's auditors.

2. Note receivable

Note receivable	$	59,893
Less current portion due in 2007		6,000
Long term portion due in 2008	$	53,893

3. Property and equipment:

September 30, 2006	Cost	Accumulated amortization	Net book value
Sound source and control equipment	$ 550,664	$ 536,508	$ 14,156
Real time systems	905,534	902,294	3,240
Furniture and fixtures	230,668	216,553	14,115
Computer equipment	1,116,586	869,039	247,547
Software and production tooling	1,632,281	1,488,208	144,073
	$ 4,435,733	$ 4,012,602	$ 423,131

4. Deferred development costs:

September 30, 2006	Cost	Accumulated amortization	Net book value
Software development costs	$ 1,079,001	$ 765,063	$ 313,938

5. Other intangible assets

September 30, 2006	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 951,454	$ 805,729	$ 145,725
Purchased customer list	34,418	32,697	1,721
Licensing rights	428,453	428,453	–
	$ 1,414,325	$ 1,266,879	$ 147,446

6. Convertible debt:

In March 2006, the Company entered into a Convertible Promissory Note Agreement and a Share Purchase Warrant Agreement (the “Agreements”) with the purchasers named therein (the “Purchasers”). The transaction closed on March 27, 2006. Pursuant to these Agreements, the Purchasers loaned $1,000,000 to the Company for a term of five years. The loan bears interest at the US prime rate and is payable quarterly.

The Promissory Note is convertible at the option of the holder at any time and from time to time into Common Stock of the Company at a conversion price of $3.25 per share. Additionally, in the event that the Company issues common stock in an equity financing at a price less than the then conversion price, the conversion price shall be immediately adjusted to the price at which such Common Stock was issued.

Pursuant to the Share Purchase Warrant, the Company also issued Common Stock Warrants (the “Warrants”) to the Purchasers. The Warrants were exercisable from March 27, 2006 until March 27, 2011 to purchase up to 400,000 shares of common stock at an exercise price of $4.50 per share (the “Exercise Price”).

The Warrants contain provisions to adjust the Exercise Price in the event that the Company issues common stock in an equity financing at a price less than the then applicable Exercise Price, in which case the Exercise Price shall be reduced to the price at which such common stock was issued.

If the aggregate principal amount owing under the Promissory Note is converted, the Company will issue 307,692 shares. The first payment of accrued interest was made on June 30, 2006 and if the Promissory Note is not converted, additional payments will be due on the last day of each quarter thereafter with the final payment due on June 30, 2011.

The amount of $435,608 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 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	3 Years
Dividend yield	0%

$435,608 has been allocated as debt discount and will be amortized over 5 years. $44,109 has been charged to income in 2006.

Face value of loan	$	1,000,000
Unamortized debt discount		391,499
	$	608,501

7. Share capital

	Number of shares	Consideration
Balance June 30, 2006	9,301,085	$ 47,040,909
Issued for cash on exercise of options	25,500	43,821
Reclassification from contributed surplus on exercise of stock options	–	9,531
Balance September 30, 2006	9,326,585	$ 47,094,261

8. Contributed surplus

Balance June 30, 2006	$ 1,459,178
Increase due to stock based compensation	70,506
Decrease due to stock options exercised	(9,532)
Balance September 30, 2006	$ 1,520,152

9. Stock option plan

During the three month period ended September 30, 2006, the Company granted 30,000 options (2005 – nil) to employees with exercise prices at the market price of the Company's stock on the date of grant. For the three month period ended September 30, 2006 $13,663 (2005 – nil) of compensation cost related to options granted to directors has been recognized, and $56,842 (2005 – $64,769) of compensation cost related to options granted to employees has been recognized. For the nine month period ended September 30, 2006 $94,391 (2005 – nil) of compensation cost related to options granted to directors has been recognized, and $99,326 (2005 – $82,922) of compensation cost related to options granted to employees has been recognized. In 2005 an additional $18,822 has been recognized as compensation costs related to options issued to non-employees. The compensation costs related to options issued to non-employees has been capitalized to software and production tooling.

	Number of shares	**Exercise price per share**	**Weighted average exercise price**
Balance June 30, 2006	933,433	$ 0.47 – 5.02	$ 1.71
Granted	30,000	$ 5.16	5.16
Exercised	(26,500)	$ 0.47 – 4.20	1.72
Cancelled	(2,233)	$ 2.40	$ 2.40
Balance September 30, 2006	934,700	$ 0.47 – 5.16	$ 1.82

The following table summarized the information about stock options outstanding at September 30, 2006

	Options Outstanding			**Options Exercisable**	
Range of Exercise prices	**Number Outstanding at September 30, 2006**	**Weighted-Average Remaining Term (Years)**	**Weighted-Average Exercise Price**	**Number Exercisable at September 30, 2006**	**Weighted-Average Exercise Price**
$ 0.47 – 1.65	571,500	1.8	$ 0.96	571,500	$ 0.96
2.05 – 2.40	204,200	5.6	2.24	114,200	2.11
3.50 – 3.57	45,000	2.9	3.55	45,000	3.55
4.20 – 5.02	114,000	3.5	4.68	28,000	4.48
	934,700	2.9	$ 1.82	758,700	$ 1.42

10. Supplementary cash flow information

Changes in non-cash working capital balances	For the three months ended Sept 30, 2006	For the three months ended Sept 30, 2005	For the nine months ended Sept 30, 2006	For the nine months ended Sept 30, 2005
Accounts receivable	$ (111,101)	$ 16,944	$ (236,085)	$ (447,542)
Inventory	5,730	6,098	(3,724)	59,025
Deposits and prepaid expenses	19,270	18,143	(31,404)	(44,921)
Accounts payable and accrued liabilities	19,706	75,328	(64,815)	33,257
Deferred revenue	206,925	6,054	200,318	(5,555)
	$ 140,530	$ 122,567	$ (135,710)	$ (405,736)
Interest received in cash	$ 16,693	$ 7,813	$ 49,784	$ 38,745
Withholding taxes paid in cash	$ 18,954	$ 11,547	$ 32,431	$ 33,100

11. Segmented information

For the three month period ended September 30, 2006	Audio	E-Commerce	Telephony	Total
Revenues	$ 288,113	$ 41,668	$ 11,906	$ 341,687
Interest revenue	22,587	–	1,135	23,722
Amortization	29,748	7,137	63,418	100,303
Segment loss before other items	(386,344)	(22,729)	(71,621)	(480,694)
Segment assets	3,710,645	94,306	236,561	4,041,512
Expenditures for segment property and equipment	2,070	–	–	2,070
Expenditures for segment other intangible assets	6,541	–	–	6,541

For the three month period ended September 30, 2005	Audio	E-Commerce	Telephony	Total
Revenues	$ 204,351	$ 44,724	$ 13,362	$ 262,437
Interest revenue	11,389	–	550	11,939
Amortization	39,360	5,003	12,126	56,489
Segment loss before other items	(349,311)	(51,500)	(195,481)	(596,292)
Segment assets	2,773,166	128,316	448,918	3,350,400
Expenditures for segment property and equipment	216,147	7,485	–	223,632
Expenditures for segment other intangible assets	16,953	–	–	16,953

For the nine month period ended September 30, 2006	Audio	E-Commerce	Telephony	Total
Revenues	$ 1,292,394	$ 124,789	$ 28,442	$ 1,445,625
Interest revenue	52,956	–	3,042	55,998
Amortization	170,780	21,410	190,253	382,443
Segment loss before other items	(762,960)	(62,554)	(222,243)	(1,047,757)
Expenditures for segment property and equipment	25,764	316	–	26,080
Expenditures for segment other intangible assets	22,547	–	–	22,547

For the nine month period ended September 30, 2005	Audio	E-Commerce	Telephony	Total
Revenues	$ 953,513	$ 145,557	$ 41,155	$ 1,140,225
Interest revenue	39,483	–	1,475	40,958
Amortization	120,925	15,008	97,587	233,520
Segment loss before other items	(648,635)	(133,072)	(675,152)	(1,456,859)
Expenditures for segment property and equipment	283,524	25,201	41,208	349,933
Expenditures for segment other intangible assets	38,806	–	–	38,806

11. Segmented information (continued)

Geographic Information		For the three months ended September 30, 2006		For the three months ended September 30, 2005		For the nine months ended September 30, 2006		For the nine months ended September 30, 2005
Canada	$	–	$	4,240	$	10,847	$	10,472
United States		242,855		190,514		566,700		721,274
Asia		98,016		64,668		859,362		366,208
Europe		–		–		–		34,026
Other		816		3,015		8,716		8,245
	$	341,687	$	262,437	$	1,445,625	$	1,140,225

12. Reconciliation to United States accounting principles:

		For the three months ended September 30, 2006		For the three months ended September 30, 2005		For the nine months ended September 30, 2006		For the nine months ended September 30, 2005
Net loss for the period as reported in accordance with Canadian GAAP	$	(524,093)	$	(1,219,178)	$	(1,115,915)	$	(2,075,485)
Amortization of deferred development costs		–		–		20,217		–
Additional amortization of debt discount		(28,422)		–		(57,151)		–
Change in fair value of convertible debt conversion feature		19,001		–		38,718		–
Excess fair value of convertible debt at transaction date		–		–		(224,633)		–
Net loss under US GAAP	$	(533,514)	$	(1,219,178)	$	(1,338,762)	$	(2,075,485)
Loss per share (basic and diluted) under US GAAP	$	(0.06)	$	(0.14)	$	(0.15)	$	(0.25)

September 30, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,103,104	$ –	$ 3,103,104
Note receivable	53,893	–	53,893
Property and equipment	423,131		423,131
Deferred development costs	313,938	(60,653)	253,285
Intangible assets	147,446	–	147,446
	$ 4,041,512	$ (60,653)	$ 3,980,859

Current liabilities	$ 466,300	$ –	$ 466,300
Convertible debt	608,501	(507,242)	101,259
Conversion feature	–	750,308	750,308
Shareholders' equity:			
Share capital	47,094,261	202,058	47,296,319
Warrants	1,720,489	–	1,720,489
Contributed surplus	1,520,152		1,520,152
Deficit	(47,368,191)	(505,777)	(47,873,968)
	$ 4,041,512	$ (60,653)	$ 3,980,859

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