

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, 2005.

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 \_\_\_\_\_ Name of each exchange on which registered \_\_\_\_\_

Securities registered or to be registered pursuant to Section 12(g) of the Act: **Common Shares - without nominal or par value.**

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, 2005: 8,661,985**

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. On July 9, 2001 our shareholders approved a one-for-four share consolidation. Unless otherwise indicated, all share and option figures in this Annual Report have been adjusted retroactively to reflect the share consolidation.**

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 following table sets forth certain selected consolidated financial information with respect to QSound for the periods indicated. It should be read in conjunction with Item 5. "Operating and Financial Review and Prospects" and our Consolidated Financial Statements.

The selected data presented below for, and as of the end of, each of the years in the five-year period ended December 31, 2005, are derived from the consolidated financial statements of QSound and subsidiaries, which financial statements have been audited by the external auditors for the company. The consolidated financial statements as of December 31, 2005 and 2004, and for each of the years in the three-year period ended December 31, 2005, and the report thereon, are included elsewhere in this report. These financial statements have been prepared in accordance with generally accepted accounting principles in Canada which, except as indicated in Note 22 to the Consolidated Financial Statements, are also, in all material respects, in accordance with generally accepted accounting principles in the United States. The financial statements have been audited in accordance with both Canadian and United States Generally Accepted Auditing Standards, and in 2005 in accordance with the standards of the Public Company Accounting Oversight Board (United States).

The selected financial data presented below has been prepared in accordance with generally accepted accounting principles in the United States.

Selected Financial Data					
Years ended December 31, 2005, 2004, 2003, 2002, and 2001					
(Under United States GAAP in United States Dollars)					
	2005	2004	2003	2002	2001
Revenue:					
Royalties, license fees and product sales	\$ 1,543,240	\$ 2,213,178	\$ 2,043,088	\$ 4,224,311	\$ 3,025,994
Cost of product sales	(179,781)	(419,290)	(425,091)	(271,530)	(91,438)
	<u>1,363,459</u>	<u>1,793,888</u>	<u>1,617,997</u>	<u>3,952,781</u>	<u>2,934,556</u>

Expenses:					
Marketing	963,255	1,129,781	1,242,271	895,820	1,074,139
Operations	213,163	234,481	169,667	235,201	275,077
Product research and development	983,298	908,984	834,333	643,524	951,017
Administration	796,038	661,659	552,876	502,861	595,913
Stock based compensation	134,793	320,432	90,439	–	–
Foreign exchange	2,832	41,955	(153,849)	3,167	1,772
Depreciation and amortization	360,898	457,572	308,717	382,662	831,193
Impairment of property and equipment	89,754	–	102,900	100,000	–
Impairment of intangible assets	428,453	–	–	–	–
Impairment of goodwill	–	–	2,184,589	–	–
Termination expenses	41,380	3,880	26,647	16,237	1,842
Funding past service pension costs	–	–	–	55,189	–
Write-down of investments	–	–	–	–	8,300
	4,013,864	3,758,744	5,358,590	2,834,661	3,739,253
Operating (loss) profit	(2,650,405)	(1,964,856)	(3,740,593)	1,118,120	(804,697)
Interest and other income	56,700	78,727	41,164	29,833	73,568
Gain (loss) on sale of capital assets	–	(15,616)	2,204	740	6,492
Gain on sale of investments	–	–	–	–	24,327
Other	(163)	(1,697)	137	–	(1,775)
	56,537	61,414	43,505	30,573	102,612
Loss before taxes	(2,593,868)	(1,903,442)	(3,697,088)	1,148,693	(702,085)
Foreign withholding tax	(37,711)	(22,504)	(8,543)	(19,741)	(30,825)
Net (loss) income for the year	(2,631,579)	(1,925,946)	(3,705,631)	1,128,952	(732,910)
Deficit, beginning of year	(43,903,626)	(41,977,680)	(38,272,049)	(39,401,001)	(38,668,091)
Deficit, end of year	<u>\$(46,535,205)</u>	<u>\$(43,903,626)</u>	<u>\$(41,977,680)</u>	<u>\$(38,272,049)</u>	<u>\$(39,401,001)</u>
Comprehensive income (loss)	\$ –	\$ –	\$ –	\$ –	\$ (580,976)
Income (loss) per common share, basic	\$ (0.31)	\$ (0.25)	\$ (0.52)	\$ 0.16	\$ (0.10)
Income (loss) per					

common share, diluted	\$ (0.31)	\$ (0.25)	\$ (0.52)	\$ 0.15	\$ (0.10)
Total assets	\$ 2,921,444	\$ 5,227,834	\$ 3,776,579	\$ 7,271,766	\$ 5,966,007
Net assets	\$ 2,590,647	\$ 4,922,425	\$ 3,446,834	\$ 6,930,361	\$ 5,652,999
Share capital – common shares	\$ 46,181,113	\$ 45,994,584	\$ 44,003,303	\$ 43,974,499	\$ 43,939,684
Warrants	\$ 1,502,331	\$ 1,502,331	\$ 217,450	\$ 108,725	
Contributed surplus	\$ 1,442,408	\$ 1,329,136	\$ 1,203,761	\$ 1,119,186	\$ 1,114,316
Share capital – common shares issued and outstanding	8,661,985	8,404,085	7,199,244	7,156,074	7,085,574

At March 1, 2006 the exchange rate was U.S. \$0.8807 per CDN. \$1.00.

The high and low exchange rates for each month during the previous six months ended February 28, 2006, 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, 2005 based on the closing rates of the Bank of Canada and expressed in U.S. dollars were as follows:

	Month High	Low
February 2006	0.8798	0.8633
January 2006	0.8780	0.8543
December 2005	0.8598	0.8524
November 2005	0.8570	0.8377
October 2005	0.8456	0.8416
September 2005	0.8601	0.8412
	Average	
2005 Year	0.8259	
2004 Year	0.7698	
2003 Year	0.7135	
2002 Year	0.6368	
2001 Year	0.6458	

#### **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 2005 or in 2004 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 2005 we had revenues of \$1,543,240 and operating expenses of \$3,553,187, including cost of products sold of \$179,781. The net loss for 2005 was \$(2,550,708). In 2004 we had revenues of \$2,213,178 and operating expenses of \$4,174,154, including cost of products sold of \$419,290. The net loss for the year was \$(1,925,946). 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. 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 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 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, even on a quarterly basis and as a result, we believe that period-to-period comparisons for our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance.

**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, PC multimedia, consumer electronics 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 SmallCap Market has been and continues to be volatile. During the twelve months ending on March 28, 2006 our stock price has ranged from a high of \$ 4.86 to a low of \$2.15. 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 incorporated on December 6, 1968. We changed our name from Archer Communications Inc. to QSound Labs, Inc. on June 28, 1993. 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 the personal computer and consumer electronics, and more recently, the mobile devices, industries. In 2005 we added eight semiconductor/component and OEM licensees for microQ™, our audio software engine for portable applications, in the growing mobile and handheld devices market which we had entered in 2003, and two consumer electronics OEM 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 2005, 2004, and 2003 are detailed in the table below:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Sound source and control equipment	\$ –	\$ 1,320	\$ 12,818
Furniture and fixtures	2,014	5,092	6,747
Computer equipment	98,481	103,468	94,454
Software and production tooling	88,393	54,576	484,006
Deferred development costs	352,750	–	108,725
Patents and trademarks	50,977	46,233	51,392
Licensing rights	–	428,453	–
Total	\$ 592,616	\$ 639,142	\$ 758,142

We had no divestitures in fiscal 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. In fiscal 2003 our divestitures consisted of furniture and fixtures, computer equipment, and sound source and control equipment with a combined net book value of \$3,857.

## **B. Business Overview**

QSound was engaged in three business segments in 2005:

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, computer multimedia and consumer electronics 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 continues 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
- PC's and PC peripherals including sound cards, speakers and monitors
- stereo systems
- MP3 players
- home theatre systems, TV's and VCR's
- DVD players
- amplified and USB speakers
- 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. The 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 2005 we negotiated and completed license agreements with ten semiconductor/component companies and OEM's. Eight of these licenses were for use of microQ in the mobile and handheld devices market and two were for audio enhancement in the consumer electronics market. Among others, we added to our roster of licensees Yuhua Teltech (Shanghai) Co., Ltd., Wistron Neweb Corporation, Cellon Communications Technology (Shenzhen) Co., Ltd., Winbond Electronics Corp., Emuzed, A Flextronics Company, Thomson and Austriamicrosystems AG. Under previous licenses microQ has been incorporated in handheld and mobile devices from manufacturers including BenQ Corporation, Eten Information Systems Co., Ltd., Mitac International Corporation, ZTE Corporation, UTStarcom Inc. and Shanghai Lenovo Electronic Co., Ltd., and in reference design platforms from Broadcom Corporation, Qualcomm Incorporated, Aplix Corporation, ATI Technologies, Inc., CEVA Inc., DSP Group Ltd., Intel Corporation, LSI Logic Corporation, Tensilica Inc., Samsung Electronics Co., Ltd. and Pulsus Technologies Inc.

In the PC multimedia market, our audio enhancement technologies are incorporated in the Vinyl Audio line of audio controllers and audio codecs from Via Technologies, Inc., a leading developer of silicon chip technologies and PC platform solutions, in Sony Vaio PC products and in soundboards from Philips.

Under our 2002 joint development agreement with Royal Philips Electronics, one of the world's largest electronics companies, Philips & QSound jointly developed a soft audio engine based on QSound's QVE technology. Branded by Philips as the Philips SoundAgent2, the audio engine is bundled with soundcards, USB speakers, and mini-component stereo systems. Philips paid an upfront fee creditable against future royalties, and pays ongoing royalties. We also granted to Philips 500,000 warrants currently exercisable at \$1.04 per share and a right of first refusal to acquire control of our company. The right of first refusal is independent of the warrants and the Company does not expect that this right will be exercised. (See Item 7. "Major Shareholders and Related Party Transactions, A. Major Shareholders").

### **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 plug-in for Internet streaming audio, 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 9 Series for Windows XP.

AudioPix® is a standalone software product that enables Web users to combine images with music to create their own personalized multimedia presentations for personal or business use.

We distribute our downloadable consumer software from our Web sites [www.3dsoundstore.com](http://www.3dsoundstore.com), [www.qsound.com](http://www.qsound.com) and [www.audiopix.com](http://www.audiopix.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. Mitsumi has the right to distribute QXPANDER chips in Japan, Europe and Asia and we distribute these chips in the rest of the world. We have the right to distribute Mitsumi-manufactured QMDV chips world-wide. Renesas has the right to market and distribute QSOUND-enhanced chips world-wide except in China and Hong Kong, where we

sell these chips. NPC distributes QSOUND-enhanced chips to Japanese companies and we sell these chips to Japanese and non-Japanese companies.

### IP Telephony Business Segment

Our wholly-owned subsidiary QTelNet Inc. develops and sells Internet telephony systems under the brand-name FreeRide™. The current product offerings include:

- FreeRide FXS Gateways - products that allow conventional analog phones and switchboards to connect to a computer network
- FreeRide FXO Gateways - products that allow IP Phones to connect to conventional telephone networks.
- FreeRide IP Telephones - telephones that connect to a computer network.

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.

More specific examples of cost saving VoIP applications for small businesses using FreeRide gateways and IP telephones include:

- As a point-to-point application, eliminating high long distance charges for direct phone calls between two locations that may be a great distance apart and have high voice traffic.
- As a telecommuter application, eliminating long distance charges from remote offices by connecting them to the office switchboard so that they may work remotely as if they were at the office location.
- As a low cost alternative for adding local telephones and extensions to an existing switchboard that has reached its capacity, rather than upgrading or replacing the switchboard.
- As a low cost alternative for connecting phone extensions in different offices, allowing workers to use their existing desk phones to call through their switchboard to workers on a phone system at a different location, essentially extending the telephone system functionality in each office to include both offices.
- As a toll-free trunk line between office switchboards in different locations, linking voice traffic between switchboards via the Internet and bypassing long distance toll charges for the voice traffic between switchboards in the different offices.

Fixed wireless creates available bandwidth beyond where DSL or cable broadband can reach, extending the “last mile” and introduces new VoIP applications and opportunities for FreeRide products. Some examples of broadband wireless applications are energy companies who deploy VoIP over wireless to remote gas wells and oil derricks in the ocean and companies that use fixed wireless to provide bandwidth and VoIP phone service to temporary facilities, such as trailers used for a variety of construction and government applications.

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<sup>™</sup> 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<sup>™</sup> 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 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. In fiscal 2003, our revenues were \$1,511,312 from the audio business segment, \$346,456 from the e-commerce business segment and \$185,320 from the telephony segment.

### **Revenues by Geographic Market**

Audio Business: In 2005 product sales revenue was split between the United States and Asia. Royalties, license and engineering fees 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 primarily from the United States (62%) and Asia (28%). In 2003 product sales revenue was split between the United States and Asia and royalty revenue came primarily from the United States.

Internet Telephony Business: In 2005 75% of our revenue came from the United States, 19% from Canada, and 6% from other areas. In 2004 79% of our revenue came from the United States, 16% from Canada, and 5% from other areas. In 2003 62% came from the United States, 33% from Canada, and 5% from other areas. The remaining revenue in 2005, 2004 and 2003 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 2005, 2004 and 2003.

### **Seasonality**

We generally experience increased royalty revenues in our audio business segment in 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. In 2005 we did not experience this seasonality as royalty revenues increased in each quarter of 2005. In 2005 we did not experience any seasonal changes in our e-commerce business segment. All revenue from e-commerce was 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 in-house 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 QTelNet's sales and marketing personnel.

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 fifteen 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, two patents cover binaural hearing aid technology previously co-developed by QSound Labs and the House Ear Institute of Los Angeles, California. At the date of this 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; PC multimedia market; the consumer electronics 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 (\$6867.00 U.S. at December 31, 2005). 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 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following discussion and analysis of the financial condition and results of operations of QSound and subsidiaries should be read in conjunction with the consolidated financial statements of QSound and related notes contained elsewhere in this Annual Report on Form 20-F. These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada. Except as disclosed in Note 22 to the Consolidated Financial Statements and as explained below, there are no material differences as pertains to these statements between accounting principles generally accepted in Canada and in the United States. We measure and report in United States currency.

The preparation of these financial statements requires us to make estimates, judgments and assumptions that we believe are reasonable based upon available information, historical experience and/or forecasts. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported revenues and expenses during the reporting periods. Actual results could differ from these estimates

### **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 84%, 82% and 74% of total consolidated revenues in fiscal 2005, 2004 and 2003 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 4%, 7% and 9% of total consolidated revenues in fiscal 2005, 2004 and 2003 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 12%, 11% and 17% of total consolidated revenues in fiscal 2005, 2004 and 2003 and are comprised primarily of monthly subscription fees.

The following represents a summary of our critical accounting policies, defined as those policies that are both very important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective or complex judgments. Our most critical accounting estimates include revenue recognition, research and development costs, inventory, stock based compensation and income taxes.

### **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, if applicable, has been received, and collection is reasonably assured.

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 products. Revenue from 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 does not have obligations for additional deliverables that are essential to the functionality of the product.

#### 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 management believes is technically and economically feasible and recoverable, in which case these costs are deferred.

Deferred development costs are amortized against the related expected revenue as that revenue is recognized.

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.

#### Inventory

Inventory is comprised of finished goods and is stated at the lower of cost, being determined by the first-in, first-out method, and net realizable value. We regularly review quantities of inventory on hand, and an allowance is made for obsolete items based upon current market demand and selling prices. Adverse changes in technology or new models could result in a decreased demand for our products which may require an additional allowance to be made for obsolete inventory.

#### Stock based compensation

The company accounts for stock based compensation under the fair value method. Under the fair value based method, compensation cost is measured at fair value at the date of grant and is expensed over the vesting period. In accordance with one of the transitional options permitted under amended CICA Handbook Section 3870, the company elected to early adopt the fair value based method for all employee stock options granted on or after January 1, 2003, and accordingly, recognized compensation expense related to stock options granted to employees beginning in 2003. Pro forma disclosure of the fair value of stock options granted to employees during 2002 has been provided in note 11 of the financial statements.

#### Income taxes

The company uses the 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 realized more likely than not, a valuation allowance is provided.

### **A. Operating Results**

Overall, our results have been affected by two main factors during the three year period ended December 31, 2005. These are:

- 1) New Product introduction

The company introduced microQ in early 2002. This product is targeted for the growing mobile and handheld device market. Since introduction, the company has added a growing number of licensees. (See B. "Business Overview" in Item 4. Information on the company of this report.) Some of these licensees began shipping their products incorporating microQ in fiscal 2005 and more plan to ship in FY2006. Therefore we have not yet established a re-occurring royalty revenue base but we have received upfront license fees as compensation for customization and engineering requirements under these license contracts, and these amounts have formed a major part of our licensing, engineering and royalty revenue.

## 2) Impairment Charges in FY2003 & FY2005

We completed an analysis of the recorded goodwill asset in the e-commerce business segment in fiscal 2003. As a result of this, we determined that an impairment charge of \$2,185,000 was necessary. In fiscal 2005, we completed an analysis of property and equipment and intangible assets relating to an internet telephony project. As a result, we determined that a total impairment charge of \$518,207 was necessary.

A further factor that has affected the financial results in a more general sense during this period is the increase in value of the Canadian Dollar as measured against the United States Dollar. During the three year period ended December 31, 2005, the Canadian Dollar increased in value by approximately 36% over the United States Dollar. This has no effect on our reported revenues, since the majority of revenues are invoiced and collected in United States Dollars. However, since most of the company's operations are based in Canada, the majority of our expenses are paid in Canadian dollars, and therefore reported expenses are affected by the Canadian/United States exchange rate. During fiscal 2005, 2004 and 2003, this had a negative impact on the company's 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>2005</u>	<u>2004</u>	<u>2003</u>
<i>Royalties, licenses and engineering fees(in 000's)</i>	\$1,057	\$1,162	\$779
<i>Change year-on-year</i>	(9%)	49%	(72%)

The increase in licensing and royalty revenues from 2003 to 2004 arose primarily from new microQ design wins. These design wins are for mobile devices which traditionally have a longer product development cycle than markets the company was in previously. Consequently, recurring royalty revenues have not been material yet. The lack of growth between 2004 and 2005 reflects this.

### Product Sales

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>Product Sales(in 000's)</i>	\$487	\$1,051	\$1,264
<i>Change year-on-year</i>	(54%)	(17%)	(11%)

One distribution partner has accounted for 26.9%, 30.3% and 26.0% of the product sales revenue in 2005, 2004 & 2003 respectively. The decrease between 2004 and 2005 is directly attributable to the decline in sales during that period from this distributor.

Demand for our analog integrated circuits has decreased as demand for digital enabled products has increased. This has resulted in a 67% decrease in our analog chip sales from 2004 to 2005. Sales between 2004 and 2003 of our analog integrated circuits were not materially different.

In 2005 we chose to focus our marketing efforts in telephony on preparing for a new product that we intended to introduce during 2005. As a result, sales of our existing product line decreased 62% in 2005 over 2004. The new product was re-evaluated part way through the year and abandoned. Sales from 2004 to 2003 were not materially different.

The other major factor has been the steady decrease in revenues from our E-commerce business unit. We have chosen not to invest in marketing activities for this business unit, so consequently as subscriptions expire or are cancelled, we do not have sufficient replacement numbers to offset the decline in revenue.

Expenses

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>Marketing(in 000's)</i>	\$963	\$1,130	\$1,242
<i>Change year-on-year</i>	(15%)	(9%)	45%

We cutback on expenditures relating to our IP Telephony business unit in March 2004 so as to bring them more into line with revenues being generated from the IP Telephony business unit at that time. This has resulted in the decline in marketing expenses when comparing 2005 to 2004.

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>Product Engineering(in 000's)</i>	\$902	\$909	\$834
<i>Change year-on-year</i>	(1)%	9%	30%

Between 2003 and 2004, we scaled back on our engineering budgets for both E-commerce and IP Telephony, bringing them more into line with revenues being generated from those business units. Offsetting that in 2004, was a 33% increase in engineering cost for the audio business unit. This was a result of the increased activity brought on by the introduction of our microQ software product. This has continued into 2005.

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>Administration(000's)</i>	\$796	\$661	\$553
<i>Change year-on-year</i>	17%	20%	15%

During the three year period ended December 31, 2005 the US dollar has weakened considerably against the Canadian dollar, approximately 36%. This has also affected the company's cost base since the majority of expenses are incurred in Canadian dollars. Auditing costs have increased during this three year period as auditing firms comply with new professional standards and regulatory requirements.

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>(in 000s)</i>			
<i>Impairment of Goodwill</i>	–	–	\$2,185
<i>Impairment of Property and Equipment</i>	\$90	–	\$103
<i>Impairment if Intangible Assets</i>	\$428	–	–

In 2003, management completed an analysis of the recorded goodwill asset in the e-commerce business segment and determined that an impairment charge of \$2,184,589 was necessary. In 2005, management completed an analysis of a specific Internet Telephony project and determined that an impairment charge of \$518,207 was necessary.

**B. Liquidity and Capital Resources**

As at December 31, 2005 we had cash and cash equivalents of \$1,222,729. This is a decrease of \$2,104,814 over the balance at December 31, 2004 of \$3,327,543. \$1,594,557 (\$1,180,143 in 2004) of cash was used in operations during the 2005 fiscal year. Non cash working capital increased by \$140,395 in fiscal year 2005 to \$269,959 from \$129,564 in 2004. Financing activities generated \$165,008 in cash during fiscal 2005 (\$3,024,676 in 2003) from the exercise of options and the private placement.

Cash used in investing activities increased to \$675,265 in 2005 from \$578,083 in 2004. The largest portion of cash used in investing activities during 2005 was the investment the company made in a joint venture to develop software for a product to be introduced in 2006.

At December 31, 2005 we had working capital resources available of \$1,492,688 (December 31, 2004 - \$3,457,107) and management feels that with our current cash on hand and cash flows from operations we have sufficient capital to carry out our business plan for 2006.

## **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 2005, 2004 and 2003 we continued our previous research and development activities of developing new, and refining and upgrading existing, audio synthesis and enhancement technologies. In addition, in 2005 we concentrated on development and refinement of our microQ scalable software engine, and in 2004 our efforts were mainly centred on microQ and our QVE audio engine. Our audio research and development costs were \$803,322 in 2005, \$784,496 in 2004 and \$588,410 in 2003. We have three patent applications, two of which were filed in 2003 and 2005, in progress, as well as further applications in development. We also work jointly with our licensees and business partners to adapt and optimize our technologies for their products. (See "Intellectual Property" under Item 4 of this report.)

**E-commerce Business:** Research and development expenditures in our e-commerce business segment have steadily decreased, reflecting the satisfactory performance of our products. Research and development activities in 2005, 2004 and 2003 consisted mainly of upgrading our products, with expenditures of \$32,872 in 2005, \$39,032 in 2004, and \$50,757 in 2003.

**Internet Telephony Business:** In 2005 we had expenditures of \$112,387 in cash primarily in the development of a new telephony product. This project was re-evaluated in 2005 and abandoned. As a result we took an impairment charge totaling \$518,207 against all assets relating to the project. In 2004 we had expenditures of \$138,812 and in 2003 \$195,166 for activities consisting of upgrading and adding functionalities to our software, and re-designing the internal layout and external features of our gateways. We also had expenditures in 2004 of \$561,192 in cash and stock options in development of new telephony products. These costs have all been capitalized.

### **Share Capital**

During the 2005 fiscal year, our share capital increased from 8,404,085 common shares with a 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 stock options being exercised for cash of \$201,000. Other changes in the book value are from a reclassification from contributed surplus on the exercise of the stock options of \$21,521 and the payment of financing costs in cash of \$35,992. The financing costs all related to the private placement that occurred in 2004.

During the 2004 fiscal year, our share capital increased from 7,199,244 common shares with a total book value of \$43,801,245 to 8,404,085 common shares with a book value of \$45,792,526. The increase of 1,204,841 shares was a result of the exercise of stock options for cash of \$1,174,218 and the private placement of 347,826 shares for \$2,000,000.

As at December 31, 2005 the company had 977,533 options outstanding at exercise prices ranging from \$0.47 to \$4.56 and expiring at various times up to 2015. Further details on stock options outstanding can be found in Note 11 to the financial statements.

Subsequent to the year end and up to March 8, 2006, 62,800 stock options have been exercised for total cash consideration of \$117,565 and reclassification from contributed surplus of 56,961. This brings the total shares outstanding to 8,724,785 with a book value of \$46,153,581 and reduces the total options outstanding to 914,733.

During 2005 521,739 common share purchase warrants expired.

During the 2004 fiscal year 75,000 common share purchase warrants were issued for services rendered and the fair value of the warrants determined to be \$380,862 was charged to share capital as financing costs. As additional 660,869 warrants were issued as part of the private placement and were allocated consideration of \$904,019.

As at December 31, 2005 the company had 714,130 common share purchase warrants outstanding. These warrants entitle the holder to acquire one common share of the company for \$1.04 to \$9.12 per share. Further details on warrants outstanding can be found in Note 9 to the financial statements.

### **Convertible Loan**

On March 21, 2006, 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 five years or the date of conversion. The amount owed can be converted to common shares for \$3.25 per share at any time at the option of the lender. As part of the transaction, 400,000 warrants exercisable at \$4.50 per share with a five year term were issued.

## **Private Placement**

On December 16, 2004, we completed a private placement of 347,826 common shares at a purchase price of \$5.75 per share, Series A warrants to purchase 139,130 common shares at the exercise price of \$9.12 per share exercisable until December 16, 2009, and additional rights to purchase common shares and warrants which expired unexercised, with one investor. We filed a short form registration statement with the SEC on January 6, 2005 registering for resale the common shares issued at the closing of the transaction and 125% of the common shares issuable upon the exercise of the Series A warrants, which are subject to customary anti-dilution adjustments.

## **D. Trends**

The 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.

To date, the majority of revenue derived from this market segment has been license fees and custom engineering fees. Most license agreements incorporate a third revenue element, namely, per unit royalties. The fourth quarter of 2005 saw the first significant recurring royalty revenues from this segment when UTStarcom began shipping QSound-enabled mobile phones in China. As more licensees begin shipping their products in 2006, recurring royalty revenue will become a larger portion of the total revenue received.

This revenue trend will not affect costs directly since these comprise mostly fixed compensation and travel expenses.

The company has no plans for any major capital expenditures.

The company will continue to focus its development and marketing efforts on providing audio and voice IP to OEMs in 2006. Accordingly, the other business segments, e-commerce and IP telephony, are expected to continue at current performance levels.

## **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	-	-	-	-	-
Capital (Finance) Lease Obligations	-	-	-	-	-
Operating Lease Obligations	300,597	97,047	180,360	23,190	-
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, 2006. Mr. Robert Starr, formerly Vice President – Business Development, left the company on September 12, 2005. 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
Doug Drury	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 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.

Doug Drury, a Certified Management Accountant, is our Controller since December, 1999. Mr. Drury has twenty years of financial and accounting experience. Prior to joining our company Mr. Drury was Controller of Meyers Sheet Metal Ltd., Master Plastics Inc. and Jenkins Control Systems Ltd. He also taught accounting at the University of Calgary and the Southern Alberta Institute of Technology and operated his own public accounting firm from 1986 to December, 1997.

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-six 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 Controller of T.P Racing L.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 Drury.

## **B. Compensation**

Remuneration paid or payable to our directors and executive officers during fiscal year 2005 was an aggregate \$ 497,955 for compensation paid to Messrs. Gallagher, Starr and Drury, and Ms. Varvos. No cash or other bonuses were paid to executive officers in 2004. Mr. Gallagher's salary for 2005 was \$197,854. 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. On June 29, 2005 we granted options to purchase 10,000 common shares to each director, exercisable for five years at the exercise price of \$3.57 per share. These options are subject to approval by the shareholders of QSound, which we will seek to obtain at the Annual Meeting of Shareholders scheduled to take place on April 28, 2006. If approval is not obtained, these directors have agreed to accept an aggregate cash payment of \$75,000 in lieu of 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 2005 \$22,749 Cdn was contributed to the plan for fiscal 2005. \$23,500 was accrued in 2005 as settlement for past wages that had been deferred by Mr Gallagher prior to 2002. In 2004 \$14,822 Cdn. was contributed to the plan for fiscal 2004. In 2003 \$56,301 Cdn. for past service and \$11,692 Cdn. for fiscal 2002, and \$11,692 for fiscal 2003, was contributed to the plan.

The Compensation Committee of the Board of Directors has approved extension of the expiry date of options previously granted to Messrs. Gallagher and Drury and Ms. Varvos from the original expiry date July 22, 2006 to July 22, 2011. The following table gives information concerning these amendments, which are subject to shareholder approval which QSound will seek to obtain at the annual meeting of shareholders scheduled to take place on April 28, 2006.

Name	Date of Grant	No. of Options Granted	No. of Options Outstanding	Exercise Price/Market price on Date of Grant	Original Expiry Date	New Expiry Date
David J. Gallagher	July 23, 2001	253,190	235,190	\$1.04 U.S.	July 22, 2006	July 22, 2011
Joanna Varvos	July 23, 2001	25,467	25,467	\$1.04 U.S.	July 22, 2006	July 22, 2011
Doug Drury	July 23, 2001	5,536	5,536	\$1.04 U.S.	July 22, 2006	July 22, 2011

The following table gives information concerning stock options granted as compensation to outside directors during 2005. These options are subject to shareholder approval which QSound will seek to obtain at the annual meeting of shareholders scheduled to take place on April 28, 2006.

Name	Date of Grant	No. of Options Granted	Exercise Price	Market Price on Date of Grant	Expiry Date
M. Patty Chakour	June 29, 2005	10,000 <sup>1</sup>	\$3.57 U.S.	\$3.57 U.S.	June 29, 2010
Stanley E. McDougall	June 29, 2005	10,000 <sup>1</sup>	\$3.57 U.S.	\$3.57 U.S.	June 29, 2010
D. Tony Stelliga	June 29, 2005	10,000 <sup>1</sup>	\$3.57 U.S.	\$3.57 U.S.	June 29, 2010

<sup>1</sup> These options are subject to approval by the shareholders of QSound, which we will seek to obtain at the Annual Meeting of Shareholders scheduled to take place on April 28, 2006. If approval is not obtained, these directors have agreed to accept an aggregate cash payment of \$75,000 in lieu of options.

### **C. Board Practices**

During 2005, the members of our board of directors were David J. Gallagher, Stanley E. McDougall, M. Patty Chakour, D. Tony Stelliga (who was elected at the annual meeting of shareholders on April 29, 2005) and Louis W. MacEachern (who was appointed to the board on January 17, 2005 and who did not stand for re-election at the annual meeting). 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.

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 the 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.

#### D. Employees

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. At December 31, 2003 we had 31 employees and persons engaged by contract on a fulltime basis, of whom 9 were in research, product development and technical support, 11 were in marketing and sales, 5 were in customer support and 6 were in administrative positions. Six 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, 2006.

## 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	513,000 <sup>1</sup>	5.9%
Joanna Varvos Corporate Secretary	126,000 <sup>2</sup>	*
Doug Drury Controller	33,000 <sup>3</sup>	*
Stanley E. McDougall Director	25,000	*
M. Patty Chakour Director	25,000 <sup>4</sup>	*
D. Tony Stelliga Director	0	

<sup>1</sup> Includes options to purchase 501,000 common shares.

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

<sup>3</sup> Includes options to purchase 32,000 common shares.

<sup>4</sup> Includes options to purchase 25,000 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, 2005.

<u>Name and Position</u>	<u>Options</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
David J. Gallagher President and CEO and Director	235,190 165,810 100,000	\$1.04 \$0.47 \$1.65	July 22, 2006 <sup>1</sup> December 2, 2006 December 30, 2007
Joanna Varvos Corporate Secretary	25,467 50,533 50,000	\$1.04 \$0.47 \$2.05	July 22, 2006 <sup>1</sup> December 2, 2006 April 1, 2009
Doug Drury Controller	5,536 1,464 25,000	\$1.04 \$0.47 \$2.05	July 22, 2006 <sup>1</sup> December 2, 2006 April 1, 2009
Stanley E. McDougall Director	10,000 <sup>2</sup>	\$3.57	June 29, 2010
M. Patty Chakour Director	25,000 10,000 <sup>2</sup>	\$1.88 \$3.57	March 10, 2009 June 29, 2010
D. Tony Stelliga Director	10,000 <sup>2</sup>	\$3.57	June 29, 2010

<sup>1</sup> Shareholders will be asked at the upcoming Annual Meeting of Shareholders scheduled to take place on April 28, 2006 to extend expiry date of these options to July 22, 2011.

<sup>2</sup> These options are subject to approval by the shareholders of the company, which we will seek to obtain at the upcoming Annual Meeting of Shareholders.

We may grant stock options to officers, directors, key employees and persons or companies providing ongoing services for QSound or its subsidiaries pursuant to our 1998 Stock Option Plan ("Plan"). The board of directors or a committee appointed by the board may in its discretion from time to time grant stock options under the Plan at exercise prices determined by the board or the committee. The board or the committee may also delegate to an executive officer the authority to grant options to employees who are not insiders. The purchase price of shares covered by each option granted by an executive officer may not be less their market value on the date of grant. The term of each stock option must be determined by the board or committee when the option

is granted, and may not exceed ten years from the date of grant. Options may be exercised for a period of 30 days after termination of the optionee's employment, or the expiration of the term, whichever period is shorter. If an optionee should die while a service provider of QSound or its subsidiaries, his or her options may be exercised by the optionee's legal representative until the earlier of one year after the date of death or the expiration of the term. The foregoing 30 day and one year time periods may be increased by the board of directors. The Plan may be amended by the board provided that any such amendment may not adversely affect any outstanding option without the consent of the optionee. Options granted under the Plan may also be amended upon agreement with the optionee.

In the event there should be any subdivision or consolidation of our common shares the price of shares then subject to each option 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.

We may also grant options outside of the Plan. Pursuant to The NASDAQ Stock Market, all grants of options made by the company outside of the Plan to officers, directors, employees or consultants require the approval of shareholders of the company.

## **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, 2005, 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>	8.1%
David J. Gallagher	513,000 <sup>4</sup>	5.9%
Fred Kayne <sup>5</sup>	511,000 <sup>6</sup>	5.8%
Philips Electronics North America Corporation	500,000 <sup>7</sup>	5.7%

<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 8,724,785 common shares outstanding as of March 1, 2006.

<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 Loan" in Item 5. of this report.)

<sup>4</sup> Includes options to purchase 501,000 shares.

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

<sup>6</sup> These shares are disclosed in Schedule 13D filed on April 29, 2005.

<sup>7</sup> These shares are issuable to Philips upon the exercise of existing warrants, exercisable at the price of \$1.04 per share until March 24, 2007.

At March 1, 2006 we had 8,724,785 common shares issued and outstanding. At such date, there were 362 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 2005 except for compensation of executive officers as employees or consultants. (See "Compensation" in Item 6. B of this 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 2005.

### **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 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 66% of our export sales were made to the United States, 30% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China, and a further 4% were made to other areas. In 2003 76% of our export sales were made to the United States, 23% were made to Asian companies located in Japan, Hong Kong, and Taiwan, and a further 1% 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 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 SmallCap Market.

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

<u>Fiscal Year</u>	<u>High</u>	<u>Low</u>
2005	8.47	2.15
2004	8.40	1.52
2003	2.65	1.01
2002	2.28	0.53
2001	4.87	0.42

The high and low market prices for each of the four quarters of 2005 and 2004:

<u>Quarter Ending</u>		<u>High</u>	<u>Low</u>
December	2005	4.86	2.15
September	2005	4.04	3.05
June	2005	4.50	3.40
March	2005	8.47	4.34
December	2004	8.40	4.55
September	2004	6.75	3.73
June	2004	7.54	1.91
March	2004	2.75	1.52

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

<u>Month</u>		<u>High</u>	<u>Low</u>
February	2006	4.74	3.65
January	2006	4.43	3.25
December	2005	4.86	3.81
November	2005	3.99	2.15
October	2005	3.10	2.22
September	2005	3.35	3.05

#### **B. Plan of Distribution**

Not Applicable

#### **C. Markets**

Our shares trade (since January, 1989) on The NASDAQ SmallCap 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 report there are 8,729,785 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; or (i) 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 after December 31, 2002 and before January 1, 2009, 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 incorporated in a possession of the U.S., (b) QSound is eligible for the benefits of the Canada-U.S. Tax Convention, or (c) 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. In 2003, the U.S. Department of the Treasury (the “Treasury”) and the IRS announced that they intended to issue Treasury Regulations providing procedures for a foreign corporation to certify that it is a QFC. Although these Treasury Regulations have not yet been issued, the Treasury and the IRS have confirmed their intention to issue these Treasury Regulations. It is expected that these Treasury Regulations will obligate persons required to file information returns to report a dividend paid by a foreign corporation as a dividend from a QFC if the foreign corporation has, among other things, certified under penalties of perjury that the foreign corporation was not a “passive foreign investment company” for the taxable year during which the foreign corporation paid the 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, 2005, and does not expect that it will be a “passive foreign investment company” for the taxable year ending December 31, 2006. (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, 2006, 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, 2006 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 (including "passive income," "high withholding tax interest," "financial services income," "general income," and certain other categories of income). Dividends paid by QSound generally will constitute "foreign source" income and generally will be categorized as "passive income" or, in the case of certain U.S. Holders, "financial services income." However, for taxable years beginning after December 31, 2006, the foreign tax credit limitation categories are reduced to "passive category income" and "general category income" (and the other categories of income, including "financial services income," are eliminated). 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.

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, 2005, and does not expect that it will be a PFIC for the taxable year ending December 31, 2006. 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, 2006 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 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:

Room 1200  
450 Fifth Street N.W.  
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**

We use the U.S. dollar as our currency of measurement and display. We are exposed to foreign currency fluctuation on our 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 our overseas transactions are conducted in U.S. dollars.

#### **Interest Rates**

QSound's exposure to market risk for changes in interest rates relates to our invested balances of cash and cash equivalents. QSound's investment policy specifies excess funds are to be invested in a manner that preserves capital, provides liquidity and generates the highest available after-tax return. To limit exposure to market risk, QSound places its cash in banks and cash not required for immediate operations is placed in bank term deposits. QSound does not invest in any derivative instruments. The fair value of QSound's cash and cash equivalents or related income would not be significantly impacted by either a 100 basis point increase or decrease in interest rates as most investments are at fixed rates and are relatively short term. All cash and cash equivalents are carried at fair value, which approximates cost.

### **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, 2005, 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.

There were no changes in our internal control over financial reporting that occurred during the period covered by this 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, 2005.

### **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**

KPMG, our external accountants until April 29, 2005, billed \$67,065 in 2005, \$89,000 in 2004 and \$55,000 Cdn. in 2003 for audit services and services related to statutory filings. Grant Thornton, who were appointed to act as our auditors on April 29, 2005, billed \$11,500 in 2005.

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

KPMG did not bill any audit-related, tax or other fees in 2005 or 2004 and Grant Thornton did not bill any such fees in 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. and subsidiaries:

Report of Independent Registered Public Accounting Firm to the Shareholders.

Consolidated Balance Sheets – December 31, 2005 and 2004.

Consolidated Statements of Operations and Deficit – Years ended December 31, 2005, 2004 and 2003.

Consolidated Cash Flows– Years ended December 31, 2005, 2004 and 2003.

Notes to Consolidated Financial Statements – Years ended December 31, 2005, 2004 and 2003.

**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 Grant Thornton Consent of Auditors.
- 14.2 KPMG Consent of Auditors.
- 15.1 Audit Committee Charter (Incorporated by reference to our Annual Report on Form 20-F filed March 21, 2005.)

**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 30, 2006



## EXHIBITS INDEX

Exhibit No.	Description of Document
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Report of Independent Registered Public Accounting Firm  
to the Shareholders of QSound Labs, Inc.

We have audited the accompanying consolidated balance sheet of QSound Labs, Inc. as at December 31, 2005 and the consolidated statement of operations and deficit and cash flows for the year ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). These standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. 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. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and the results of its operations and its cash flows for the year ended December 31, 2005 in accordance with Canadian generally accepted accounting principles.

Canadian generally accepted accounting principles vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences are presented in Note 22 to the consolidated financial statements.

The consolidated balance sheet as at December 31, 2004 and the consolidated statements of operations and cash flows for the two years ended December 31, 2004 were audited by another firm of chartered accountants who expressed an unqualified opinion on these financial statements in their report dated February 25, 2005.

Grant Thornton LLP  
Chartered Accountants  
Calgary, Canada  
March 29, 2006

**Consolidated Financial Statements****Consolidated****Balance sheets**

December 31, 2005 and 2004

(Expressed in United States dollars)

	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>		
<i>Current assets</i>		
Cash and cash equivalents	\$ 1,222,729	\$ 3,327,543
Accounts receivable (net) and accrued revenue	401,524	210,967
Note receivable (note 4)	82,648	–
Inventory	40,438	162,568
Deposits and prepaid expenses	76,146	61,438
	1,823,485	3,762,516
Property and equipment (note 5)	670,635	809,171
Deferred development costs (note 6)	352,750	64,974
Intangible assets (note 7)	155,445	591,173
	\$ 3,002,315	\$ 5,227,834
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<i>Current liabilities</i>		
Accounts payable and accrued liabilities	\$ 285,786	\$ 245,664
Deferred revenue	45,011	59,745
	330,797	305,409
<i>Shareholders' equity</i>		
Share capital (note 8)	45,979,055	45,792,526
Warrants (note 9)	1,502,331	1,502,331
Contributed surplus (note 10)	1,442,408	1,329,136
Deficit	(46,252,276)	(43,701,568)
	2,671,518	4,922,425
Commitments and contingencies (note 21)		
	\$ 3,002,315	\$ 5,227,834

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, 2005, 2004 and 2003  
(Expressed in United States dollars)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>REVENUE</b>			
Royalties, license and engineering fees	\$ 1,056,509	\$ 1,162,303	\$ 779,396
Product sales	486,731	1,050,875	1,263,692
	1,543,240	2,213,178	2,043,088
Cost of product sales	179,781	419,290	425,091
	1,363,459	1,793,888	1,617,997
<b>EXPENSES</b>			
Marketing	963,255	1,129,781	1,242,271
Operations	213,163	234,481	169,667
Product engineering	902,427	908,984	834,333
Administration	796,038	661,659	552,876
Stock based compensation	134,793	320,432	90,439
Foreign exchange loss (gain)	2,832	41,955	(153,849)
Amortization	360,898	457,572	308,717
	3,373,406	3,754,864	3,044,454
Loss before other items	(2,009,947)	(1,960,976)	(1,426,457)
<b>OTHER ITEMS</b>			
Interest income	56,700	78,727	41,164
(Loss) gain on sale of property and equipment	-	(15,616)	2,204
Impairment of property and equipment (note 12)	(89,754)	-	(102,900)
Impairment of intangible assets (note 13)	(428,453)	-	-
Impairment of goodwill (note 14)	-	-	(2,184,589)
Termination expenses	(41,380)	(3,880)	(26,647)
Other	(163)	(1,697)	137
	(503,050)	57,534	(2,270,631)
Loss before taxes	(2,512,997)	(1,903,442)	(3,697,088)
Foreign withholding tax	(37,711)	(22,504)	(8,543)
Net loss for year	(2,550,708)	(1,925,946)	(3,705,631)
Deficit, beginning of year	(43,701,568)	(41,775,622)	(38,069,991)
Deficit, end of year	\$ (46,252,276)	\$ (43,701,568)	\$ (41,775,622)
Loss per common share (basic and diluted) (note 15)	\$ (0.30)	\$ (0.25)	\$ (0.52)

See accompanying notes to consolidated financial statements

**Consolidated  
Statements of Cash Flows**

Years ended December 31, 2005, 2004 and 2003  
(Expressed in United States dollars)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Cash provided by (used in):			
<b>OPERATIONS</b>			
Loss for the year	\$ (2,550,708)	\$ (1,925,946)	\$ (3,705,631)
Items not requiring (providing) cash:			
Amortization	360,898	457,572	308,717
Stock based compensation	134,793	320,432	90,439
Loss (gain) on sale of property and equipment	–	15,616	(2,204)
Impairment of property and equipment	89,754	–	102,900
Impairment of intangible assets	428,453	–	–
Impairment of goodwill	–	–	2,184,589
Changes in non-cash working capital balances (note 17)	(57,747)	(47,817)	581,497
	(1,594,557)	(1,180,143)	(439,693)
<b>FINANCING</b>			
Issuance of common shares, net	165,008	2,120,657	22,940
Issuance of warrants	–	904,019	–
	165,008	3,024,676	22,940
<b>INVESTMENTS</b>			
Note receivable	(82,648)	–	–
Purchase of property and equipment	(188,890)	(164,457)	(98,026)
Purchase of deferred development costs	(352,750)	–	–
Purchase of intangible assets	(50,977)	(418,056)	(51,394)
Proceeds from sale of property and equipment	–	4,430	6,061
	(675,265)	(578,083)	(143,359)
(Decrease) increase in cash and cash equivalents	(2,104,814)	1,266,450	(560,112)
Cash and cash equivalents, beginning of year	3,327,543	2,061,093	2,621,205
Cash and cash equivalents, end of year	\$ 1,222,729	\$ 3,327,543	\$ 2,061,093

See accompanying notes to consolidated financial statements

## Notes to Consolidated Financial Statements

Years Ended December 31, 2005, 2004, and 2003  
(Expressed in United States dollars)

### 1. Organization:

Since its inception in 1988, QSound Labs, Inc. (the "Company") has established itself as a leading audio technology company. The Company has developed proprietary audio solutions that include virtual surround sound, positional audio and stereo enhancement for mobile devices, consumer electronics, PC/multimedia, and Internet markets. The Company's cutting-edge audio technologies create rich 3D audio environments allowing consumers to enjoy stereo surround sound from two, four and up to 7.1 speaker systems.

The Company's subsidiary QCommerce Inc. provides complete e-commerce solutions for small and medium sized businesses.

The Company's subsidiary QTelNet Inc. delivers award-winning, highly interoperable Voice Over IP solutions.

### 2. Significant accounting policies:

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with those in the United States, except as outlined in note 22. All amounts are expressed in United States dollars.

The Company's significant accounting policies are as follows:

#### Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses. Actual results could differ from these estimates.

#### 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 intercompany transactions and balances have been eliminated on consolidation.

#### Cash and cash equivalents:

Cash equivalents are short term deposits with original maturities of less than 90 days for which cost approximates market value.

#### Inventory:

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

#### Property and equipment:

Property and equipment is recorded at cost and is amortized annually, beginning the year after acquisition, 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 Company assesses impairment of property and equipment by comparing the carrying value of the property and equipment and its recoverable value. When the carrying value exceeds its recoverable value from future undiscounted cash flows, an impairment is recognized and charged to period earnings equal to the excess of the carrying value over the recoverable value.

**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 management believes is technically and economically feasible and recoverable, in which case these costs are deferred.

Deferred development costs are amortized against the related expected revenue as that revenue is recognized.

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.

**Goodwill:**

The Company uses the purchase method to account for all business combinations and identifies separate from goodwill, other intangible assets that arise. Pursuant to this policy, goodwill is no longer amortized, but is tested for impairment on an annual basis. In 2003, an analysis of the recorded goodwill was completed and an assessed goodwill impairment of the remaining balance was recognized as at December 31, 2003.

**Intangible assets:**

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

Licensing rights are recorded at cost and amortized over the estimated life. The Company assesses impairment of licensing rights by determining whether their recoverable amounts are less than their unamortized balance. When a potential impairment is identified, the amount of impairment is calculated as the amount the carrying value of the licensing rights exceeds the expected future cash flows and charged to period earnings.

**Foreign currency translation:**

The Company's functional currency is United States Dollars. The Company translates monetary assets and liabilities into United States dollars at the rate of exchange in effect as at the balance sheet date, and revenues and expenses at the average rates in effect during the year. Foreign exchange gains and losses on translation of these amounts are included in the determination of net income or loss for the year.

**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, if applicable, has been received, and collection is reasonably assured.

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 products. Revenue from 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 does not have obligations for additional deliverables that are essential to the functionality of the product.

**Interest income:**

Interest income is recognized as it is earned.

**Income taxes:**

The Company uses the 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 realized, a valuation allowance is provided.

**Per share amounts:**

Per share amounts are calculated using the weighted average number of common shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock method.

**Stock based compensation:**

The Company accounts for stock based compensation under the fair value method. Under the fair value based method, compensation cost is measured at fair value at the date of grant and is expensed over the vesting period. In accordance with one of the transitional options permitted under amended CICA Handbook Section 3870, the Company elected to early adopt the fair value based method for all employee stock options granted on or after January 1, 2003, and accordingly, recognized compensation expense related to stock options granted to employees beginning in 2003. Pro forma disclosure of the fair value of stock options granted to employees during 2002 has been provided (note 11). Consideration paid by employees to the Company on the exercise of stock options are recorded in share capital upon receipt, along with the amount of non-cash stock based compensation expense recognized in contributed surplus.

**3. Joint venture:**

During 2005, the Company entered into a joint venture agreement (the “Agreement”) for the development of and sale of software for the gaming industry. Under the terms of the Agreement, the Company has provided the financing to the joint venture necessary to undertake the software development. In return, the Company has control over the venture under the Agreement until such time as its financing is repaid through the sale of the related software being developed. As such, these financial statements include 100% of the assets, liabilities, revenues and expenses of the joint venture as follows:

Accounts receivable	\$	754
Deferred development costs		352,750
Net joint venture equity		(353,504)
Engineering fee revenue		40,254
Expenses		19,750

Upon repayment of its financing, the Company’s interest in the joint venture will be 45% at which point the Company will record a disposition and account for its interest in the joint venture using the proportionate consolidation method.

During 2005, the Company provided the joint venture financing in the amount of \$ 353,504 plus funded the expenses of \$19,750. These amounts were paid to a joint venture partner to facilitate the software development.

**4. Note receivable:**

The note receivable is due from a joint venture partner, bears interest at 8% per annum, and is due June 30, 2006. The joint venture partner’s interest in the joint venture has been pledged as security.

**5. Property and equipment:**

2005	Cost	Accumulated amortization	Net book value
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

Included in the accumulated amortization above for computer equipment is a 2005 year asset impairment charge of \$1,362. Included in the accumulated amortization above for software and production tooling is a 2005 year asset impairment charge of \$88,392.

<b>2004</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</b>
Sound source and control equipment	\$ 545,463	\$ 523,174	\$ 22,289
Real time systems	905,534	899,563	5,971
Furniture and fixtures	228,654	203,298	25,356
Computer equipment	997,224	728,490	268,734
Software and production tooling	1,543,888	1,057,067	486,821
	\$ 4,220,763	\$ 3,411,592	\$ 809,171

#### 6. Deferred development costs:

	<b>2005</b>	<b>2004</b>
Software development costs	\$ 804,564	\$ 451,814
Accumulated amortization	451,814	386,840
Net book value	\$ 352,750	\$ 64,974

In accordance with the accounting policy of the Company, included in the deferred development costs are \$352,750 (2004 - \$ nil) that are not yet in commercial production and therefore not subject to amortization. In 2005, amortization of \$64,974 (2004 - \$112,711) was recorded and included in amortization expense.

#### 7. Intangible assets:

<b>2005</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</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

  

<b>2004</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</b>
Patents and trademarks	\$ 877,929	\$ 728,976	\$ 148,953
Purchased customer list	34,418	20,651	13,767
Licensing rights	428,453	–	428,453
	\$ 1,340,800	\$ 749,627	\$ 591,173

Included in the accumulated amortization above for licensing rights is a 2005 year asset impairment charge of \$428,453.

#### 8. 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, 2002	7,156,074	\$ 43,772,441
Issued for cash on exercise of options	43,170	22,940
Reclassification from contributed surplus on exercise of stock options	–	5,864
Balance December 31, 2003	7,199,244	43,801,245
Issued for cash:		
On exercise of options	857,015	1,174,218
Private placement		
Cash received	347,826	2,000,000
Less financing costs paid in cash	–	(149,541)
Less warrants valued under Black-Scholes as part of private placement costs (note 9)	–	(380,862)
Less deemed allocation to warrants (note 9)	–	(904,019)
Reclassification from contributed surplus on exercise of stock options	–	251,485
Balance December 31, 2004	8,404,085	45,792,526
Issued for cash on exercise of options	257,900	201,000
Reclassification from contributed surplus on exercise of stock options	–	21,521
Less financing costs paid in cash	–	(35,992)
Balance December 31, 2005	8,661,985	\$ 45,979,055

## 9. Warrants:

	Number of Warrants	Consideration
Balance December 31, 2002	250,000	\$ 108,725
Issued for services received	250,000	108,725
Balance December 31, 2003	500,000	217,450
Issued for services received	75,000	380,862
Issued for cash	660,869	904,019
Balance December 31, 2004	1,235,869	1,502,331
Expired	(521,739)	–
Balance December 31, 2005	714,130	\$ 1,502,331

The warrants issued in 2004 for services received were allocated to share issue costs. The warrants issued in 2003 for services received were capitalized to software and production tooling.

The fair value of the warrants issued for services received was calculated using the Black-Scholes pricing model with the following weighted average assumptions:

	2004	2003
Risk free interest rate	4.5%	4.5%
Volatility	93%	80%
Life of the warrant	7 months to 5 years	4.5 years
Dividend yield	0%	0%

The amount allocated to the warrants issued for cash was calculated taking the total cash proceeds of the shares issued in the private placement on a pro-rata basis with the fair value of the warrants issued using the Black-Scholes pricing model using the assumptions stated above and the market value of the shares issued in the private placement.

The following table summarizes the information about warrants outstanding at December 31, 2005:

<b>Warrants Outstanding and Exercisable</b>	<b>Exercise Price</b>	<b>Remaining Term (years)</b>
500,000	\$ 1.04	1.2
75,000	7.77	4.0
139,130	9.12	4.0
714,130	\$ 3.32	2.0

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

#### 10. Contributed surplus:

Balance December 31, 2002	\$ 1,119,185
Increase due to stock based compensation	90,439
Decrease due to stock options exercised	(5,864)
Balance December 31, 2003	1,203,760
Increase due to stock based compensation	376,861
Decrease due to stock options exercised	(251,485)
Balance December 31, 2004	1,329,136
Increase due to stock based compensation	134,793
Decrease due to stock options exercised	(21,521)
Balance December 31, 2005	\$ 1,442,408

#### 11. Stock option plan:

The Company has a stock option plan under which the Board of Directors may grant stock options to directors, officers, consultants and employees for the purchase of authorized but unissued common shares. At December 31, 2005, stock options to purchase 977,533 common shares are outstanding. The stock options are exercisable at prices ranging from \$0.47 to \$4.56 per share and expire on various dates between 2006 and 2015.

During the year ended December 31, 2005, the Company granted 180,933 (2004 – 570,720; 2003 – 280,000) options to employees and directors with exercise prices at or greater than the market price of the Company's stock on the date of grant. Of these 180,933 (2004 – 570,720; 2003 – 280,000) options, 7,000 (2004 – 245,720; 2003 – 30,000) vested immediately. The remaining 173,933 (2004 – 325,000; 2003 – 250,000) options vest at various times depending upon individual specified performance criteria being met. At December 31, 2005, 22,500 of these options had vested.

In 2005, the Company did not grant any options to non-employees (2004 – 60,000; 2003 – 55,000) in connection with services to be performed. All of these options vest depending upon specified performance criteria being met. At December 31, 2005, all of these options had vested or had been cancelled.

The fair value of the vested options granted during 2005, 2004 and 2003 is estimated on the day of grant using the Black-Scholes option pricing model with the following assumptions;

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Risk free interest rate	4.5%	4.5%	4.5%
Weighted average volatility	66%	94%	105%
Expected life of option	90 days to 10 years	15 days to 5 years	3 to 5 years
Dividend yield	0%	0%	0%

For the year ended December 31, 2005, \$134,793 (2004 – \$320,432; 2003 – \$90,439) has been recognized as compensation cost related to options granted to employees and directors. In 2005, no compensation cost (2004 – \$56,429; 2003 - \$59,619) has been recognized as compensation cost related to options issued to non-employees. In

2004, the compensation costs related to options issued to non-employees has been capitalized to intangible assets. In 2003, the compensation costs related to options issued to non-employees has been expensed to marketing expenses.

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 pro-forma net loss for the year ended December 31, 2005 would have been increased by \$21,982 to \$2,572,690, the pro-forma net loss for 2004 would have been increased by \$81,620 to \$2,007,566, and the pro-forma net loss for 2003 would have increased by \$103,602 to \$3,809,233. Pro-forma loss per common share (basic and diluted) would have not changed for 2005 while 2004 and 2003 would have both been increased by \$0.01 to \$0.26 in 2004, and \$0.53 in 2003.

Changes in options granted during the years ended December 31, 2005, 2004 and 2003 were as follows:

	Number of Shares	Exercise price per share			Weighted average exercise price
Balance December 31, 2002	1,595,922	\$ 0.47	-	12.24	\$ 1.26
Granted	335,000	1.00	-	1.48	1.24
Exercised	(43,170)	0.47	-	1.00	0.53
Cancelled or expired	(148,987)	1.21	-	12.24	5.97
Balance December 31, 2003	1,738,765	0.47	-	1.75	0.87
Granted	630,720	1.65	-	5.00	2.58
Exercised	(857,015)	0.47	-	5.00	1.37
Cancelled or expired	(354,970)	1.21	-	1.72	1.36
Balance December 31, 2004	1,157,500	0.47	-	4.56	1.29
Granted	180,933	2.40	-	3.57	2.59
Exercised	(257,900)	0.47	-	4.56	0.78
Cancelled or expired	(103,000)	2.05	-	4.56	3.34
Balance December 31, 2005	977,533	\$ 0.47	-	4.56	\$ 1.45

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

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding at Dec. 31, 2005	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at Dec. 31, 2005	Weighted Average Exercise Price	
\$ 0.47	219,307	0.9	\$ 0.47	219,307	\$ 0.47	
1.04 to 1.75	413,693	1.0	1.21	413,693	1.21	
1.88 to 2.40	309,533	5.3	2.19	188,100	2.06	
3.57 to 4.56	35,000	4.4	3.71	5,000	4.56	
	977,533	2.5	\$ 1.45	826,100	\$ 1.23	

## 12. Impairment of property and equipment:

In accordance with the Company's accounting policy, an analysis of property and equipment was completed in 2005. As a result of the re-evaluation of a telephony project, an assessed property and equipment impairment of \$89,754 was recognized on some telephony assets during 2005. In 2003, an assessed property and equipment impairment of \$102,900 was recognized on an audio segment asset.

## 13. Impairment of intangible asset:

In accordance with the Company's accounting policy, an analysis of intangible assets was completed in 2005. As a result of the re-evaluation of a telephony project, an assessed intangible assets impairment of \$428,453 was recognized during 2005.

#### 14. Impairment of goodwill:

In accordance with the Company's accounting policy, an analysis of the recorded goodwill was completed in 2003. As a result of the declining activity in the E-Commerce operating segment, an assessed goodwill impairment of \$2,184,589 was recognized as at December 31, 2003.

#### 15. Loss per share:

<b>Basic loss per share</b>	<b>2005</b>		<b>2004</b>		<b>2003</b>	
Net loss	\$	(2,550,708)	\$	(1,925,946)	\$	(3,705,631)
Weighted average number of shares outstanding		8,497,201		7,628,238		7,171,217
Loss per share	\$	(0.30)	\$	(0.25)	\$	(0.52)

  

<b>Diluted loss per share</b>	<b>2005</b>		<b>2004</b>		<b>2003</b>	
Net Loss	\$	(2,550,708)	\$	(1,925,946)	\$	(3,705,631)
Weighted average number of shares outstanding		8,497,201		7,628,238		7,171,217
Weighted average stock options potentially exercisable		704,827		1,570,357		588,919
Weighted average warrants potentially exercisable		379,674		384,578		139,894
Weighted average number of diluted shares outstanding		9,581,702		9,583,173		7,900,030
Diluted loss per share	\$	(0.30)	\$	(0.25)	\$	(0.52)

In calculating the weighted average number of diluted shares above, the Company excluded 59,000 stock options (2004 – 57,000; 2003 – 253,987) and 214,130 warrants (2003 – 735,869; 2003 - nil) because the exercise price was greater than the average market price for the year.

#### 16. Defined benefit pension plan:

During the 2002 year the Company 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 will make 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:

	<b>2005</b>		<b>2004</b>		<b>2003</b>	
Fair value of plan assets	\$	302,827	\$	255,628	\$	200,695
Accrued benefit obligation		(283,799)		(236,744)		(188,056)
Funded Status:						
Plan assets in excess of benefit obligation		19,028		18,884		12,639
Unamortized net actuarial loss (gain)		(8,124)		(14,403)		(11,231)
Accrued benefit asset	\$	10,904	\$	4,481	\$	1,408

The financial statements presented do not reflect the accrued benefit asset shown above, since it is considered insignificant.

Economic assumptions used to determine benefit obligation and periodic expense were:

	2005	2004	2003
Discount rate	5.50%	5.75%	6.25%
Expected rate of return on assets	7.50%	7.50%	7.50%
Rate of compensation increase	5.50%	5.50%	5.50%
Average remaining service period of covered employee	12	13	14

Actuarial evaluations are required every three years, the next evaluation being January 1, 2006.

Pension expense, included in the Company's marketing expense, is as follows:

	2005	2004	2003
Current service cost	\$ 18,551	\$ 16,063	\$ 13,886
Interest on accrued benefit obligation	20,743	15,667	6,241
Expected return on plan assets	(19,734)	(15,560)	(6,182)
Pension expense included in marketing expense	\$ 19,560	\$ 16,170	\$ 13,945

The company expects to contribute \$20,589 to the plan in 2006.

#### 17. Supplementary cash flow information:

Changes in non-cash working capital balances	2005	2004	2003
Accounts receivable	\$ (190,557)	\$ 10,227	\$ 708,325
Inventory	122,130	(55,191)	(90,920)
Deposits and prepaid expenses	(14,708)	21,483	(24,247)
Accounts payable and accrued liabilities	40,122	12,466	12,303
Deferred revenue	(14,734)	(36,802)	(23,964)
	\$ (57,747)	\$ (47,817)	\$ 581,497
Interest received in cash	\$ 55,981	\$ 85,546	\$ 38,664
Income taxes paid in cash	\$ 37,711	\$ 22,504	\$ 8,543

#### 18. 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 income (loss) for the year. The reasons for the differences are as follows:

	2005	2004	2003
Loss for the year	\$ (2,512,997)	\$ (1,903,442)	\$ (3,697,088)
Combined Canadian Federal and Provincial statutory rate	33.62%	33.87%	36.75%
Computed tax (recovery)	(844,870)	(644,696)	(1,358,680)
Increase (decrease) resulting from:			
Change in valuation allowance	768,000	165,000	506,000
Income taxes computed at different rates in the United States	(2,903)	(1,214)	10,487
Reduction of unrealized future tax assets for enacted changes in income tax rates	36,714	223,049	73,137
Stock based compensation	45,317	108,530	33,236
Other permanent differences	35,453	171,835	744,363
Actual expense (recovery)	\$ 37,711	\$ 22,504	\$ 8,543

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

	Canada		United States		2005	2004		
Future income tax assets:								
Capital assets	\$	1,341,000	\$	–	\$	1,341,000	\$	981,000
Share issue costs		35,000		–		35,000		31,000
Loss and SRED carry-forwards		3,197,000		3,505,000		6,702,000		6,306,000
Intangible assets		200,000		85,000		285,000		277,000
Investments		–		158,000		158,000		158,000
		4,773,000		3,748,000		8,521,000		7,753,000
Less: Valuation allowance		(4,773,000)		(3,748,000)		(8,521,000)		(7,753,000)
Net future tax assets	\$	–	\$	–	\$	–	\$	–

In 2005, management determined that the basis used in estimating future income tax assets differed from actual income tax returns filed. Accordingly, the value of these assets has been recalculated to reflect income tax returns filed, and the comparative figures for 2004 and 2003 have been adjusted in the above tables. Additionally, the valuation allowance has been adjusted accordingly resulting in total net future tax assets of zero as previously reported.

The Company has Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of \$4,777,000 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
2006	\$ 889,259	\$ 2,053,162
2007	86	–
2008	86	776,287
2009	–	373,177
2010	1,435,341	412,789
2011	–	107,980
2012	–	59,918
2014	1,187,240	–
2015	1,416,649	–
2018	–	2,052,039
2019	–	164,364
2020	–	1,295,294
2021	–	1,422,885
2022	–	188,145
2023	–	716,280
2024	–	149,172
2025	–	241,617
	\$ 4,928,661	\$ 10,013,109



## 19. Segmented information:

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

<b>2005</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Telephony</b>	<b>Total</b>
Revenues	\$ 1,304,832	\$ 182,940	\$ 55,468	\$ 1,543,240
Interest revenue	54,470	12	2,219	56,701
Amortization	211,464	27,045	122,389	360,898
Segment loss before other items	(1,243,781)	(233,166)	(533,000)	(2,009,947)
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

  

<b>2004</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Telephony</b>	<b>Total</b>
Revenues	\$ 1,820,028	\$ 245,238	\$ 147,912	\$ 2,213,178
Interest revenue	78,254	12	461	78,727
Amortization	251,362	35,273	170,937	457,572
Segment loss before other items	(653,710)	(138,369)	(1,168,897)	(1,960,976)
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
Stock based compensation capitalized as intangible asset	–	–	56,429	56,429

  

<b>2003</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Telephony</b>	<b>Total</b>
Revenues	\$ 1,511,312	\$ 346,456	\$ 185,320	\$ 2,043,088
Interest revenue	41,132	–	32	41,164
Amortization	261,713	47,004	–	308,717
Segment loss before other items	(596,419)	(65,628)	(764,410)	(1,426,457)
Segment assets	2,731,693	175,363	869,523	3,776,579
Expenditures for property and equipment	20,682	867	576,477	598,026
Expenditures for intangible assets	51,354	–	40	51,394

  

<b>Geographic information</b>	<b>2005 Revenue</b>	<b>2004 Revenue</b>	<b>2003 Revenue</b>
Canada	\$ 10,472	\$ 73,294	\$ 64,449
United States	966,980	1,418,029	1,515,602
Asia	489,625	644,503	456,194
Europe	49,026	72,102	4,365
Other	27,137	5,250	2,478
	\$ 1,543,240	\$ 2,213,178	\$ 2,043,088

As at December 31, 2005 and 2004, substantially all of the Company's product assets and employees were located in Canada. As at December 31, 2003, substantially all of the Company's Audio and E-Commerce product assets and employees were located in Canada and all of the Company's Telephony product assets were located in Canada. In 2003, 25% of the Company's Telephony employees were located in Canada and 75% were located in the United States.

## 20. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 2005 due to their short maturity terms.

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, 2005, entered into foreign currency derivatives to hedge its exposure to foreign exchange risk.

The Company is exposed to credit risk on its accounts receivable and accrued revenue. As at December 31, 2005, there were outstanding accounts receivable and accrued revenue balances from three entities which comprised 49% of the total balance. These entities are located in the United States and Asia. While none of these amounts have been collected subsequent to the year end management believes that all are fully collectable.

As at December 31, 2004, there were outstanding accounts receivable balances from four entities which comprised 61% of the total balance. These entities are located in the United States and Asia. These amounts have been collected subsequent to the 2004 year end.

As at December 31, 2003, there were outstanding accounts receivable balances from two entities which comprised 57% of the total balance. These entities are located in the United States and Asia. These amounts have been collected subsequent to the 2003 year end.

During 2005, two customers contributed 23% of the total revenues, each providing greater than 10% of the total revenues. For 2004 and 2003, no one individual customer provided greater than 10% of total revenues.

For Audio, during 2005, 38% of total Audio revenue arose from three customers, each of which individually provided greater than 10% of total Audio revenues. For 2004, 52% of total Audio revenue arose from four customers, each of which individually provided greater than 10% of total Audio revenues. For 2003, 74% of total Audio revenue arose from three customers, each of which individually provided greater than 10% of total Audio revenues.

For E-Commerce, during 2005, 2004, and 2003, no one customer contributed to more than 10% of total E-Commerce revenue.

For Telephony, during 2005, 32% of total Telephony revenue arose from two customers, each of which individually provided greater than 10% of total Telephony revenues. For 2004, 37% of total Telephony revenue arose from three customers, each of which individually provided greater than 10% of total Telephony revenues. For 2003, 61% of total Telephony revenue arose from two customers, each of which individually provided greater than 10% of total Telephony revenues.

## **21. Commitments and contingencies:**

The Company is involved in litigation and claims which arise from time to time in the normal course of business. In the opinion of management, any liability that may arise from such contingencies would not have a significant adverse effect on the consolidated financial position of the Company.

In 2004, QTelNet Inc. entered into an agreement with a third party for the development of a telephony product. Under the agreement, QTelNet provided funding and loans, and the Company issued 50,000 stock options exercisable at \$2.05 U.S. and vesting at the rate of 4,166 options per month, to the third party in exchange for the development. The development was never completed, or a product delivered, by the third party. Under the agreement, any dispute must be settled first by mediation and arbitration and then by the courts. QTelNet has commenced mediation. The options have been cancelled and QTelNet Inc. is seeking repayment of \$485,000 Cdn. for recovery of intangible asset. The third party has countered that it is owed \$300,000 Cdn. from its inability to exercise the options, and \$290,000 Cdn. in additional development funds. The Company and QTelNet believe that they have good defenses and that these claims are without merit, therefore no amounts have been accrued in the consolidated financial statements.

Under the terms of its lease agreements for office space and equipment, the Company is obligated at December 31, 2005 to make the following minimum lease payments over the next five years and in total:

2006	\$	97,047
2007		97,047
2008		83,313
2009		14,646
2010		8,544
	\$	300,597

Minimum lease payments of \$92,756 (2004 - \$88,458; 2003 - \$70,564) are included in the calculation of the loss for the year.

## 22. United States accounting principles:

The 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:

- (a) The Company follows 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).
- (b) Prior to 2003, the Company had applied the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations, in accounting for its stock options issued to employees, directors and officers of the Company for purposes of reconciliation to US GAAP. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. In addition, variable accounting would be applied to stock options that have been repriced, whereby compensation expense would be recorded or recovered on the date of reporting only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, "Accounting for Stock-Based Compensation", established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company had elected to continue to apply the intrinsic value-based method of accounting described above and adopted the disclosure requirements of SFAS No. 123. Stock options issued to consultants and other third parties are accounted for at their fair values in accordance with SFAS No. 123. In accordance with the adoption of the fair value-based method for Canadian GAAP purposes, the Company elected to prospectively adopt the fair value-based method under US GAAP, as provided for under SFAS No. 123, effective January 1, 2003. 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.
- (c) Under US GAAP, \$80,871 of the deferred development costs were expensed to product engineering. Under Canadian GAAP these costs were recorded as deferred development costs.

Other differences between Canadian and United States accounting principles are summarized as follows:

There was no difference in the weighted average number of shares outstanding in the years ended December 31, 2005, 2004 and 2003 under Canadian and United States GAAP.

The effect on the loss for each of the years in the three year period ended December 31, 2005 of the differences between Canadian and United States generally accepted accounting principles is summarized as follows:

<b>Years ended December 31,</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net loss for the year as reported in accordance with Canadian GAAP	\$ (2,550,708)	\$ (1,925,946)	\$ (3,705,631)
Development expense	(80,871)	–	–
<b>Net loss under US GAAP</b>	<b>\$ (2,631,579)</b>	<b>\$ (1,925,946)</b>	<b>\$ (3,705,631)</b>
<b>Net loss per share (basic and diluted) under US GAAP</b>	<b>\$ (0.31)</b>	<b>\$ (0.25)</b>	<b>\$ (0.52)</b>

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

<b>December 31, 2005</b>	<b>As reported in accordance with Canadian GAAP</b>	<b>Differences</b>	<b>Under US GAAP</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
	<b>\$ 3,002,315</b>	<b>\$ (80,871)</b>	<b>\$ 2,921,444</b>

Current liabilities	\$ 330,797	\$ –	\$ 330,797
Shareholder's equity:			
Common shares	45,979,055	202,058	46,181,113
Warrants	1,502,331	–	1,502,331
Contributed Surplus	1,442,408	–	1,442,408
			(46,535,205)
Deficit	(46,252,276)	(282,929)	( )
	<b>\$ 3,002,315</b>	<b>\$ (80,871)</b>	<b>\$ 2,921,444</b>

<b>December 31, 2004</b>	<b>As reported in accordance with Canadian GAAP</b>	<b>Differences</b>	<b>Under US GAAP</b>
Current assets	\$ 3,762,516	\$ –	\$ 3,762,516
Property and equipment	809,171	–	809,171
Deferred development costs	64,974	–	64,974
Intangible assets	591,173	–	591,173
	<b>\$ 5,227,834</b>	<b>\$ –</b>	<b>\$ 5,227,834</b>

Current liabilities	\$ 305,409	\$ –	\$ 305,409
Shareholder's equity:			
Common shares	45,792,526	202,058	45,994,584
Warrants	1,502,331	–	1,502,331
Contributed Surplus	1,329,136	–	1,329,136
			(43,903,626)
Deficit	(43,701,568)	(202,058)	( )
	<b>\$ 5,227,834</b>	<b>\$ –</b>	<b>\$ 5,227,834</b>

Included in the current liabilities above are accrued liabilities of \$138,731 in 2005 and \$95,360 in 2004.

Aggregate amortization expense for intangible assets for each of the five succeeding fiscal years is estimated to be:

2006	\$	55,991
2007		40,161
2008		29,695
2009		19,402
2010		10,196
	\$	155,445

During the years ended December 31, 2005, 2004 and 2003 the Company granted options to employees, directors and officers. Compensation cost is recorded in the Company's statement of operations and deficit for options granted and vested during 2005, 2004 and 2003 in accordance with the adoption of the fair value based method effective January 1, 2003.

The Company has calculated the fair value of stock options granted to employees using the Black-Scholes option pricing model with the following weighted-average assumptions:

	2005	2004	2003
Risk free interest rate	4.5%	4.5%	4.5%
Weighted average volatility	66%	94%	105%
Expected life of option	90 days to 10 years	15 days to 5 years	3 to 5 years
Dividend yield	0%	0%	0%

Had the Company determined compensation cost based on the fair value at the grant date for its stock options issued in 2002 under SFAS No. 123, the Company's net income (loss) and basic and diluted income (loss) per share would have been reduced to the pro forma amounts indicated below:

	2005	2004	2003
Net loss under US GAAP:			
As reported	\$ (2,631,579)	\$ (1,925,946)	\$ (3,705,631)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effect	(21,982)	(81,620)	(103,602)
Pro forma	\$ (2,653,561)	\$ (2,007,566)	\$ (3,809,233)
Basic and diluted loss per common share under US GAAP:			
As reported	\$ (0.31)	\$ (0.26)	\$ (0.52)
Pro forma	\$ (0.31)	\$ (0.26)	\$ (0.53)

### 23. Comparative figures:

Certain comparative information has been reclassified to conform with the current year's presentation. The reclassifications that have occurred are as follows:

#### Property and equipment, deferred development costs, and intangible assets:

In prior years, intangible assets consisted of only patents and trademarks and purchased customer list. All other items were shown as one figure as capital assets. In the current year's presentation licensing rights have been shown as part of intangible assets, and deferred development costs have been shown separately.

#### Cost of product sales:

In prior years, a write down of inventory in 2003 was included in impairment of assets. In the current year's presentation this amount has been included as part of cost of product sales.

#### Stock based compensation and operating expenses:

In prior years, stock based compensation had been included in marketing, operations, product engineering, and administration expenses. In the current year's presentation stock based compensation has been shown separately.

Foreign exchange loss (gain):

In prior years, a foreign exchange gain realized in 2003 had been shown as part of other expenses. In the current year's presentation this gain has been shown as part of foreign exchange loss (gain).

Foreign withholding tax, termination expense and other:

In prior years, foreign withholding tax, termination expense, and other were shown together as other. In the current year's presentation these amounts have been shown separately.

Consolidated statements of cash flows and notes to financial statements:

The comparative figures in the consolidated statements of cash flows and in the notes to the financial statements have been reclassified in accordance with the items described above to conform with the current year's presentation.

## **24. Subsequent event**

Subsequent to the year end, the Company has 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 term equal to the loan, will be issued. The warrants may be exercised at any time during the term in lots of 25,000 warrants or more. The Company has agreed to file a short form registration statement under the United States Securities Act of 1933 to register the Shares issued upon conversion of the Loan and exercise of the warrants, provided that QSound is not obligated to file more than one such registration statement annually during the Term.

## 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 2005 of QSound Labs, Inc.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact necessary to make the statements made, in light of the circumstances under which they 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, 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)) and 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 registrant, its consolidated subsidiaries, is made known to us by others within those entities, during the period in which this report is being prepared;
  - b) evaluated the effectiveness of the company's disclosure controls and procedures and reported our conclusions about the effectiveness of the disclosures and procedures, 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 knowledge of the internal control over financial reporting, to the company's auditors and the audit committee members (or directors (or persons performing the equivalent function)):
  - a) All significant deficiencies and material weaknesses in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the company's ability to summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other persons in 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 30, 2006

## **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 2005 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 30, 2006



## **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 2005 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 30, 2006

**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, 2005 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 30, 2006

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 Form 20-F for the year ended December 31, 2005. 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 and 333-117165, effective July 2, 2004) and on Form F-3/A (File No. 333-121871, effective April 7, 2005).

*Grant Thornton LLP*

Chartered Accountants  
Calgary, Canada  
March 29, 2006

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### 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 and 333-117165) and on Form F-3 (No. 333-121871) of QSound Labs, Inc. of our report dated February 25, 2005, with respect to the consolidated balance sheets of QSound Labs, Inc. as of December 31, 2004 and 2003, and the related consolidated statements of operations and deficit and cash flows, for each of the years in the three-year period ended December 31, 2004, which report appears in the December 31, 2005, annual report on Form 20-F of QSound Labs, Inc. Our report refers to a change to the method of accounting for stock-based compensation.

*KPMG LLP*

Chartered Accountants

Calgary, Canada  
March 29, 2006