

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, 2007.

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 – 12th 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 Common Shares Name of each exchange on which registered The Nasdaq Stock Market

Securities registered or to be registered pursuant to Section 12(g) of the Act:

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, 2007: 9,462,985**

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.

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. Forward-looking statements are based on the current expectations, projections and opinions of QSound's management, and we do not undertake to update such statements unless securities laws require us to do so.

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 selected financial data presented below for the five years ended December 31, 2007 is derived from QSound Labs, Inc. ("QSound" or the "Company") consolidated financial statements that were examined by the Company's independent auditors. The information set forth below should be read in conjunction with the consolidated financial statements of QSound (including notes thereto) included under Item 17 and "Operating and Financial Review and Prospects" included under Item 5. The selected financial data presented below is presented in United States dollars and in accordance with Canadian generally accepted accounting principles ("Canadian GAAP").

Selected Financial Data

Years ended December 31, 2007, 2006, 2005, 2004 and 2003

Under Canadian GAAP in United States Dollars

	2007	2006	2005	2004	2003
Revenue	\$ 2,379,139	\$ 1,989,030	\$ 1,543,240	\$ 2,213,178	\$ 2,043,088
Gross Margin	2,292,209	1,903,357	1,363,459	1,793,888	1,617,997
Expenses	3,491,418	3,565,999	3,933,156	3,754,864	3,044,454
Operating (loss) profit	(1,199,209)	(1,662,642)	(2,569,697)	(1,960,976)	(1,426,457)
Other items	(64,373)	(20,733)	56,700	57,534	(2,270,631)
Loss before taxes	(1,263,582)	(1,683,375)	(2,512,997)	(1,903,442)	(3,697,088)
Foreign withholding tax	(42,485)	(50,849)	(37,711)	(22,504)	(8,543)
Net (loss) income for the year	(1,306,067)	(1,734,224)	(2,550,708)	(1,925,946)	(3,705,631)
Deficit, beginning of year	(47,986,500)	(46,252,276)	(43,701,568)	(41,775,622)	(38,069,991)
Deficit, end of year	<u>\$(49,292,567)</u>	<u>\$(47,986,500)</u>	<u>\$(46,252,276)</u>	<u>\$(43,701,568)</u>	<u>\$(41,775,622)</u>

Income (loss) per common share, basic and diluted	\$ (0.14)	\$ (0.19)	\$ (0.30)	\$ (0.25)	\$ (0.52)
Total assets	\$ 2,626,663	\$ 3,534,885	\$ 3,002,315	\$ 5,227,834	\$ 3,776,579
Capital Stock	\$ 47,473,681	\$ 47,208,942	\$ 45,979,055	\$ 45,792,526	\$ 44,108,140
Shareholders' equity	\$ 1,894,985	\$ 2,831,012	\$ 2,671,518	\$ 4,922,425	\$ 3,446,834
Share capital – common shares issued and outstanding	9,462,985	9,375,585	8,661,985	8,404,085	7,199,244

Net loss, shareholders' equity and other balance sheet amounts as determined in accordance with Canadian GAAP differ from those determined in accordance with United States generally accepted accounting principles ("U.S. GAAP"), due principally to the recording of compensation expense for stock options prior to January 1, 2003, the recording of certain deferred development costs as an expense rather than capitalized, the recording of the conversion feature of the loan note within equity rather than bifurcating the liability and equity components and recording the funded status of the Defined Benefit Pension as an asset or liability. See Note 17 to the December 31, 2007 consolidated financial statements included under Item 17.

	Under U.S. GAAP in United States Dollars				
	2007	2006	2005	2004	2003
Net (loss) income for the year	\$ (1,262,842)	\$ (1,681,675)	\$ (2,631,579)	\$ (1,925,946)	\$ (3,705,631)
Income (loss) per common share, basic and diluted	\$ (0.13)	\$ (0.18)	\$ (0.31)	\$ (0.25)	\$ (0.52)
Total assets	\$ 2,490,677	\$ 3,474,232	\$ 2,921,444	\$ 5,227,834	\$ 3,776,579
Shareholders' equity	\$ 2,081,840	\$ 3,075,272	\$ 2,590,647	\$ 4,922,425	\$ 3,446,834

At March 14, 2008 the exchange rate was U.S. \$0.9968 per CDN. \$1.00.

The high and low exchange rates for each month during the previous six months ended February 28, 2008, 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, 2007 based on the closing rates of the Bank of Canada and expressed in U.S. dollars were as follows:

	Month High	Low
February 2008	1.0207	0.9805
January 2008	1.0058	0.9644
December 2007	1.0183	0.9756
November 2007	1.0767	0.9980
October 2007	1.0477	0.9988
September 2007	1.0048	0.9438

	Average
2007 Year	0.9304
2006 Year	0.8820
2005 Year	0.8259
2004 Year	0.7698
2003 Year	0.7135

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 2007 or in 2006 in any of our business segments. The e-commerce business unit has 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 2007 we had revenues of \$2,379,000 and operating expenses of \$3,578,000, including cost of products sold of \$87,000. In 2006 we had revenues of \$1,989,000 and operating expenses of \$3,652,000, including cost of products sold of \$86,000. The net loss for 2007 was \$1,306,000. The net loss for the 2006 was \$1,734,000. 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 to fund our operations. If we are unable to raise financing when and in the amount required, we may be required to cease operations.

If we do not demonstrate compliance with the minimum listing standards for continued quotation on the Nasdaq Capital Market our shares will become subject to delisting.

At the date of this Annual Report QSound is not in compliance with requirements for continued listing on the Nasdaq Capital Market in that as of December 31, 2007 we do not have a minimum shareholders' equity of \$2,500,000, at least \$35,000,000 market value of listed securities or at least \$500,000 net income from continuing operations for the last fiscal year or two of the three most recently completed fiscal years. Upon determining that we are not in compliance, Nasdaq will notify us that we do not meet the listing requirements and we will have fifteen calendar days from the date of the notice to submit a plan to regain compliance. Nasdaq may in its discretion provide additional time, not to exceed in total 105 days from the date of the notice, to regain compliance.

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 and recurring royalties 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 mobile device manufacturers who wish to incorporate our microQ audio engine technology into their products. Under most of these agreements, we generate revenue based on the number of units incorporating our microQ audio engine distributed 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.

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, consumer electronics, PC multimedia 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.

The length and complexity of completing our audio licensing transactions can cause delays in generating additional revenues and prohibits us from accurately predicting future revenues.

The licensing and implementation of our audio technologies tends to be a lengthy process due to a number of factors which may include:

- complexity of technical issues;
- need for considerable dedicated engineering resources;
- time required to customize our technologies for specific platforms and customer requirements;
- protracted license negotiation; and
- changes required by the customer during the implementation process.

Market entry of products using our technology may be delayed or even abandoned. We may also spend substantial time and management attention on potential license agreements that are not concluded or on licensee's products that do not sell in large quantities. As a result, we are not able to predict either the amount or the timing of our future revenues, or the results of our operations, with any degree of certainty.

Some of our customers and potential customers in the audio industry have acquired or are acquiring their own in-house audio solutions. If we lose the opportunity to license to these companies, our audio business will suffer.

Some semiconductor companies that are or could become our customers have developed or acquired, or are in the process of developing or acquiring, their own in-house solutions for audio rendering and enhancement. If we do not develop technologically superior products and if we are unable to convince these companies that our products are not only superior and but also add value, we may lose these companies as customers and potential customers, resulting in a negative impact on our audio business.

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 industry is intensely competitive. We have competitors who have technologies and products that are similar to ours and compete directly with us. Many of these competitors, including potential customers who develop competitive products in-house, 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.

Telecommunications failures, computer viruses, breaches of security or terrorist attacks could disrupt our e-commerce business 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 would be negatively impacted. Any shift of consumers away from the Internet would adversely impact sales of our 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.

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 Capital Market has been and continues to be volatile. During the twelve months ending on February 28, 2008 our stock price has ranged from a high of \$6.09 to a low of \$1.75. 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 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, one of our directors lives in the United Kingdom, 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 one director lives in the United Kingdom, and most of our assets, and the assets of those officers and directors, are located in Canada or the United Kingdom. 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 was originally incorporated on

December 6, 1968. The address of our registered office is Suite 400 – 3115 12th Street N.E., 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 semiconductor/component and OEM licensees in the mobile devices, consumer electronics and personal computer industries. In 2007 we added six licensees for microQ® our audio software engine for portable applications, in the growing mobile and handheld devices market, and six consumer electronics and PC licensees for audio enhancement. 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 2007, 2006, and 2005 are detailed in the table below:

	2007	2006	2005
Sound source and control equipment	\$ 3,050	\$ 2,895	\$ –
Furniture and fixtures	–	185	2,014
Computer equipment	15,193	39,346	98,481
Software and production tooling	–	–	88,393
Deferred development costs	–	39,500	352,750
Patents and trademarks	10,328	(1,097)	50,977
Licensing rights	1,530	–	–
Total	\$ 30,101	\$ 80,829	\$ 592,616

In fiscal 2007 the Company divested sound source and control equipment with a combined net book value of \$Nil, for proceeds of \$586. We had no divestitures in either fiscal 2006 or 2005.

B. Business Overview

QSound was engaged in three business segments in 2007:

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, consumer electronics, and computer multimedia markets and by selling downloadable software products for Internet streaming audio, primarily through third parties and also directly, to consumers over the Internet.

b) 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.

c) Internet Telephony Business Segment Our wholly owned subsidiary QTelNet Inc. is not actively marketing its telephony products but continues to sell remaining inventory.

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 synthesizer, a digital audio playback engine, a sample rate converter and a mixer.

QSOUND technologies are currently shipped in:

- mobile phones and PDA's
- DVD players
- home theatre systems, TV's and VCR's

- stereo systems
- amplified and USB speakers
- PC's and PC peripherals including sound cards, speakers and monitors
- 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 Engine

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, a sample rate converter, and a voice chat module that enables Internet communication using VoIP technology which we added in 2007.

- 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. QSURROUND 5.1 creates an enhanced immersive QSURROUND experience for multiple speaker systems.

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

QMSS™: QSOUND Multiple Speaker System (“QMSS”) processes 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.

QVERB™: QVERB is a digital reverberation effect.

QLOUDNESS™: QLOUDNESS is a Fletcher-Munson equalization loudness curve.

QEQ™: QEQ is a static multi-band equalizer.

QDRC™: QDRC is a dynamic range control.

QLIMITER™: QLIMITER is an anti-saturation dynamic range control.

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 our 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. Most 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. Licensing activity for 2007 and ongoing business activities for microQ and for QSOUND audio are as follows:

2007 Licensing Activity: To date our microQ wavetable synthesizer has been included in over 50 mobile phone models which have cumulatively shipped over 15 million units. In 2007 we negotiated and completed license agreements with twelve semiconductor/component companies and OEM’s. Six of these licenses were for use of microQ in the mobile and handheld devices market (including licenses with Pantech for mobile phones and with CSR for the BlueCore-Multimedia Bluetooth platform), with the remaining agreements covering our audio enhancement technologies in consumer electronics products and multi-media PC’s.

microQ: Under our 2006 strategic collaboration agreement with ARM Limited, highly optimized QSOUND audio software solutions for mobile phone ringtone, music and gaming markets are available across the ARM CPU architecture family. We also partner with Sun Microsystems, Inc. to offer solutions for Sun’s JSR 135 and JSR 234 platforms, and with mobile software solutions providers including Trolltech, Inc. and ACCESS Systems Americas, Inc. microQ has been incorporated in handheld and mobile devices from manufacturers including Qisda Corporation, Eten Information Systems Co., Ltd., Mitac International Corporation, Shanghai Lenovo Electronic Co., Ltd., UTStarcom Inc., Wistron Neweb Corporation, Yuhua Teltech (Shanghai) Co., Ltd. and ZTE Corporation, and in reference design platforms from Aplix Corporation, Aricent (formerly Emuzed, A Flextronics Company), ATI Technologies, Inc., Broadcom Corporation, CEVA Inc., DSP Group Ltd., Intel Corporation, LSI Logic Corporation, Pulsus Technologies Inc., Qualcomm Incorporated, Samsung Electronics Co., Ltd., Tensilica Inc., and Winbond Electronics Corp. microQ-enabled mobile phones in the marketplace include models by Qisda, Curitel, Eten, i-Mobile, LG, Lenovo, Mitac, Panasonic, Pantech, Philips, Samsung, UTStarcom and ZTE.

QSOUND Audio: ST Microelectronics, one of the world’s largest semiconductor manufacturers and a global leader in consumer IC’s, has incorporated QSound’s audio enhancement into its Sound Terminal IC’s for use in flat-panel TV’s, active speakers and home-theatre-in-a-box systems. Our other licensees include RCA, Sanyo, Sharp, Taiyo and Toshiba which use QSOUND in DVD’s, TV’s, home-theatre-in-a-box systems and Via Technologies, Inc., Sony Vaio PC and Philips in the PC multi-media market.

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 stand-alone Internet streaming audio effects software, 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 a custom iQms2 plug-in for Windows Media Player 11 Series for Windows XP. We distribute our downloadable consumer software from our Web site www.qsound.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 Seiko NPC Corporation.

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, *QCART*™ secure credit card authorization, verification and database management system, 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.

Revenues by Business Segment

In fiscal 2007, our revenues were \$2,242,000 from the audio business segment, \$134,000 from the e-commerce business segment, and \$3,000 from the telephony segment. In fiscal 2006, our revenues were \$1,799,000 from the audio business segment, \$158,000 from the e-commerce business segment and \$31,000 from the telephony segment. In fiscal 2005, our revenues were \$1,305,000 from the audio business segment, \$183,000 from the e-commerce business segment and \$55,000 from the telephony segment.

Revenues by Geographic Market

Audio Business: In 2007 product sales revenue came primarily from the United States and Asia. Royalties, license and engineering fees came primarily from the United States (70%) and Asia (23%). In 2006 product sales revenue was split between the United States and Asia. Royalties and license fee revenue came primarily from the United States (45%) and Asia (55%). In 2005 product sales revenue was split between the United States and Asia. Royalties and license fee revenue came from the United States (57%) and Asia (36%).

E-commerce Business: Revenue for our e-commerce business segment has come primarily from the United States in 2007, 2006 and 2005.

Internet Telephony Business: In 2007 78% of our revenue came from the United States and 22% from Panama. In 2006 48% of our revenue came from the United States, 44% from Canada, and 8% from other areas. In 2005 75% came from the United States, 19% from Canada, and 6% from other areas.

Seasonality

Historically QSound has experienced increased royalty revenues in our audio business segment during 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. However, both 2007 and 2006 did not experience this seasonality. In 2007 and 2006 we did not experience any seasonal changes in our e-commerce business segment, and all revenue from e-commerce continues to be 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 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 from our own web sites.

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 twelve 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, one patent covers binaural hearing aid technology previously co-developed by QSound Labs and the House Ear Institute of Los Angeles, California. At the date of this Annual Report, one additional patent application for QSOUND complementary technology has been filed and more applications are in development. 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 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.

Competition

The industries in which we engage are intensely competitive. 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: Some of our potential customers are very large companies with significant engineering resources providing capability for development of products in-house that are competitive with our products. Motivating factors for in-house development include the desire to cease dependence upon third party technologies and product cost reduction. We also have other competitors that market competing products in the mobile devices market; the consumer electronics market; PC multimedia market; audio enhancement software plug-ins for Internet media players; the headphone audio enhancement area; and the multi-channel home theatre 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.

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. QSound Ltd. is the parent of wholly owned subsidiary QCommerce Inc., a Washington corporation, which operates our e-commerce business segment. QSound Labs, Inc. is also the parent of QTelNet Inc., an Alberta corporation and wholly owned subsidiary that formerly operated our Internet telephony activities.

D. Property, Plants and Equipment

Our head office, including research facilities and a sound studio, is located at 400 – 3115 12th 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. Our audio and e-commerce businesses are operated from our Calgary office. We intend to re-lease the office space or to re-locate elsewhere within Calgary.

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 4A. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following Management's Discussion and Analysis of the Financial Condition and Results of Operations ("MD&A") is provided to assist readers in understanding QSound Labs, Inc.'s ("QSound" or the "Company") and its subsidiaries financial performance during the periods presented and significant trends that may impact the future performance of QSound. This discussion should be read in conjunction with the audited consolidated financial statements of QSound Labs, Inc. and the related notes thereto.

All amounts are expressed in United States dollars and in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), except where otherwise noted. For a discussion of the principle differences between QSound's financial results as calculated under U.S. GAAP, see note 17 to the consolidated financial statements of QSound.

Overview

QSound is a developer and provider of software solutions for audio, voice and e-commerce applications. The Company operates its business through three different operating units; QSound Labs, the parent company; its wholly-owned subsidiary QCommerce Inc; and its wholly-owned subsidiary QTelNet Inc.

Audio Business Unit

The 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 94%, 90% and 84% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are derived primarily through licensing fees, non-recurring engineering fees and per unit royalty agreements.

E-Commerce Business Unit

The 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 6%, 8% and 12% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are comprised primarily of monthly subscription fees.

Telephony Business Unit

The Telephony business unit distributes IP Telephony products which are targeted for the small business environment. Revenues from this business unit comprised 0%, 2% and 4% of total consolidated revenues in fiscal 2007, 2006 and 2005 and are derived from product sales to distributors.

Business Outlook

The Company's business is dependent on continued marketing of its microQ software solutions and establishment of strategic partnerships in the mobile device market, together with the marketing its technology in the home entertainment and Bluetooth audio markets. The Company continues to seek out new licensees from which are derived a combination of: up front licensing fees, non recurring engineering fees (compensation for customization, integration support and specific engineering requirements), annual license fees and per unit royalty agreements.

A. Operating Results

The following table summarizes the consolidated results of operations of the Company for the last three years:

	2007		2006		2005	
	Amount	%	Amount	%	Amount	%
Revenue	2,379,139	100%	1,989,030	100%	1,543,240	100%
Cost of sales	(86,930)	(4%)	(85,673)	(4%)	(179,781)	(12%)
Gross Margin	2,292,209	96%	1,903,357	96%	1,363,459	88%
Marketing, Engineering and Administrative Expenses	(3,261,158)	(137%)	(3,040,859)	(153%)	(3,051,219)	(198%)
Foreign Exchange Loss	(3,751)	—	(25,912)	(1%)	(2,832)	—
EBITDA ⁽¹⁾	(972,700)	(41%)	(1,163,414)	(58%)	(1,690,592)	(110%)
Interest Income	72,559	3%	85,686	4%	56,700	4%
Amortization	(226,509)	(10%)	(331,419)	(17%)	(360,898)	(23%)
Impairment of assets	—	—	(167,809)	(8%)	(518,207)	(34%)
Interest on convertible debt	(81,240)	(3%)	(61,336)	(3%)	—	—
Accretion of debt discount	(56,278)	(2%)	(45,083)	(2%)	—	—
Gain on sale of property and equipment	586	—	—	—	—	—
Loss before taxes	(1,263,582)	(53%)	(1,683,375)	(84%)	(2,512,997)	(163%)
Taxes	(42,485)	(2%)	(50,849)	(3%)	(37,711)	(2%)
Net loss	(1,306,067)	(55%)	(1,734,224)	(87%)	(2,550,708)	(165%)

(1) EBITDA represents net income before interest, taxes, depreciation and amortization. EBITDA is a supplemental non-GAAP financial measure used by management, as well as industry analysts, to evaluate operations. Management believes that EBITDA, as presented, represents a useful means of assessing the performance of the Company's ongoing operating activities, as it reflects the Company's earnings trends without showing the impact of certain charges. The use of EBITDA by the Company has certain material limitations because it excludes the recurring expenditures of interest, income tax, and amortization expenses. Interest expense is a necessary component of the Company's expenses because the Company borrows money to finance its working capital and capital expenditures. Income tax expense is a necessary component of the Company's expenses because the Company is required to pay cash income taxes. Amortization expense is a necessary component of the Company's expenses because the Company uses property and equipment to generate sales. Management compensates for these limitations to the use of EBITDA by using EBITDA as only a supplementary measure of profitability. EBITDA is not used by management as an alternative to net income as an indicator of the Company's operating performance, as an alternative to any other measure of performance in conformity with generally accepted accounting principles or as an alternative to cash flow from operating activities as a measure of liquidity. A reconciliation of EBITDA to Net Income is provided within the table above. Not all companies calculate EBITDA in the same manner and EBITDA does not have a standardized meaning prescribed by GAAP. Accordingly, EBITDA, as the term is used herein, is unlikely to be comparable to EBITDA as reported by other entities

2007 compared to 2006

The Company's net loss for 2007 narrowed further to \$1,306,067 (\$0.14 per share) from \$1,734,224 (\$0.19 per share) in 2006, a reduction of 25%. Revenue increased by 20% due to increasing levels of recurring royalty revenue and annual license fees, while gross margin remained constant at 96%. Marketing, Engineering and Administrative Expenses increased \$220,000 (7%) due to increased compensation costs and the impact of a weaker US dollar generally on Canadian dollar denominated expenses. Lower amortization expense can be attributed to the impairment of assets that occurred in both 2006 and 2005. Costs associated with the convertible notes increased 29% in 2007 as the convertible notes were only issued on March 27, 2006.

2006 compared to 2005

The Company's net loss for 2006 decreased to \$1,734,224 (\$0.19 per share) from \$2,550,708 (\$0.30 per share) in 2005, a reduction of 32%. Revenue increased by 29% due to receipt of two large license fees from partners, together with an acceleration of recurring royalty revenue and annual license fees. Marketing, Engineering and Administrative Expenses remained fairly

consistent with only a \$10,360 decrease reported. Impairment of assets declined 68% in 2006 as 2005 included an impairment of \$428,453 relating to licensing rights whereas 2006's impairment was against telephony assets. Costs associated with the convertible notes only occur in 2006 as the convertible notes were issued on March 27, 2006.

A more detailed discussion of the Company's annual results from operations is provided below:

Revenue:

Sales for 2007 were \$2,379,139 an increase of 20% from \$1,989,030 in 2006 principally due to increased recurring royalty revenue and annual license fees reflecting increased levels of product sales with microQ embedded technology by the Company's customers.

	2007		2006		2005	
	\$	%	\$	%	\$	%
Up front license fees	289,217	12%	740,697	37%	649,524	42%
Royalties and recurring license fees	1,853,617	78%	951,972	48%	406,985	26%
Product Sales	236,305	10%	296,361	15%	486,731	32%
	<u>2,379,139</u>	<u>100%</u>	<u>1,989,030</u>	<u>100%</u>	<u>1,543,240</u>	<u>100%</u>

Royalty and recurring license fee revenue for the year ended December 31, 2007 increased 95% to \$1,853,617 from \$951,972 for the year ended December 31, 2006. This increase reflects the growth in recurring royalty revenue from the microQ technology and results from the Company acquiring new licensees during the year combined with licensees continuing to launch new products and increasing levels of sales throughout the year. This annual increase is indicative of the Company's strategic focus of continuing to grow recurring revenues from licensing of its microQ technology.

Up front license fees for the year ended December 31, 2007 and 2006 were \$289,217 and \$740,697 respectively, a decrease of 61%. The decrease is attributable to a large fee received from a major video game manufacturer during 2006. As the Company's focus continues to be to build a more stable base of recurring revenue the influence on the Company's total revenue by large up front license or engineering fees that may have been negotiated within license agreements will be less marked, although QSound will continue to negotiate these into its license agreements.

Product sales saw a further decline of 20% in 2007 to \$236,305 from \$296,361 in 2006 which was attributable to two main factors.

Sales to one of the Company's distribution partners which accounted for 32% and 34% of the product sales revenue in 2007 and 2006 respectively have continued to decline during 2007. The impact on the Company is a reduction in revenue of \$26,000 from 2006.

Sales in the Company's telephony division declined further in 2007. Revenues fell by 90% (2006: 44% decline) from \$31,000 to \$3,000 during 2007. This decline was as expected as the division receives no marketing efforts subsequent to the abandonment of an anticipated product launch scheduled to occur during 2005. The Company expects revenue to remain at this level in 2008 as the Company sells through the remaining inventory.

Expenses:

	2007	2006	2005
Marketing (\$000)	1,216	1,112	1,000
Change year over year	9%	11%	(20%)

2007 saw a 9% increase in marketing expenses, totalling \$1,216,000 for 2007 compared to \$1,112,000 in 2006. The increase primarily occurred as the Company continued to increase the level of marketing support for its microQ software technology in order to establish strategic partnerships in the mobile device market. Marketing expense increased primarily due to compensation costs increasing \$23,000, consultant costs increasing \$50,000 and travel costs increasing \$17,000, as the Company aligned itself with the major platform providers.

	2007	2006	2005
Product Engineering (\$000)	787	819	952
Change year over year	(4%)	(14%)	(1%)

For the year ended December 31, 2007 product engineering expenses decreased by 4% to \$787,000 from \$819,000 in 2006. The decrease is attributable to decreases of \$65,000 and \$13,000 in compensation expenses and travel expenses respectively being partly offset by an increase in consultant costs of \$55,000.

	2007	2006	2005
Administration (\$000)	1,117	973	883
Change year over year	15%	10%	10%

Administration costs have increased 15% to \$1,117,000 for the year ended December 31, 2007 from \$973,000 for the previous year principally due to two factors: an increase in compensation expenses (\$84,000) and an increase in audit fees (\$76,000). The Company has seen salaries increase over the prior year due to inflationary pressures within Western Canada and a strong Canadian dollar, while audit fees have increased as the Company now undergoes a review of its interim financial statements due to the increasing complexity of Canadian and U.S. accounting standards. The strong Canadian dollar has also contributed to other Canadian based expenses increasing over the course of 2007.

Amortization for the year ended December 31, 2007 decreased 31% to \$227,000 from \$331,000 in 2006, the decrease occurring as a result of the impairment charge on property and equipment which occurred during 2006.

	2007	2006	2005
(\$000)			
Impairment of Property and Equipment	–	168	90
Impairment of Intangible Assets	–	–	428

Impairment charges were recorded in 2006 and 2005 as changes in circumstances indicated that the carrying amount of particular groups of assets may not be recoverable. The impairment charges were recorded against the telephony business segment assets in both years. In 2007 there have been no events or changes in circumstances to indicate that the carrying value of the remaining assets is not recoverable.

Interest income was \$73,000 in the year ended December 31, 2007 compared to \$86,000 for the year ended December 31, 2006. The decrease is resultant from lower levels of surplus cash balances being invested due to the cash requirements of the Company's operating activities. The Company expects interest income to continue to decrease in the short term due to cash balances being used for operating activities and the expected decrease in US interest rates.

Interest on convertible notes has increased 33% to \$81,000 for the year ended December 31, 2007 compared to \$61,000 for the year ended December 31, 2006. The increase is as expected and results from the issuance of the convertible notes on March 27, 2006. The Company expects interest on convertible notes to decrease in the short term due to expectations of falling US interest rates.

Accretion expense for the year ended December 31, 2007 increased 24% to \$56,000 from \$45,000 in the corresponding period in 2006, with the increase attributable to using the Effective Interest Rate within the accretion calculation.

Summary of Quarterly Financial Data

The selected quarterly financial data presented below is presented in United States dollars and in accordance with Canadian GAAP. The information is derived from the Company's unaudited quarterly financial statements.

	2007				2006			
	Dec 31	Sept 30	Jun 30	Mar 31	Dec 31	Sept 30	Jun 30	Mar 31
Revenue	304,455	672,294	796,030	606,360	543,405	341,687	430,168	673,770
Net loss	(516,616)	(234,544)	(158,179)	(396,728)	(509,781)	(533,020)	(491,072)	(200,351)
Loss per share	(0.05)	(0.02)	(0.02)	(0.04)	(0.05)	(0.06)	(0.06)	(0.02)
Total cash	1,232,255	1,507,956	1,832,503	1,824,038	2,316,476	2,307,783	2,464,122	2,223,655
Total assets	2,626,663	3,251,976	3,363,809	3,531,771	3,534,885	4,041,512	4,202,713	4,411,921
Total debt	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000

Sales for the quarter ended December 31, 2007 decreased 44% to \$304,455 from \$543,405 for quarter ended December 31, 2006 reflecting both a decrease in up front license fees and royalties and recurring license fees. Upfront license fees for the three months ended December 31, 2007 and 2006 were \$10,000 and \$50,000 respectively, a decrease of 80%, while royalty and recurring license fee revenue decreased 43% to \$240,741 for the quarter ended December 31, 2007 compared to \$423,694 in the corresponding period in 2006. The reasons for the decline in revenue for the quarter ended December 31, 2007 were threefold:

- recognition of annual license fees in 2006 that were previously amortized over time and are now recognized upfront in accordance with revenue recognition criteria. This resulted in a one-time increase to revenue in 2006 of \$200,000.
- one license agreement ended during the quarter ended September 30, 2007. This license was renewed as an annual license fee rather than a royalty per unit agreement as the licensee's products are near to the end of their life cycle. The annual license fee had been recognized in revenue in the quarter ended September 30, 2007, thus no revenue was recorded for this license in the quarter ending December 31, 2007.
- an over estimate of royalties in the quarter ended September 30, 2007 as licensees were late in submitting their royalty statements to QSound. Discussions with these companies led management to estimate the royalties due, however royalties were overestimated by \$93,000 and thus revenue in the quarter ended December 31, 2007 was impacted negatively by this adjustment.

Expenses have decreased 21% to \$789,829 compared to \$1,003,232 in the previous year as a result of lower stock based compensation costs in 2007. Net loss was \$516,616 or \$0.05 per share (basic and diluted) for the quarter ended December 31, 2007, compared to \$509,781 or \$0.05 per share for the quarter ended December 31, 2006.

Revenue for the quarter ended December 31, 2007 decreased 55% from \$672,294 to \$304,455 over the quarter ended September 30, 2007, for the reasons previously discussed. Recurring royalty revenue, when adjusted for the over estimate in the quarter ended September 30, 2007, has declined slightly due to a licensee moving over to an annual license fee. Expenses have remained comparable at \$789,829 for the quarter ended December 31, 2007 compared to \$859,816 for the previous quarter. Net loss was \$516,616 or \$0.05 per share (basic and diluted) compared to \$234,544 or \$0.02 per share for the quarter ended September 30, 2007, the increase being reflective of the decrease in revenue.

B. Liquidity and Capital Resources

The Company has historically financed its operations through the issuance of common shares and debt. As at December 31, 2007 the Company had cash and cash equivalents of \$1,232,255 compared to \$2,316,476 as at December 31, 2006.

For the year ended December 31, 2007 cash used in operating activities was \$1,247,205 compared to \$708,651 for the year ended December 31, 2007.

For the years ended December 31, 2007 and 2006 cash provided from financing activities was \$156,499 and \$1,857,882 respectively. In 2007 exercise of stock options generated all of the cash provided, while 2006 saw 500,000 warrants being exercised for \$520,000, issuance of \$1,000,000 convertible notes and exercise of stock options for \$337,882.

For the year ended December 31, 2007 cash provided from investing activities was \$6,485 compared to cash used in investing activities of \$55,484 for the year ended December 31, 2006. Cash provided from investing activities resulted primarily from receipt of \$36,000 of the outstanding note receivable and receipt of \$586 from the Sale of Property and Equipment, offset by investment in Property and Equipment of \$18,243 and Intangible Assets of \$11,858. Cash used in investing activities for the year ended December 31, 2006 resulted from \$39,500 expended on Deferred Development Costs and \$42,426 on Property and Equipment, being offset by receipt of \$26,442 of the outstanding Note Receivable.

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 2007, 2006 and

2005 we continued our previous research and development activities of developing new, and refining and upgrading existing, audio synthesis and enhancement technologies. This work is in part carried out through work with our licensees and business partners through integration of our technology into their products and also through joint venture projects. In 2007, 2006 and 2005 continued development and refinement of the Company's microQ scalable software engine was the main "in house" focus. The Company's audio research and development costs were \$787,000 in 2007, \$819,000 in 2006 and \$952,000 in 2005. Also during 2006 and 2005, the Company, through participation in a joint venture, undertook development of a voice chat conferencing system, incurring costs of \$39,000 and \$353,000 respectively. These costs have been capitalized and from 2006, as this is when commercial production commenced, have been amortized over the useful economic life of the asset. The Company has one patent application, as well as further applications in development. (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 performance of our products. There were no research and development activities during 2007 and 2006, with expenditures in 2005 totalling \$33,000 respectively relating to upgrading of products.

Internet Telephony Business: Subsequent to the abandoning of a telephony project in 2005 the Company has not incurred any further research and development expenses within its telephony business segment. During 2005 the Company incurred expenditure of \$112,000 relating to this project. Due to the abandonment of the project an impairment charge totaling \$518,000 was booked as the Company determined that the carrying value of the project assets was not recoverable. However, further to resolution of legal proceedings with the project developer during 2006, the Company now has possession of the assets and fully intends to use these in the future.

Share Capital

The weighted average number of shares (basic and diluted) outstanding during 2007 was 9,420,808, an increase of 246,723 (3%) over the prior year due to the exercise of stock options.

As at December 31, 2007, the following shares and securities convertible into shares, were outstanding:

	December 31, 2007 Shares	December 31, 2006 Shares
Shares outstanding	9,462,985	9,375,585
Stock options	858,500	981,700
Warrants	614,130	614,130
Convertible note	307,693	307,693
Shares outstanding and issuable	11,243,308	11,279,108

Convertible Note

On March 27, 2006, the Company issued a \$1,000,000 convertible note and 400,000 related share purchase warrants. The note is due in five years and bears interest at the US prime rate payable quarterly in arrears.

The note is convertible at the option of the holder at any time and from time to time into common stock of the Company at a conversion price of \$3.25 per share. Additionally, in the event that the Company issues securities convertible into common stock at a price less than this conversion price, the conversion price shall be immediately adjusted to the price at which such securities were issued.

The warrants issued are each exercisable into one common share at an exercise price of \$4.50 per share until March 27, 2011.

The warrants also contain provisions to adjust the exercise price in the event that the Company issues securities convertible into shares at a price less than the then applicable exercise price, in which case the exercise price shall be reduced to the same terms as the convertible securities issued.

Significant Accounting Policies and Application of Critical Accounting Estimates

The significant accounting policies used by the Company are described below. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in these estimates and assumptions may have a material impact on

the Company's financial results and condition. The following discusses such accounting policies and is included herein to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. Management reviews its estimates and assumptions regularly. The emergence of new information and changed circumstances may result in changes to estimates and assumptions which could be material and the Company might realize different results from the application of new accounting standards promulgated, from time to time, by various regulatory rule-making bodies. The following assessment of significant accounting policies is not meant to be exhaustive.

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 has been received, and collection is reasonably assured. When software sales arrangements contain multiple elements, the Company allocates revenue to each element of accounting based on vendor specific objective evidence of fair value. In the absence of fair value for a delivered element, the Company allocates revenue to the undelivered items based on fair value with the residual amount allocated to the delivered elements. Where the fair value of an undelivered element cannot be determined, the Company would defer revenue for the delivered elements until the undelivered elements are delivered.

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 other products. Revenue from other 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 has no further obligations relating to 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.

Amortization of deferred development costs commences with commercial production / use of the process, and is amortized at a rate of 20% per annum over its useful economic life.

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.

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.

Stock based compensation

Stock Options: The fair value of each option granted is estimated on date of grant using the Black Scholes option pricing model. The amount is credited to contributed surplus and expensed over the vesting period. Upon exercise of the options, the exercise proceeds together with amounts credited to contributed surplus are credited to share capital.

Share Awards: The fair value of each award issued is calculated using the closing price on the date of grant.

Recent Accounting Pronouncements

Under revised CICA section 1506 “Accounting Changes” and the Securities and Exchange Commission’s (SEC) Staff Accounting Bulletin 74 (SAB 74), the Company is required to disclose certain information related to recently issued accounting standards. This guidance requires that when a new accounting standard has been issued but not yet adopted, the Company should discuss the effect that the new standard will have on the Company’s financial statements when adopted.

Canadian GAAP pronouncements

(i) Financial Instruments (CICA 1530, 3855, 3861)

Effective January 1, 2007, the Company adopted Section 1530 - Comprehensive Income, Section 3855 - Financial Instrument Recognition and Measurement and Section 3861 - Financial Instruments Disclosure and Presentation, of the Canadian Institute of Chartered Accountants Handbook in accordance with the transitional provisions in each respective section.

The adoption of Sections 1530, 3855 and 3861 did not have a material impact on the financial statements of the Company and did not result in any adjustments for the recognition, de-recognition or measurement of financial instruments as compared to the financial statements for periods prior to the adoption of these sections.

(ii) CICA 1506 – Accounting Changes

Effective January 1, 2007, the Company adopted revised CICA section 1506, “Accounting Changes.” The amendments in the revised standard indicate that voluntary changes in accounting policy are only permitted if they result in financial statements that provide more reliable and relevant information. When a change in accounting policy is made, this change is applied retrospectively unless impractical. Changes in accounting estimates are generally applied prospectively and material prior period errors are corrected retrospectively. This section also outlines additional disclosure requirements when accounting changes are applied including justification for voluntary changes, complete description of the policy, primary source of GAAP and detailed effect on financial statement line items.

(iii) CICA 3031 – Inventories

This section replaces CICA Section 3030 and applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The new section is harmonized with International Accounting Standards and provides additional guidance on the measurement and disclosure requirements for inventories. Specifically, inventories are required to be measured at the lower of cost and net realizable value. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company’s financial statements.

(iv) CICA 3862 – Financial Instruments - Disclosure and CICA 3863 – Financial Instruments - Presentation

Both sections establish new levels of disclosure required for financial instruments in the financial statements. The section is effective for annual periods beginning on/after October 1, 2007.

US GAAP pronouncements

(i) FAS 157 – Fair Value Measurements

This statement defines fair value, establishes a framework for measuring fair value within GAAP and expands disclosures about fair value measurements. This is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company’s financial statements.

(ii) FAS 159 – The Fair Value Option for Financial Assets and Financial Liabilities

This statement permits entities to choose to measure financial instruments and other certain items at fair value that are not currently required to be measured at fair value. This is effective for fiscal years beginning after November 15, 2007. The Company has reviewed and assessed the impact of these statements and determined that adoption of the statements will not have a material impact on the Company’s financial statements.

D. Trends

The continuing 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 in recent years. The Company has focused primarily on this market segment. 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.

The mobile device market is driven by consumer growth in Asia, however, QSound continues to enter license agreements with companies that are headquartered in the U.S. but have a worldwide presence. The Company expects that future revenues will

continue to be largely derived from the U.S. but that percentage growth will be seen from Asian licensees. The following table presents the geographic segment information:

	2007	2006	2005
U.S.	72%	49%	63%
Asia	21%	50%	32%
Europe	1%	-	3%
Canada	6%	1%	-
Other	-	-	2%
	100%	100%	100%

The Company anticipates that it will continue to acquire new licensees through marketing of existing audio and voice IP, together with development of new technology.

The Company has seen growth in its recurring revenue base (royalties and annual license fees) in recent years and the Company anticipates that this will continue with the acquisition of new licensees, as the new license agreements incorporate per unit royalties.

	2007	2006	2005
Up front license fees	12%	37%	42%
Royalties and recurring license fees	78%	48%	26%
Product Sales	10%	15%	32%
	100%	100%	100%

As the Company will continue to focus its development and marketing efforts on its microQ software technology in 2008 its other business segments, e-commerce and IP telephony, are expected to continue at current performance levels.

With the continued focus on marketing of its microQ software technology, the Company believes that marketing expenditure will increase in 2008. This is directly attributable to increased compensation levels as a result of new hires in the latter part of 2007, together with an increasing presence at international trade shows.

Other costs will not be affected through the increase in revenues as they mostly comprise fixed compensation and travel expenses, although inflationary pressures in Western Canada and a continuing weak US dollar will mean other operating expenses will remain at the levels experienced during 2007.

The Company has no plans for any major capital expenditures.

E. Off-Balance Sheet Arrangements

The Company has not engaged in off-balance sheet financing arrangements through special purpose entities.

F. Tabular Disclosure of Contractual Obligations

Period Due	Long Term Debt	Operating Lease Commitments	Total
<i>(US Dollars)</i>			
2008	63,108	97,744	160,852
2009	60,000	17,183	137,183
2010	60,000	10,023	24,160
2011	14,137	-	-
2012	-	-	-
	197,245	124,950	322,195

The commitment classified as long term debt is the cash interest expense and is calculated assuming that US prime rate remains at 6%.

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 14, 2008. Mr. Stanley E. MacDougall resigned as a member of the board of directors on May 4, 2007. Mr. Murray Bruce, Controller, acted as a board member from his appointment on May 7, 2007 to his resignation on August 22, 2007. Mr. Douglas Balfour was appointed as a member of the board on June 7, 2007. 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
Murray Bruce	Controller
M. Patty Chakour	Director
D. Tony Stelliga	Director
Douglas Balfour	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-five 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.

Murray Bruce, a chartered accountant, joined QSound as our Controller on December, 4, 2006. Mr. Bruce has over thirteen years of public and corporate accounting experience, with seven years in managing Company-wide financial accounts systems. From September, 2005 to December, 2006 Mr. Bruce was an audit manager with Deloitte and Touche in Calgary, Alberta and prior, from 1999 to 2005 he acted as financial accountant with responsibilities including preparation of accounts, budgets and corporation tax computations for Cambridge Laboratories Limited, U.K.

M. Patty Chakour was appointed to the board of directors on March 10, 2004. Ms. Chakour is Chief Financial Officer of T.P Racing 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-two 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.

Douglas Balfour was appointed to the board of directors on June 7, 2007. Mr Balfour is the General Manager of Quantum Research Group, a position he has held since October, 2007. Mr. Balfour has over thirty years experience working in the electronics industry including computer hardware, semiconductor, consumer products, display, audio software and IP licensing areas. Mr. Balfour was previously the Managing Director of Sensaura. He has also led the sales and marketing activities for Hitachi Europe in the field of display products and has held managerial roles in Texas Instruments and Siemens semiconductor divisions. Prior to entering the semiconductor field, Mr. Balfour held various positions with a number of multi-national computer companies. Mr. Balfour is a member of the Institute of Engineering and Technology, the Audio Engineering Society and the British Academy of Film and Television Arts.

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 Bruce.

B. Compensation

Remuneration paid or payable to our directors and executive officers during fiscal year 2007 was an aggregate \$434,446 for compensation paid to Messrs. Gallagher and Bruce and Ms. Varvos. Options to purchase 30,000 shares at the exercise price of \$4.96 per share previously granted to Mr. Bruce were cancelled and in lieu thereof a share award of 10,000 fully paid shares was granted. 4000 of these shares vested and were issued on January 9, 2008 and 2000 shares are subject issuance upon vesting on each of June 30, September 30 and December 31, 2008. No cash or other bonuses were paid to executive officers in 2007.

Mr. Gallagher's salary for 2007 was \$224,226 (\$240,000 Cdn.). In November 2007, the compensation committee determined that Mr. Gallagher's outstanding options to purchase 100,000 common shares at the exercise price of \$1.65, which were to expire on December 30, 2007, be amended by extending the expiry date by one year to December 31, 2008. These options are granted under the Company's 1998 Stock Option Plan and the amendment did not require shareholder approval.

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 Mr. Gallagher's 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, 2007 for a further one year term. If there is a change in control of the Company Mr. Gallagher is entitled to vesting of any unvested 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 2007 \$25,615 Cdn was contributed to the plan for fiscal 2007. In 2006 \$24,153 Cdn. was contributed to the plan for fiscal 2006. In 2005 \$22,749 Cdn. was contributed to the plan for fiscal 2005. Further, \$17,400 Cdn. (of \$23,500 Cdn. which was accrued in 2005 as settlement for past wages that had been deferred by Mr. Gallagher prior to 2002) was contributed in 2006 to Mr. Gallagher's RSP.

Our directors were paid cash compensation in the aggregate of \$28,000 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.

The following table gives information concerning stock options granted as compensation to outside directors during 2007. These options were granted under the Stock Option Plan for Outside Directors which was previously approved by shareholders.

Name	Date of Grant	No. of Options Granted	Exercise Price	Market Price on Date of Grant	Expiry Date
M. Patty Chakour	April 27, 2007	10,000	\$4.77	\$4.77	April 28, 2012
D. Tony Stelliga	April 27, 2007	10,000	\$4.77	\$4.77	April 28, 2012
Douglas Balfour	June 7, 2007	10,000	\$4.41	\$4.41	June 6, 2012

C. Board Practices

During 2007, the members of our board of directors were David J. Gallagher, M. Patty Chakour, D. Tony Stelliga, Douglas Balfour (appointed June 7, 2007), Murray Bruce (appointed May 7, 2007 and resigned August 22, 2007) and Stanley E. McDougall (resigned May 4, 2007). 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 M. Patty Chakour, D. Tony Stelliga and Douglas Balfour.

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.

D. Employees

At December 31, 2007 we had 21 employees and persons engaged by contract on a fulltime basis, of whom 9 were in research, product development and technical support, 5 were in marketing and sales, 1 was in customer support and 6 were in administrative positions. One of these employees one was located in the United States, one was in the U.K., one was in Hong Kong 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 14, 2008.

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	470,050 ¹	5%
Joanna Varvos Corporate Secretary	126,000 ²	1%
Murray Bruce Controller	10,000 ³	*
M. Patty Chakour Director	30,000 ⁴	*
D. Tony Stelliga Director	30,000 ⁴	*
Douglas Balfour Director	10,000 ⁵	*

¹ Includes options to purchase 446,000 common shares.

² Options to purchase 126,000 common shares.

³ Issued pursuant to a share award. 6000 of these shares are subject to issuance upon vesting on each of June 30, September 30 and December 31, 2008.

⁴ Options to purchase 30,000 common shares.

⁵ Options to purchase 10,000 common shares.

* represents less than 1%

Options

The following tables show information as to options granted to directors and executive officers as of March 14, 2008.

<u>Name and Position</u>	<u>Options</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
David J. Gallagher President and CEO and Director	235,190 110,810 100,000	\$1.04 \$0.47 \$1.65	July 22, 2011 December 2, 2011 December 30, 2008
Joanna Varvos Corporate Secretary	25,467 50,533 50,000	\$1.04 \$0.47 \$2.05	July 22, 2011 December 2, 2011 April 1, 2009
M. Patty Chakour Director	10,000 10,000 10,000 ¹	\$3.57 \$5.02 \$4.77	June 29, 2010 May 1, 2011 April 28, 2012
D. Tony Stelliga Director	10,000 10,000 10,000 ¹	\$3.57 \$5.02 \$4.77	June 29, 2010 May 1, 2011 April 28, 2012
Douglas Balfour Director	10,000 ¹	\$4.41	June 6, 2012

¹ 2500 of these options are subject to vesting on April 27, 2008.

The board of directors or the compensation committee may in its discretion from time to time grant options and stock awards to officers, directors, key employees and persons or companies providing services for the Company. Pursuant to the NASDAQ Stock Market, all such grants made to officers, directors, employees and consultants require the approval of shareholders, unless the grants are made under an equity compensation plan that has been approved by shareholders.

In 2007 we established an equity compensation plan for officers, employees and consultants which reserved up to 750,000 shares for grant as awards consisting of stock awards and stock options ("2007 Plan"). The 2007 Plan was approved at the meeting of shareholders which took place on April 27, 2007. At the date of this report, 733,300 shares are issuable by way of stock awards and stock options under the 2007 Plan. Under our 2006 Stock Option Plan for Outside Directors, 100,000 options remain available for the grant to outside directors. Under our 2006 Employee Stock Option Plan 90,000 options remain available for grant to employees and consultants that are not officers or directors.

The board and the compensation committee administer our equity compensation plans. With respect to awards to employees who are not officers and to consultants, the compensation committee may appoint a committee consisting of one or more persons to determine, among other things, the persons to whom awards will be made, the time or times at which such awards will be granted, the types of awards to be granted and the number of shares subject to such awards, and the specific terms, conditions, performance criteria, restrictions and other provisions applicable to awards, including, but not limited to, the duration, vesting and exercise periods. In determining the size and vesting provisions of stock award and option grants, the factors considered are the individual's performance, achievement of objectives, responsibilities, base salary level, previous option and share award grants and the overall corporate performance of the Company.

The exercise price of an option will not be less than the fair market value per share on the date of grant. Options expire no later than the tenth anniversary of the date of grant to the extent they are not previously exercised or forfeited. Options may be exercised following termination of employment or contractual relationship with the Company, if for cause on the date of termination and if other than for cause for a period of thirty days (twelve months in the event of death or disability) following termination. The foregoing time periods may be extended by the plan administrator.

The 2007 Plan permits the Company to grant awards of shares to participants upon such terms (including vesting), as the plan administrator may determine.

If we declare a dividend payable in common shares, or we subdivide or consolidate our common shares or we are reorganized or merged with another corporation, the price and number of shares then subject to each stock award and option is to be adjusted so as to preserve the rights of the award recipient substantially proportionate to the rights of the award recipient prior to such event.

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 15, 2008, by each person or entity known to own beneficially 5% or more 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.

Name	Number of Common Shares Beneficially Owned¹	Percentage of Outstanding Common Shares²
KBW Partners	707,692 ³	7%
Fred Kayne ⁴	665,346 ⁵	7%
John C. and Deborah A. Prelaz	550,000 ⁶	5%
David Gallagher	470,050 ⁷	5%

¹ These shares do not carry voting rights different from the voting rights of our outstanding common shares.

² The percentage of outstanding common shares is based on 9,468,985 common shares outstanding as of March 15, 2008.

³ 307,692 shares are issuable upon conversion of the convertible loan and 400,000 shares are issuable upon the exercise of warrants. (See "Convertible Note" in Item 5. of this Annual Report.)

⁴ Mr. Kayne is a partner in KBW Partners.

⁵ These shares are disclosed in Schedule 13D filed on March 27, 2006.

⁶ These shares are disclosed in Schedule 13D filed on March 14, 2008.

⁷ Includes options to purchase 446,000 common shares.

At March 14, 2008 we had 9,468,985 common shares issued and outstanding. At such date, there were 365 shareholders of record in the United States who collectively held approximately 83% 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 2007 except for compensation of executive officers as employees or consultants. (See "Compensation" in Item 6. B of this Annual 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 2007.

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 2007 77% of our export sales were made to the United States, 22% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China, and a further 1% were made to other areas. In 2006 49% of our export sales were made to the United States, 50% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China. 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 5% 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 Annual 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 Capital Market.

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

<u>Fiscal Year</u>	<u>High</u>	<u>Low</u>
2007	6.09	2.03
2006	6.45	3.25
2005	8.47	2.15
2004	8.40	1.52
2003	2.65	1.01

The high and low market prices for each of the four quarters of 2007 and 2006:

<u>Quarter Ending</u>		<u>High</u>	<u>Low</u>
December	2007	3.90	2.03
September	2007	4.39	2.47

June	2007	5.21	3.50
March	2007	6.09	4.31
December	2006	5.47	4.28
September	2006	5.50	3.58
June	2006	6.45	3.65
March	2006	4.74	3.25

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

<u>Month</u>		<u>High</u>	<u>Low</u>
February	2008	2.29	1.75
January	2008	2.60	2.04
December	2007	2.71	2.04
November	2007	3.45	2.03
October	2007	3.90	3.10
September	2007	3.73	2.88

B. Plan of Distribution

Not Applicable

C. Markets

Our shares trade (since January, 1989) on The NASDAQ Capital 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 Annual Report there are 9,468,985 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. Electronic delivery is permitted. 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; (i) U.S. Holders who are U.S. expatriates or former long-term residents of the United States.; or (j) U.S. Holders that own (directly, indirectly, or by attribution) 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 before January 1, 2011, 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 eligible for the benefits of the Canada-U.S. Tax Convention, or (b) 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.

As discussed below, QSound does not believe that it was a "passive foreign investment Company" for the taxable year ended December 31, 2007, and does not expect that it will be a "passive foreign investment Company" for the taxable year ending December 31, 2008. (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, 2008, 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, 2008 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 unless the gain is subject to tax in Canada and resourced as "foreign source" under the U.S.-Canada Tax Convention and the U.S. Holder elects to treat such gain as "foreign source".

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. Dividends paid by QSound generally will constitute "foreign source" income and generally will be categorized as "passive income." 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.

In addition, if QSound is a PFIC and owns shares of another foreign corporation that also is a PFIC, under certain indirect ownership rules, a disposition of the shares of such other foreign corporation or a distribution received from such other foreign corporation generally will be treated as an indirect disposition by a U.S. Holder or an indirect distribution received by a U.S. Holder, subject to the rules of Section 1291 of the Code discussed below. To the extent that gain recognized on the actual disposition by a U.S. Holder of Common shares or income recognized by a U.S. Holder on an actual distribution received on Common Shares was previously subject to U.S. federal income tax under these indirect ownership rules, such amount generally should not be subject to U.S. federal income tax.

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, 2007, and, based on current operations and financial projections, does not expect that it will be a PFIC for the taxable year ending December 31, 2008. 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, 2008 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, the Regulations promulgated thereunder, the Canada-United States Income Tax Treaty Convention (1980) (the "1980 Convention") and our understanding of the current administrative practices published by the Canada Revenue Agency. This summary takes into account proposals to amend the Act, the Regulations and the 1980 Convention 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 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 designated 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, on the Canadian System for Electronic Document Analysis and Retrieval website www.sedar.com, and may be inspected and copied at the public reference facilities maintained by the SEC:

100 F Street, N.E.
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

The Company uses the U.S. dollar as the currency of measurement and display. The Company is exposed to foreign currency fluctuation on 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 overseas transactions are conducted in U.S. dollars.

The Company has not entered into any foreign currency contracts to hedge this risk.

Interest Rates

The Company's exposure to market risk includes changes in interest rates, which relates to both our invested balances of cash and cash equivalents, and convertible loan notes.

The Company invests excess funds in a manner that preserves capital, provides liquidity and generates the highest available after-tax return. To limit exposure to market risk, the Company places its cash in banks and cash not required for immediate operations is placed in bank term deposits. At December 31, 2007 this amounted to \$940,927 (2006: \$2,055,166). The fair value of QSound's cash and cash equivalents would not be significantly impacted by a decrease in interest rates. All cash and cash equivalents are carried at fair value, which approximates cost.

The Company's convertible loan notes are for the principal amount of \$1,000,000 and are repayable on March 27, 2011. The notes bear interest at US prime rate, based on the prime rate in effect on the last day of the immediately preceding calendar quarter, and is payable quarterly in arrears. The US prime rate at December 31, 2007 was 7.25%. The weighted average interest rate for the year ended December 31, 2007 was 7.88% (2006: 8.08%). The Company has exposure to interest rate fluctuations on its convertible loan notes but the Company would not be significantly impacted by an increase in interest rates.

The Company has not entered into any contracts to hedge its interest rate risk during 2007.

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

Disclosure Controls and Procedures

We conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) as of December 31, 2007. 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. Based on that evaluation we concluded that our disclosure controls and procedures were not effective due to the material weakness in our internal controls over financial reporting noted below.

Management's Report on Internal Control over Financial Reporting

QSound's management is responsible for establishing and maintaining a system of adequate internal controls over financial, or causing them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting procedures. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007 based on the criteria set forth in Internal Control Over Financial Reporting – Guidance for Smaller Public Companies issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment the Company has identified the following material weakness:

- Due to the limited number of accounting staff at QSound, it is not feasible to achieve complete segregation of duties.

This weakness could result in more than a remote likelihood that a material misstatement would not be prevented or detected.

This Annual Report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to such attestation pursuant to temporary SEC rules which permit the Company to provide only management's report in this Annual Report.

Changes in Internal Controls Over Financial Reporting

In order to address the above mentioned weakness management plans on further improving the review process undertaken by both the audit committee and board of directors. Management will review existing mitigating controls, and if appropriate implement changes to internal controls over financial reporting whereby more effective mitigating controls will be adopted.

Inherent Limitations of Disclosure Controls and Internal Control Over Financial Reporting

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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. 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

Grant Thornton, who acted as our accountants from April 29, 2005 to October 6, 2006, billed \$11,000 in 2007 and \$96,000 in 2006 for audit services and services related to statutory filings. KPMG, our external accountants prior to April 29, 2005 and after October 6, 2006, billed \$185,048 in 2007 and \$9,520 in 2006 for audit services and services related to statutory filings.

Audit-Related Fees, Tax Fees and All Other Fees

Grant Thornton and KPMG did not bill any audit-related, tax or other fees in 2007 or 2006.

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.
Report of Independent Registered Public Accounting Firm to the Shareholders.
Management's Report.

Consolidated Balance Sheets – December 31, 2007 and 2006.

Consolidated Statements of Operations and Deficit – Years ended December 31, 2007, 2006 and 2005.

Consolidated Cash Flows – Years ended December 31, 2007, 2006 and 2005.

Notes to Consolidated Financial Statements – Years ended December 31, 2007, 2006 and 2005.

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 KPMG Consent of Auditors.
- 14.2 Grant Thornton Consent of Auditors (Incorporated by reference to our Annual Report on Form 20-F filed March 23, 2007.)
- 15.1 Audit Committee Charter (Incorporated by reference to our Annual Report on Form 20-F filed March 21, 2005.)
- 15.2 Audit Committee Charter dated August 2, 2006 (Incorporated by reference to our Annual Report on Form 20-F filed March 23, 2007).
- 15.3 Audit Committee Charter dated August 8, 2007.

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 28, 2008

EXHIBITS INDEX

Exhibit No.	Description of Document
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Consolidated Financial Statements



KPMG LLP
Chartered Accountants
2700 205 - 5th Avenue SW
Calgary AB T2P 4B9

Telephone (403) 691-8000
Fax (403) 691-8008
Internet www.kpmg.ca

AUDITOR'S REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of QSound Labs, Inc. (the "Company") as of December 31, 2007 and 2006 and the consolidated statements of operations and deficit and cash flows for each of the years in the two year period ended December 31, 2007. 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 audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006 and the results of its operations and its cash flows for each of the years in the two year period ended December 31, 2007, in conformity with Canadian generally accepted accounting principles.

Canadian generally accepted accounting principles vary in certain significant respects from US generally accepted accounting principles. Information relating to the nature and effect of such differences is presented in Note 17 to the consolidated financial statements.

Chartered Accountants

Calgary, Canada
March 5, 2008

MANAGEMENT'S REPORT

The accompanying consolidated financial statements of QSound Labs Inc. and all of the information included in this report are the responsibility of management and have been approved by the Company's Board of Directors.

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects.

In discharging its responsibilities, management maintains and relies upon a system of internal controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that the Company's assets are properly accounted for and adequately safeguarded. Management has tested the effectiveness of internal controls.

Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee.

The Audit Committee of the Board of Directors, composed entirely of independent directors, meets regularly with management, as well as the external auditors, to discuss auditing, internal controls, accounting policy and financial reporting matters. The Committee reviews the financial statements with both management and the independent auditors and reports its finding to the Board of Directors before such statements are approved by the Board.

"signed"

David Gallagher
President, Chief Executive Officer
and Chief Financial Officer

Consolidated Balance sheets

December 31, 2007 and 2006
(Expressed in United States dollars)

	2007	2006
ASSETS		
<i>Current assets</i>		
Cash and cash equivalents	\$ 1,232,255	\$ 2,316,476
Accounts receivable (net) and accrued revenue	506,648	316,298
Note receivable	27,400	6,000
Inventory	12,217	19,422
Deposits and prepaid expenses	188,568	60,933
	1,967,088	2,719,129
Employee future benefits (note 11)	95,551	–
Note receivable	–	55,325
Property and equipment (note 3)	258,414	348,280
Deferred development costs (note 4)	235,350	313,800
Intangible assets (note 5)	70,260	98,351
	\$ 2,626,663	\$ 3,534,885
LIABILITIES AND SHAREHOLDERS' EQUITY		
<i>Current liabilities</i>		
Accounts payable and accrued liabilities	\$ 262,718	\$ 268,439
Deferred revenue	22,820	45,572
	285,538	314,011
Convertible notes (note 6)	446,140	389,862
<i>Shareholders' equity</i>		
Share capital (note 7)	47,473,681	47,208,942
Warrants (note 8)	1,027,114	1,027,114
Contributed surplus (note 9)	2,686,757	2,581,456
Deficit	(49,292,567)	(47,986,500)
	1,894,985	2,831,012
	\$ 2,626,663	\$ 3,534,885

See accompanying notes to consolidated financial statements.

Approved by the Board:

/s/ David Gallagher

David Gallagher
Director

/s/ Marian P. Chakour

M. Patty Chakour
Director

Consolidated Statements of Operations and Deficit

Years ended December 31, 2007, 2006 and 2005

(Expressed in United States dollars)

	2007	2006	2005
REVENUE			
Royalties, license and engineering fees	\$ 2,142,834	\$ 1,692,669	\$ 1,056,509
Product sales	236,305	296,361	486,731
	2,379,139	1,989,030	1,543,240
Cost of product sales	86,930	85,673	179,781
	2,292,209	1,903,357	1,363,459
EXPENSES			
Marketing	1,215,544	1,111,988	999,875
Operations	141,234	136,386	216,409
Product engineering	787,024	819,277	952,050
Administration	1,117,356	973,208	882,885
Foreign exchange loss	3,751	25,912	2,832
Amortization	226,509	331,419	360,898
Impairment of property and equipment (note 3)	—	167,809	89,754
Impairment of intangible assets	—	—	428,453
	3,491,418	3,565,999	3,933,156
Loss before other items	(1,199,209)	(1,662,642)	(2,569,697)
OTHER ITEMS			
Interest income	72,559	85,686	56,700
Interest on convertible notes	(81,240)	(61,336)	—
Accretion expense on convertible notes	(56,278)	(45,083)	—
Gain on sale of property and equipment	586	—	—
	(64,373)	(20,733)	56,700
Loss before taxes	(1,263,582)	(1,683,375)	(2,512,997)
Foreign withholding tax	(42,485)	(50,849)	(37,711)
Net loss	(1,306,067)	(1,734,224)	(2,550,708)
Deficit, beginning of year	(47,986,500)	(46,252,276)	(43,701,568)
Deficit, end of year	\$ (49,292,567)	\$ (47,986,500)	\$ (46,252,276)
Loss per common share (basic and diluted)	\$ (0.14)	\$ (0.19)	\$ (0.30)

See accompanying notes to consolidated financial statements

Consolidated Statements of Cash Flows

Years ended December 31, 2007, 2006 and 2005
(Expressed in United States dollars)

	2007	2006	2005
Cash provided by (used in):			
OPERATIONS			
Loss for the year	\$ (1,306,067)	\$ (1,734,224)	\$ (2,550,708)
Items not requiring (providing) cash:			
Amortization	226,509	331,419	360,898
Stock based compensation	213,541	380,614	134,793
Accretion expense on convertible notes	56,278	45,083	—
Employee future benefits	(95,551)	—	—
Gain on sale of property and equipment	(586)	—	—
Impairment of property and equipment	—	167,809	89,754
Impairment of intangible assets	—	—	428,453
Other	(2,076)	(4,021)	—
Changes in non-cash working capital balances (note 12)	(339,253)	104,669	(57,747)
	(1,247,205)	(708,651)	(1,594,557)
FINANCING			
Issuance of common shares, net	156,499	857,882	165,008
Proceeds on issuance of convertible notes	—	1,000,000	—
	156,499	1,857,882	165,008
INVESTMENTS			
Note receivable	36,000	26,442	(82,648)
Purchase of property and equipment	(18,243)	(42,426)	(188,890)
Deferred development costs	—	(39,500)	(352,750)
Purchase of intangible assets	(11,858)	—	(50,977)
Proceeds from sale of property and equipment	586	—	—
	6,485	(55,484)	(675,265)
Increase (decrease) in cash and cash equivalents	(1,084,221)	1,093,747	(2,104,814)
Cash and cash equivalents, beginning of year	2,316,476	1,222,729	3,327,543
Cash and cash equivalents, end of year	\$ 1,232,255	\$ 2,316,476	\$ 1,222,729
Cash on hand and balances with banks	\$ 291,328	\$ 261,310	\$ 32,842
Short term deposits with banks	\$ 940,927	\$ 2,055,166	\$ 1,189,887
Supplementary information (note 12)			

See accompanying notes to consolidated financial statements

Notes

to Consolidated Financial Statements

Years Ended December 31, 2007, 2006, and 2005
(Expressed in United States dollars)

1. Financial statement presentation:

The consolidated financial statements include the accounts of QSound Labs, Inc., a company organized under the laws of the Province of Alberta, and its subsidiaries (collectively "QSound" or the "Company") and are presented in accordance with Canadian generally accepted accounting principles. These accounting principles, in the case of the Company, conform in all material respects with those in the United States, except as outlined in note 17. All amounts are expressed in United States Dollars

QSound Labs, Inc. is an audio technology company which develops proprietary audio solutions, including virtual surround sound, positional audio and stereo enhancement for mobile devices, consumer electronics, PC/multimedia and Internet markets. Its subsidiaries QCommerce Inc. and QTelNet Inc. provide e-commerce solutions for small and medium sized businesses and Voice Over IP solutions respectively.

2. Significant accounting policies:

Measurement uncertainty:

The timely preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires that management make estimates and assumptions and use judgment regarding the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Such estimates primarily relate to unsettled transactions and events as of the date of the consolidated financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur. Amounts recorded for depreciation, valuation of convertible notes and income taxes (which are subject to re-assessment by tax authorities) and recoverability of deferred development costs are based on management estimates and assumptions.

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 has been received, and collection is reasonably assured. When software sales arrangements contain multiple elements, the Company allocates revenue to each element of accounting based on vendor specific objective evidence of fair value. In the absence of fair value for a delivered element, the Company allocates revenue to the undelivered items based on their fair value with the residual amount allocated to the delivered elements. Where the fair value of an undelivered element cannot be determined, the Company would defer revenue for the delivered elements until the undelivered elements are delivered.

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 other products. Revenue from other 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 has no further obligations relating to the product.

Cash and cash equivalents:

Cash and cash equivalents include short term deposits with initial maturities of three months or less at the date of acquisition. At December 31, 2007 cash and cash equivalents are classified as held for trading and carried at fair value.

Inventory:

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

Foreign currency translation:

The Company's functional currency is United States Dollars. The Company translates its foreign denominated monetary assets and liabilities at the exchange rate prevailing at the year end. Non-monetary assets, liabilities and depreciation are translated at historic rates. Revenues and expenses are translated at the average rate of exchange for the year and any resulting foreign exchange gains or losses are included in determination of net income or loss for the year.

Property and equipment:

Property and equipment is recorded at cost and is amortized 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 carrying value of property and equipment is assessed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

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 meet certain criteria and are expected to be fully recoverable, in which case these costs are deferred.

Amortization of deferred development costs commences with commercial production or use of the process at an annual rate of 20% over its estimated useful economic life.

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 present value of expected future cash flows and charged to period earnings.

Intangible assets:

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

Income taxes:

The Company uses the asset and 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 to be realized, a valuation allowance is provided.

Per share amounts:

Basic per share amounts are calculated using the weighted average number of common shares outstanding for the year. The Company applies the treasury stock method to calculate diluted per share amounts. The treasury stock method assumes that any proceeds from the exercise of in-the-money stock options and other dilutive instruments would be used to purchase common shares at the average market price during the period.

Stock based compensation:

Stock options: The fair value of each option granted is estimated on the date of grant using the Black Scholes option pricing model. This amount is credited to contributed surplus and expensed over the vesting period. Upon exercise of the options, the exercise proceeds together with amounts credited to contributed surplus are credited to share capital.

Share awards: The fair value of each award issued is calculated using the closing price on the date of grant.

Employee future benefits:

The costs of the defined benefit pension plan are determined using the projected benefit method prorated on service and management's best estimate of future salary levels, retirement ages of employees and other actuarial factors. For the purpose of calculating the expected return on plan assets, those assets are valued at a market related value. Actuarial gains (losses) arise from the difference between actual long-term rate of return on plan assets for a period and the expected long-term rate of return on plan assets for that period or from changes in actuarial assumptions used to determine the accrued benefit obligation. The excess of the net accumulated actuarial gain (loss) over 10 percent of the greater of the benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active employees. The cost of the Company's portion of the defined contribution plan is expensed as incurred.

Financial instruments:

Concentration of credit risk: Financial instruments that primarily subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, and accounts receivable. Cash and cash equivalents consist of deposits with, or guaranteed by, major commercial banks. With respect to accounts receivable, the Company performs credit evaluations of the financial condition of its licensees, and in certain instances, requires prepaid royalties from them. Management assesses the need for allowances for credit losses by considering the risk of specific customers and other available information.

At December 31, 2007, three entities represented 69% (2006: 66%) of accounts receivable. During 2007, five customers, within the Audio segment, contributed 71% of the total revenues, each providing greater than 10% of the total revenues. For 2006, three customers within the audio segment contributed 52% of the total revenues, each providing greater than 10% of the total revenues whilst in 2005 two customers within the audio segment contributed 23% of total revenues.

Interest rate risk: The Company is subject to interest rate risk on its cash and cash equivalents and convertible notes as each bears interest at floating rates.

Foreign currency risk: The Company is exposed to foreign currency fluctuations on its Canadian dollar denominated cash, receivables and payables. The Company has not, at December 31, 2007, entered into foreign currency derivatives to hedge its exposure to foreign exchange risk.

Changes in accounting policies:

Financial instruments: Effective January 1, 2007, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3855, Financial Instruments - Recognition and Measurement, retrospectively without restatement. This new section establishes standards for the recognition and measurement of all financial instruments, provides a characteristics-based definition of a derivative financial instrument, provides criteria to be used to determine when a financial instrument should be recognized, and provides criteria to be used when a financial instrument is to be extinguished. The adoption of this Handbook Section had no impact on opening deficit.

Under Section 3855, financial instruments must be classified into one of these five categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments, including derivatives, are initially measured in the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-

trading financial assets are measured at fair value and changes in fair value are recognized in net income; available for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

Upon adoption of these new standards, the Company designated its cash and cash equivalents as held-for-trading, which are measured at fair value. Accounts receivable and note receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities and convertible notes, are classified as other financial liabilities. The Company had neither available for sale, nor held-to-maturity instruments during the year ended December 31, 2007.

In addition, the Company adopted the new recommendations of CICA Handbook Section 1530, Comprehensive Income and Section 3251, Equity, retroactively without restatement. Section 1530 establishes standards for reporting and presenting comprehensive income, which is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles.

The Company had no "other comprehensive income" transactions during the year ended December 31, 2007, and no opening or closing balances for accumulated other comprehensive income or loss.

Accounting changes: Effective January 1, 2007, the Company adopted revised CICA Handbook Section 1506, Accounting changes. The amendments in the revised standard indicate that voluntary changes in accounting policy are only permitted if they result in financial statements that provide more reliable and relevant information. When a change in accounting policy is made, this change is applied retrospectively unless impractical. Changes in accounting estimates are generally applied prospectively and material prior period errors are corrected retrospectively. This section outlines additional disclosure requirements when accounting changes are applied including justification for voluntary changes, complete description of the policy, primary source of GAAP and detailed effect on financial statement line items.

3. Property and equipment:

2007	Cost	Accumulated amortization	Net book value
Sound source and control equipment	\$ 553,715	\$ 545,408	\$ 8,307
Real time systems	905,534	903,486	2,048
Furniture and fixtures	230,853	214,924	15,929
Computer equipment	1,147,938	965,322	182,616
Software and production tooling	1,632,281	1,582,767	49,514
	\$ 4,470,321	\$ 4,211,907	\$ 258,414

2006	Cost	Accumulated amortization	Net book value
Sound source and control equipment	\$ 550,664	\$ 536,591	\$ 14,073
Real time systems	905,534	902,608	2,926
Furniture and fixtures	230,853	211,714	19,139
Computer equipment	1,132,745	891,337	241,408
Software and production tooling	1,632,281	1,561,547	70,734
	\$ 4,452,077	\$ 4,103,797	\$ 348,280

In accordance with the Company's accounting policy, an analysis of property and equipment was completed in 2006 on the telephony assets, as changes in this market indicated that the carrying amount may not be recoverable. Included in accumulated amortization above are asset impairment charges of \$167,809 (2005: \$89,754) relating to software and production tooling. During 2007 there were no events or changes in circumstances that indicated that the carrying value of the remaining assets would not be recoverable.

4. Deferred development costs:

		2007		2006
Software development costs	\$	844,064	\$	844,064
Accumulated amortization		608,714		530,264
Net book value	\$	235,350	\$	313,800

In 2007, amortization of \$78,450 (2006: \$78,450; 2005: \$64,974) was recorded and included in amortization expense.

5. Intangible assets:

		2007		2006
Patents and trademarks	\$	939,669	\$	927,811
Accumulated amortization		869,409		829,460
Net book value	\$	70,260	\$	98,351

6. Convertible notes:

On March 27, 2006 the Company issued \$1,000,000 in convertible notes and 400,000 related share purchase warrants. The notes are due in five years and bear interest at the US prime rate payable quarterly in arrears.

The notes are convertible at the option of the holders at any time and from time to time into common stock of the Company at a conversion price of \$3.25 per share. Additionally, in the event that the Company issues securities convertible into common stock at a price less than this conversion price, the conversion price shall be immediately adjusted to the price at which such securities were issued.

The warrants issued are each exercisable into one common share at an exercise price of \$4.50 per share until March 27, 2011.

The warrants also provide for an adjustment to the exercise price in the event that the Company issues securities convertible into shares at a price less than the then applicable exercise price, in which case the exercise price shall be reduced to the same exercise price as that of the convertible securities subsequently issued.

The convertible notes were bifurcated into an equity component and a liability component, which together with the warrants were fair valued on initial recognition, with the total cash proceeds being allocated to the components on a pro-rata basis using the calculated fair values. As these notes are classified as other financial liabilities and measured at amortized cost, the difference between the \$1,000,000 due on maturity and the initial liability component will be accreted over the term of five years. The accretion amount expensed and added to the convertible notes liability was \$56,278 (2006: \$45,083).

		2007		2006
Fair value of loan	\$	785,980		802,283
Face value of loan	\$	1,000,000		1,000,000
Accretion expense to be recognized in future periods		553,860		610,138
Carrying value of loan	\$	446,140		389,862

7. 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, 2004	8,404,085	\$ 45,792,526
Issued upon exercise of options	257,900	222,521
Share issue costs	–	(35,992)
Balance December 31, 2005	8,661,985	45,979,055
Issued upon exercise of options	213,600	508,155
Issued upon exercise of warrants	500,000	737,450
Share issue costs	–	(15,718)
Balance December 31, 2006	9,375,585	47,208,942
Issued upon exercise of options	76,700	243,375
Share awards issued	10,700	31,345
Share issue costs	–	(9,981)
Balance December 31, 2007	9,462,985	\$ 47,473,681

8. Warrants:

	Number of Warrants	Consideration
Balance December 31, 2004	1,235,869	\$ 1,502,331
Expired	(521,739)	(598,593)
Balance December 31, 2005	714,130	903,738
Exercised	(500,000)	(217,450)
Issued	400,000	340,826
Balance December 31, 2006 and 2007	614,130	\$ 1,027,114

Each warrant outstanding at December 31, 2007 is exercisable into one common share of the Company as follows:

Warrants Outstanding and Exercisable	Exercise Price	Remaining Term (years)
75,000	\$ 7.77	2.0
139,130	9.12	2.0
400,000	4.50	3.2
614,130	\$ 5.95	2.8

9. Contributed surplus:

Balance December 31, 2004	\$	1,329,136
Stock - based compensation		134,793
Options exercised		(21,521)
Expired warrants		598,593
Balance December 31, 2005		2,041,001
Stock - based compensation		380,614
Options exercised		(154,555)
Value of equity component of convertible notes		314,396
Balance December 31, 2006		2,581,456
Stock - based compensation		182,196
Options exercised		(76,895)
Balance December 31, 2007	\$	2,686,757

10. Stock option plan:

On April 27, 2007 at the Company's Annual and Special Meeting, the Equity Compensation Plan for officers, employees and consultants of the Company was approved. There are 750,000 common shares reserved for issuance, either via Stock Awards or Stock Options, under this plan.

Stock options awarded expire no later than 10 years after date of grant; have an exercise price not less than Fair Market Value on date of grant; and will vest either evenly over a service period or on achievement of performance objectives.

(a) In 2007, the Company awarded 10,700 vested shares with a weighted average grant-date fair value of \$2.93 to various employees. A non cash expense of \$31,345 (2006: \$Nil; 2005: \$Nil) was charged to earnings in respect of these awards.

(b) A summary of the Company's outstanding stock options at December 31, 2007, 2006 and 2005 and changes during those years is presented below

	Number of Shares		Weighted average exercise price
Balance December 31, 2004	1,157,500	\$	0.87
Granted	180,933		2.59
Exercised	(257,900)		0.78
Cancelled or expired	(53,000)		4.56
Balance December 31, 2005	1,027,533		1.48
Granted	170,000		4.69
Exercised	(213,600)		1.66
Cancelled or expired	(2,233)		2.40
Balance December 31, 2006	981,700		1.99
Granted	30,000		4.65
Exercised	(76,700)		2.17
Cancelled or expired	(76,500)		4.57
Balance December 31, 2007	858,500	\$	1.84

All stock options granted have expiry dates between 2008 and 2015. Of the stock options granted in 2007, 15,000 stock options vested in 2007 and 15,000 stock options vest in 2008. The table below summarizes unexercised stock options:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price	
\$ 0.47 to 1.65	531,500	3.2	\$ 0.99	531,500	\$ 0.99	
2.05 to 2.40	188,500	4.43	2.24	98,500	2.09	
3.50 to 3.57	35,000	1.46	3.54	35,000	3.54	
3.57 to 5.33	103,500	3.69	4.89	71,000	4.90	
	858,500	3.43	\$ 1.84	736,000	\$ 1.63	

In 2007, a non cash expense of \$182,196 (2006: \$380,614; 2005: \$134,793) was recorded reflecting the fair value of employee and directors stock options granted and vesting during the year. Of the \$182,196 expense, \$16,100 related to modification of 100,000 existing stock options. These fully vested stock options had their expiry date extended through to 2008.

The fair value of the options granted during 2007, 2006 and 2005 is estimated on the day of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2007	2006	2005
Risk free interest rate	4.79%	4.8%	4.5%
Volatility	45.47%	64%	66%
Expected life	2 years	2 years	3.4 years
Dividend yield	0%	0%	0%
Forfeitures	0%	10%	28%

11. Employee future benefits:

(a) The defined benefit pension plan for the President

The Company established an individual pension plan for the President in 2003. The Company's policy is to make annual contributions as determined by regular actuarial valuations, up to the date of retirement. Contributions to the plan are expected to return an average of 7.5% per annum between each triennial valuation. If a funding deficiency exists at the valuation date the Company will be responsible for any shortfall. The next actuarial evaluation occurs on January 1, 2009.

Details of this plan are as follows:

	2007	2006
Fair value of plan assets	\$ 430,112	\$ 352,507
Accrued benefit obligation	(435,191)	(322,372)
Funded Status – (deficit) surplus	(5,079)	30,135
Unamortized net actuarial loss / (gain)	35,910	(12,465)
Unamortized past service costs	64,720	–
Accrued benefit asset	\$ 95,551	\$ 17,670

At December 31, 2007 an accrued benefit asset has been recognized in the financial statements as it is now considered significant. The economic assumptions used to determine benefit obligation and periodic expense were:

	2007	2006	2005
Discount rate	5.5%	5.5%	5.5%
Expected rate of return on assets	7.5%	7.5%	7.5%
Rate of compensation increase	5.5%	5.5%	5.5%
Average remaining service period of covered employee	10	11	12

Pension expense, included in marketing expense, is as follows:

	2007	2006	2005
Current service cost	\$ 23,832	\$ 21,001	\$ 18,551
Interest on accrued benefit obligation	20,536	24,329	20,743
Expected return on plan assets	(29,560)	(24,079)	(19,734)
Amortization of past service costs	6,633	—	—
Recognition of accrued benefit asset	(93,232)	—	—
Pension expense	\$ (71,791)	\$ 21,251	\$ 19,560

The Company expects to contribute \$27,778 to the plan in 2008.

(b) The defined contribution savings plan for Canadian employees

In 2007, the Company established a new defined contribution savings plan for its Canadian employees, whereby the Company matches employee contributions to a maximum of six percent of each employee's salary. In 2007, the Company contributed \$18,748 to this plan.

12. Supplementary information:

(a) Per share amounts

The following table summarizes the common shares used in per share calculations

	2007	2006	2005
Weighted average common shares outstanding (basic and diluted)	9,420,808	9,156,085	8,497,201

(b) Net change in non-cash working capital

	2007	2006	2005
Accounts receivable	\$ (190,350)	\$ 85,226	\$ (190,557)
Inventory	7,205	21,016	122,130
Deposits and prepaid expenses	(127,635)	15,213	(14,708)
Accounts payable and accrued liabilities	(5,721)	(17,347)	40,122
Deferred revenue	(22,752)	561	(14,734)
	\$ (339,253)	\$ 104,669	\$ (57,747)

(c) Supplementary cash flow information

Interest received in cash	\$ 80,377	\$ 75,291	\$ 55,981
Interest paid in cash	\$ 103,294	\$ 19,747	\$ —
Taxes paid in cash	\$ 47,612	\$ 50,849	\$ 37,711

13. 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 loss for the year. The reasons for the differences are as follows:

	2007	2006	2005
Loss before taxes	\$ (1,263,582)	\$ (1,683,375)	\$ (2,512,997)
Combined Canadian Federal and Provincial statutory rate	32.12%	32.49%	33.62%
Computed tax (recovery)	(405,863)	(546,926)	(844,870)
Increase (decrease) resulting from:			
Change in valuation allowance	934,000	(968,000)	172,000
Reduction of unrealized future tax assets for enacted changes in income tax rates	1,211,415	561,386	34,467
Benefit of tax deductions not previously recognized	(1,110,237)	–	–
Stock based compensation	68,589	140,307	45,317
Reduction due to expired Canadian tax losses	32	296,148	424,220
Reduction due to expired US tax losses	–	876,607	514,500
Impact of strengthening exchange rate	(680,642)	(322,557)	(321,878)
Other permanent differences	25,191	13,884	13,955
Actual expense	\$ 42,485	\$ 50,849	\$ 37,711

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

	Canada	United States	2007	2006
Future income tax assets:				
Property and equipment	\$ 1,465,000	\$ (7,000)	\$ 1,458,000	\$ 1,436,000
Share issue costs	17,000	–	17,000	27,000
Loss and SRED carry-forwards	3,964,000	2,845,000	6,809,000	5,839,000
Intangible assets	160,000	66,000	226,000	250,000
	5,606,000	2,904,000	8,510,000	7,552,000
Future income tax liability:				
Employee future benefits	(24,000)	–	(24,000)	–
Less: valuation allowance	(5,582,000)	(2,904,000)	(8,486,000)	(7,552,000)
Net future tax assets	\$ –	\$ –	\$ –	\$ –

The Company has Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards of \$9,294,773 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
2008	\$ 101	\$ 776,287
2009	–	373,177
2010	1,683,952	412,789
2011	–	107,980
2012	–	59,918
2014	1,392,878	–
2015	1,589,969	–
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	–	241,877
2026	885,981	92,041
2027	1,015,994	76,038
	\$ 6,568,875	\$ 8,128,286

14. Segmented information:

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

2007	Audio	E-Commerce	Telephony	Total
Revenue	\$ 2,241,735	\$ 133,905	\$ 3,499	\$ 2,379,139
Amortization	197,095	15,296	14,118	226,509
Loss before other items	(1,071,197)	(91,740)	(36,272)	(1,199,209)
Interest income	71,007	21	1,531	72,559
Segment assets	2,468,178	118,913	39,572	2,626,663
Expenditures for property and equipment	18,243	–	–	18,243
Expenditures for intangible assets	11,858	–	–	11,858

2006	Audio	E-Commerce	Telephony	Total
Revenue	\$ 1,799,395	\$ 158,269	\$ 31,366	\$ 1,989,030
Amortization	217,004	28,554	85,861	331,419
Impairment of property and equipment	–	–	167,809	167,809
Loss before other items	(1,261,852)	(97,991)	(302,799)	(1,662,642)
Interest income	81,329	19	4,338	85,686
Segment assets	3,294,716	75,977	164,192	3,534,885
Expenditures for property and equipment	42,111	315	–	42,426

2005	Audio	E-Commerce	Telephony	Total
Revenue	\$ 1,304,832	\$ 182,940	\$ 55,468	\$ 1,543,240
Amortization	211,464	27,045	122,389	360,898
Impairment of property and equipment	1,362	–	88,392	89,754
Impairment of intangible assets	–	–	428,453	428,453
Loss before other items	(1,281,926)	(234,456)	(1,053,315)	(2,569,697)
Interest income	54,470	12	2,218	56,700
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

Geographic information	2007 Revenue	2006 Revenue	2005 Revenue
Canada	\$ 147,983	\$ 13,769	\$ 10,472
United States	1,702,006	980,709	966,980
Asia	504,400	985,836	489,625
Europe	19,150	–	49,026
Other	5,600	8,716	27,137
	\$ 2,379,139	\$ 1,989,030	\$ 1,543,240

As at December 31, 2007, 2006 and 2005, substantially all of the Company’s assets and employees were located in Canada.

15. Commitments and contingencies:

Under the terms of its lease agreements for office space and equipment, the Company is obligated at December 31, 2007 to make the following minimum lease payments over the next five years and in total:

2008	\$	97,744
2009		17,183
2010		10,023
2011		—
2012		—
	\$	124,950

Minimum lease payments of \$121,308 (2006: \$98,872; 2005: \$92,756) are included in the calculation of the loss for the year.

16. Comparative figures:

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.

17. United States accounting principles:

The consolidated 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) From 2003 through 2005, the Company accounted for its stock based awards in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation", which required the use of a fair value-based method of accounting for stock-based compensation plans. 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.
- (b) The Company has applied SFAS 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" in accounting for its production costs of software. Accordingly, \$80,871 was expensed to product engineering until May 17, 2005 when technological feasibility was established. Costs subsequent to this date were capitalized as they related to the production of 'product masters'. In 2006 amortization of these costs commenced on a straight line basis over the remaining estimated useful economic life of the product which is 5 years. Resultant from \$80,871 of the costs being expensed rather than capitalized during 2005, the amortization recorded for 2007 is \$20,218 lower under US GAAP.
- (c) The Company has also determined that the conversion feature of the convertible notes meet the embedded derivative scope exemption requirements of SFAS 133. As such, the conversion option has not been separated under US GAAP. However, the Company has separated the beneficial conversion feature associated with the conversion price being less than the market price at the transaction date. The Company determined that the intrinsic value of the beneficial conversion feature was \$586,978, which reduced the initial carrying value of the notes to \$72,196, for US GAAP purposes, with a corresponding entry made to equity. As a result, additional accretion expense is recognized for US GAAP purposes.
- (d) The Company has applied SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Retirement Plans" effective January 1, 2006. Under SFAS 158, the Company is required to recognize its funded status as an asset or liability. Accordingly, the accrued benefit asset recognized for Canadian GAAP purposes would not be recognized under US GAAP, as the funded status deficit is required to be recognized in the Balance Sheet, with the unamortized past service costs and actuarial loss / gain recognized within Accumulated Other Comprehensive Income.

The effect on the net loss for each of the years in the three year period ended December 31, 2007 of the differences between Canadian and United States generally accepted accounting principles is summarized as follows:

Years ended December 31,	2007	2006	2005
Net loss for the year as reported in accordance with Canadian GAAP	\$ (1,306,067)	\$ (1,734,224)	\$ (2,550,708)
Development expense (b)	–	–	(80,871)
Amortization of deferred development costs (b)	20,218	20,218	–
Accretion of debt discount (c)	23,007	32,331	–
Net loss under US GAAP	\$ (1,262,842)	\$ (1,681,675)	\$ (2,631,579)
Net loss per share (basic and diluted) under US GAAP	\$ (0.13)	\$ (0.18)	\$ (0.31)

The effect on the other comprehensive loss for each of the years in the three year period ended December 31, 2007 of the differences between Canadian and United States generally accepted accounting principles is summarized as follows:

Years ended December 31,	2007	2006	2005
Other comprehensive loss for the year as reported in accordance with Canadian GAAP	\$ –	\$ –	\$ –
Employee future benefits	(100,630)	–	–
Other comprehensive loss under US GAAP	\$ (100,630)	\$ –	\$ –

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

December 31, 2007	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	\$ 1,967,088	\$ –	\$ 1,967,088
Employee Future Benefits	95,551	(95,551)	–
Property and equipment	258,414	–	258,414
Deferred development costs	235,350	(40,435)	194,915
Intangible assets	70,260	–	70,260
	\$ 2,626,663	\$ (135,986)	\$ 2,490,677
Current liabilities	\$ 285,538	\$ –	\$ 285,538
Liability for pension benefits	–	5,079	5,079
Convertible notes	446,140	(327,920)	118,220
Shareholder's equity:			
Common shares	47,473,681	202,058	47,675,739
Warrants	1,027,114	–	1,027,114
Contributed Surplus	2,686,757	272,582	2,959,339
Deficit	(49,292,567)	(187,155)	(49,479,722)
Accumulated Other Comprehensive Loss	–	(100,630)	(100,630)
	\$ 2,626,663	\$ (135,986)	\$ 2,490,677

December 31, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	\$ 2,719,129	\$ –	\$ 2,719,129
Note receivable	55,325	–	55,325
Property and equipment	348,280	–	348,280
Deferred development costs	313,800	(60,653)	253,147
Intangible assets	98,351	–	98,351
	\$ 3,534,885	\$ (60,653)	\$ 3,474,232
Current liabilities	\$ 314,011	\$ –	\$ 314,011
Convertible notes	389,862	(304,913)	84,949
Shareholder's equity:			
Common shares	47,208,942	202,058	47,411,000
Warrants	1,027,114	–	1,027,114
Contributed Surplus	2,581,456	272,582	2,854,038
Deficit	(47,986,500)	(230,380)	(48,216,880)
	\$ 3,534,885	\$ (60,653)	\$ 3,474,232

CERTIFICATION

I, David J. Gallagher, Chief Executive Officer of QSound Labs, Inc. certify that:

1. I have reviewed this annual report on Form 20-F for 2007 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)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) 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 Executive Officer

March 28, 2008

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 2007 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)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) 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 28, 2008

**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, 2007 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 28, 2008

**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, Chief Financial 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, 2007 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
Chief Financial Officer

March 28, 2008



KPMG LLP
Chartered Accountants
2700-205 5 Avenue SW
Calgary AB T2P 4B9

Telephone (403) 691-8000
Fax (403) 691-8008
Internet www.kpmg.ca

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. 333-117165 and 333-133714) and on Form F-3 (333-133290) of QSound Labs, Inc. of our report dated March 5, 2008, with respect to the consolidated balance sheets of QSound Labs, Inc. as of December 31, 2007 and 2006, and the consolidated statements of operations and deficit and cash flows for each of the years in the two year period ended December 31, 2007, which report appears in the December 31, 2007, annual report on Form 20-F of QSound Labs, Inc.

KPMG LLP

Chartered Accountants

Calgary, Canada
March 27, 2008

QSOUND LABS, INC.
AUDIT COMMITTEE CHARTER

Purpose

The Audit Committee (“Committee”) is appointed by the Board of Directors. The Committee’s primary functions and responsibilities are to:

- Fulfill the Committee’s oversight responsibility with respect to the Company’s accounting and reporting processes and the audits of the financial statements.
- Monitor the integrity of the Company’s financial reporting process and system of internal control over financial reporting and accounting compliance.
- Monitor the Company’s compliance with applicable legal and regulatory requirements affecting financial reporting.
- Be directly responsible for overseeing the work of the external auditor which includes monitoring their independence and performance.
- Provide an avenue for effective communication among the audit committee, external auditor, management and the Board of Directors.

In order to fulfill these functions and responsibilities the Committee has the authority to conduct any appropriate investigation, has direct access to the external auditor and employees of the Company. The Committee has the authority to retain, at the Company’s expense, special legal, accounting, or other consultants or experts it deems necessary in the performance of its duties.

Organization

- The Committee will consist of not less than three members appointed by the board.
- Each Committee member must be independent of management of the Company and free of any relationship that, in the opinion of the Board, would interfere with their exercise of independent judgment as a committee member. All members of the Committee must also qualify as independent under all relevant Canadian securities, SEC and Nasdaq Stock Market rules and regulations.
- Each Committee member must be financially literate. Financially literate means being able to read and understand fundamental financial statements, including the Company’s balance sheet, income statement and cash flow statement.
- At least one member of the Committee will have a background in financial reporting, accounting or auditing which results in the member’s financial sophistication.
- The Board will appoint one of the members of the Committee as Chairperson.

Meetings

Meetings of the Committee will be held at least quarterly, corresponding with the Company’s financial reporting cycle, and at such other times as required by the Committee Chairperson, or by a majority of the members of the Committee.

The Committee Chairperson will prepare an agenda, in consultation with management, other committee members and the external auditors, in advance of each meeting. The agenda, together with supporting materials, will be circulated sufficiently in advance of the meeting to allow members an appropriate period of time to prepare for the meeting.

The Committee will invite the Chief Executive Officer, Chief Financial Officer, internal legal counsel, Controller, the external auditor, and such other persons whose attendance is appropriate to the matters under consideration, to attend each Committee meeting.

During each Committee meeting, if appropriate, an “*in camera session*” will be held to discuss privately any matters of interest or concern to the members.

Key responsibilities and duties

The Committee shall be responsible for the following specific matters:

1. Accounting policies:

- Review the Company’s critical accounting policies and all major issues regarding accounting principles and financial statement presentations.
- Review major changes to the Company’s accounting policies and practices.
- Review and consider with the external auditor critical accounting policies and practices, alternate treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the Company, ramifications of the use of such alternative disclosure, the treatment preferred by the external auditor and all other material written communications between the external auditor and the management of the Company.
- Review with the external auditor and management the extent to which changes or improvements in financial or accounting practices, as previously reported, have been implemented.

2. Financial reporting process and financial statements:

- Review and discuss with management and the external auditor the Company’s quarterly and annual financial statements, MD&A, Annual Report on Form 20-F and annual and interim press releases before they are publicly disclosed by the Company and recommend their approval by the board of directors.
- Periodically review the Company’s procedures for public disclosure of financial information extracted or derived from the Company’s financial statements.
- On an ongoing basis review all related party transactions for potential conflicts of interest, material off balance sheet transactions and contingent liabilities.
- Inquire as to the integrity of the Company’s financial reporting processes (internal and external), and any major issues regarding the adequacy of internal control.
- Review significant accounting and reporting issues, which shall include complex or unusual transactions and highly judgmental areas.

- Review any recent professional and regulatory pronouncements and establish their impact on the financial statements.
- Review liquidity, capital resources issues.
- Discuss with the external auditors matters that generally accepted auditing standards in Canada require to be communicated with the Committee. This shall include: auditors responsibility; weaknesses in internal control; fraud, illegal acts and related party transactions; significant accounting principles and policies; management judgments and accounting estimates; significant audit adjustments; significant unadjusted audit differences; disagreement with management; consultation with other accountants by management; major issues discussed with management that influence audit appointment; and difficulties encountered in performing the audit.
- Following completion of the annual audit and interim reviews, review with the external auditor and management any audit problems, significant issues, concerns or difficulties that arose that have been subsequently resolved together with those that remain unresolved. This shall include key accounting and audit judgments, misstatements identified and explanations for those misstatements that remain unadjusted.
- Oversee the resolution of disagreements between management and the external auditor regarding financial reporting.
- Discuss with the external auditor the quality and acceptability of the Company's accounting principles.

3. External auditor

- The external auditor will report directly to the Committee.
- Be responsible for the selection, appointment, compensation, retention, termination and oversight of the Company's external auditor, and recommend to the board the nomination of the external auditor for approval by the shareholders.
- Approve in advance, in accordance with the Company's Pre-Approval Policy as may be amended from time to time, any non-audit service that the external auditor renders to the Company. This includes establishing which non audit services the external auditor is prohibited from providing.
- Prior to commencement of the annual audit review with the external auditor the proposed audit plan and scope of work.
- Consider, assess and report to the board the independence and performance of the external auditor. Review and discuss with the external auditor the written report that the external auditor is required to deliver to the Committee regarding the external auditor's independence, discuss with the external auditor its independence, and take appropriate action in response to the external auditor's report concerning independence.
- Review and approve the Company's hiring policies regarding partners, employees and former partners and employees of the Company's present and former external auditors.

4. Internal controls and risk management

- Receive and review the interim and annual CEO and CFO certifications filed with securities regulatory authorities.
- Review with management and the external auditor the effectiveness of the Company's internal controls to ensure the Company is in compliance with legal and regulatory regulations and the Company's policies.
- Discuss with management and the external auditor the design, implementation and effectiveness of the Company's internal controls over financial reporting, and the significant financial risk exposures facing the Company and the steps management has taken to monitor and control such exposures.

5. Legal compliance

- Review with the Company's counsel any legal matters that could have a significant impact upon the Company's financial statements, the Company's compliance with applicable laws and regulations, and any inquiries received from regulators or government agencies.

6. Additional responsibilities

- At least annually, review and reassess this Charter and, if appropriate, recommend changes to the Board.
- Provide minutes of Committee meetings to the Board, and report to the Board on any significant matters arising from the Committee's work.
- Establish a procedure for receipt, retention and treatment of any complaints received by the Company about its accounting, internal accounting controls or auditing matters and for the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters
- Review and monitor, as appropriate, unless already being reviewed by the Board, any compliance programs and corrective actions regarding any deficiencies noted by auditors or examiners as well as significant findings of any examination by regulatory authorities or agencies and corrective actions regarding any deficiencies noted in regulatory examinations.
- Conduct or authorize such inquiries into matters within the Committee's scope of responsibility as the Committee deems appropriate.

Board Authority

By adopting this Charter, the Board delegates to the Committee full and exclusive authority to:

- Perform each of the responsibilities of the Committee described above.
- Appoint a Chairman of the Committee.
- Engage outside counsel and other advisers as the Committee determines necessary to carry out its responsibilities.

- Cause the officers of the Company to provide such funding as the Committee will determine to be appropriate for payment of compensation to the Company's external auditor and any legal counsel or other advisers engaged by the Committee.
- Obtain advice and assistance from internal legal or other advisors.
- Approve the Company's interim financial statements and interim MD&A.

Effective August 8, 2007