
Smartphone
QSOUND
QSoundLabs
SecondQuarter2006

Management's Discussion and Analysis

Three and six month periods ended June 30, 2006

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the three and six month periods ended June 30, 2006 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarter ended March 31, 2006, and the annual audited financial statements of the company for the fiscal year ended December 31, 2005. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2005 and the quarter ended March 31, 2006.

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

Operations

Below we provide information on the significant line items in our statement of operations for the three and six month periods ended June 30, 2006 and 2005, as well as analysis of the changes period to period.

		Q2 2006		YTD 2006		Q2 2005		YTD 2005
Royalties and license fees revenues	$	364,054	$	956,711	$	253,856	$	591,504
Product sales revenues								
Audio segment	$	18,408	$	47,509	$	84,830	$	157,658
E-Commerce segment		40,319		83,121		48,189		100,833
Telephony segment		7,387		16,537		14,169		27,793
Total	$	66,114	$	147,167	$	147,188	$	286,284

The increase in royalties and license fees revenues are attributable to revenues realized from our MicroQ product. Along with the licensing fee revenue received from design wins, we receive royalties as the related products are shipped. Our legacy licenses however continue to decline and we expect them to decline further through the remainder of 2006.

The audio segment experienced a decrease in product sales of 78% in Q2 2006 from Q2 2005 primarily due to a decline in integrated circuit chip sales. As the integrated circuit chips are of an analog design, we expect these sales to continue to decline as digital technology expands as the leading design in the market place.

		Q2 2006		YTD 2006		Q2 2005		YTD 2005
Marketing expenses	$	226,420	$	427,985	$	267,325	$	498,299
Operating expenses	$	33,933	$	69,810	$	54,416	$	97,646

We have concentrated our efforts primarily on the mobile device market for the past four years. As a result, we have cut back on expenditures in the telephony and e-commerce segments of our business. Expenses in the Audio segment for Q2, 2006 have remained consistent with Q2, 2005.

	Q2 2006	YTD 2006	Q2 2005	YTD 2005
Product engineering expenses	$ 217,198	$ 432,830	$ 257,349	$ 484,374

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

	Q2 2006	YTD 2006	Q2 2005	YTD 2005
Administration and foreign exchange	$ 221,756	$ 453,413	$ 189,561	$ 384,133

The difference between 2006 and 2005 can be directly attributable to two factors, foreign exchange and stock based compensation cost. The decrease in value of the United States dollar against the Canadian dollar has increased our expenses as the majority of administrative expenses are incurred in Canadian Dollars. A larger amount of compensation cost of options issued to directors and employees was incurred in Q2 2006 than in Q2 2005.

Financial Condition
The company had a working capital surplus of $2,933,673 at June 30, 2006 as compared to $1,492,688 as at December 31, 2005.

Cash resources at the end of the second quarter of 2006 were $2,464,122 as compared to $1,222,729 at December 31, 2005. Current liabilities at the end of the second quarter of 2006 were $239,669, which consisted of $201,265 in accounts payable and accrued liabilities and $38,404 in deferred revenue. Current liabilities at December 31, 2005 were $330,797 which consisted of $285,786 in accounts payable and accrued liabilities and $45,011 in deferred revenue. Management feels that with our current cash on hand and cash flows from operations the company has sufficient capital to carry out its business plan for the remainder of 2006.

Capital Expenditures
The company continues to take steps to ensure that its technology is current and up to date. To facilitate that goal and ongoing research and development, as well as protecting its technology through the registration of trademarks and patents, the company invested $16,969 in the quarter in new computer equipment and software, trademarks and patents. In addition the company invested and capitalized $16,420 in software and production tooling in the development of our new IP Telephony product.

Consolidated
Balance sheets
As at June 30, 2006 and December 31, 2005
(Expressed in United States dollars)

	June 30, 2006	December 31, 2005
	(unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,464,122	$ 1,222,729
Accounts receivable	526,508	401,524
Note receivable (note 2)	6,000	82,648
Inventory	49,892	40,438
Deposits and prepaid expenses	126,820	76,146
	3,173,342	1,823,485
Note receivable (note 2)	53,165	–
Property and equipment (note 3)	512,255	670,635
Deferred development costs (note 4)	313,938	352,750
Other intangible assets (note 5)	150,013	155,445
	$ 4,202,713	$ 3,002,315

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 201,265	$ 285,786
Deferred revenue	38,404	45,011
	239,669	330,797
Convertible debt (net) (note 6)	586,566	–
	826,235	330,797
Shareholders' equity		
Share capital (note 7)	47,040,909	45,979,055
Warrants	1,720,489	1,502,331
Contributed surplus (note 8)	1,459,178	1,442,408
Deficit	(46,844,098)	(46,252,276)
	3,376,478	2,671,518
	$ 4,202,713	$ 3,002,315

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Operations and Deficit

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

	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
REVENUE				
Royalties, licenses, and engineering fees	$ 364,054	$ 253,856	$ 956,771	$ 591,504
Product sales	66,114	147,188	147,167	286,284
	430,168	401,044	1,103,938	877,788
Cost of product sales	(3,251)	20,884	4,823	67,690
	433,419	380,160	1,099,115	810,098
EXPENSES				
Marketing	226,420	267,325	427,985	498,299
Operations	33,933	54,416	69,810	97,646
Product engineering	217,198	257,349	432,830	484,374
Administration	221,536	194,101	444,506	386,702
Foreign exchange loss (gain)	220	(4,540)	8,907	(2,569)
Amortization	98,634	104,529	282,140	206,213
	797,941	873,180	1,666,178	1,670,665
Loss before other items	(364,522)	(493,020)	(567,063)	(860,567)

OTHER ITEMS				
Interest income	24,614	17,566	32,276	29,019
Interest on convertible debt	(19,322)	–	(19,747)	–
Amortization of debt discount	(21,631)	–	(22,174)	–
Other	(1,637)	(38)	(1,637)	(3,206)
	(17,976)	17,528	(11,282)	25,813
Loss before taxes	(382,498)	(475,492)	(578,345)	(834,754)
Foreign withholding tax	(9,142)	(5,668)	(13,477)	(21,553)
Net loss for period	(391,640)	(481,160)	(591,822)	(856,307)
Deficit, beginning of period	(46,452,458)	(44,076,715)	(46,252,276)	(43,701,568)
Deficit, end of period	$ (46,844,098)	$ (44,557,875)	$ (46,844,098)	$ (44,557,875)
Loss per common share (basic and diluted) note 10	$ (0.04)	$ (0.06)	$ (0.07)	$ (0.10)

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Cash Flows

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

	For the three months ended June 30, 2006 (unaudited)	For the three months ended June 30, 2005 (unaudited)	For the six months ended June 30, 2006 (unaudited)	For the six months ended June 30, 2005 (unaudited)
Cash provided by (used in)				
OPERATIONS				
Loss for the period	$ (391,640)	$ (481,160)	$ (591,822)	$ (856,307)
Items not requiring (providing) cash:				
Amortization	98,634	104,529	282,140	206,213
Stock based compensation	51,231	47,691	123,212	69,728
Amortization of debt discount	21,631	–	22,174	–
Changes in non-cash working capital balances (note 11)	377,392	(278,400)	(276,240)	(528,303)
	157,248	(607,340)	(440,536)	(1,108,669)
FINANCING				
Issuance of common shares, net	91,547	21,190	737,963	39,049
Proceeds from convertible debt	–	–	1,000,000	–
	91,547	21,190	1,737,963	39,049

INVESTMENTS								
Note receivable		25,061		–		23,483		–
Purchase of property and equipment		(14,588)		(49,587)		(24,011)		(132,241)
Purchase of deferred development costs		(16,420)		–		(39,500)		–
Purchase of other intangible assets		(2,381)		(6,963)		(16,006)		(21,853)
		(8,328)		(56,550)		(56,034)		(154,094)
Increase (decrease) in cash and cash equivalents		240,467		(642,700)		1,241,393		(1,223,714)
Cash and cash equivalents, beginning of period		2,223,655		2,746,529		1,222,729		3,327,543
Cash and cash equivalents, end of period	$	2,464,122	$	2,103,829	$	2,464,122	$	2,103,829

See accompanying notes to consolidated financial statements

Notes
to Consolidated Financial Statements
For the Periods Ended June 30, 2006 and 2005
Unaudited
(Expressed in United States dollars under Canadian GAAP)

1. Basis of presentation

These consolidated financial statements include the accounts of QSound Labs, Inc. a public company organized under the laws of the Province of Alberta, Canada and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated.

The statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles for interim financial statements. These financial statements follow the same accounting policies and methods of applications as the most recent annual financial statements dated December 31, 2005. These interim financial statements should be read in conjunction with the Company's December 31, 2005 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

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

2. Note receivable

Note receivable	$	59,165
Less current portion due in 2007		6,000
Long term portion due in 2008	$	53,165

3. Property and equipment:

June 30, 2006	Cost	Accumulated amortization	Net book value
Sound source and control equipment	$ 550,664	$ 534,121	$ 16,543
Real time systems	905,534	901,981	3,553
Furniture and fixtures	230,668	213,619	17,049
Computer equipment	1,114,515	849,046	265,469
Software and production tooling	1,632,281	1,422,640	209,641
	$ 4,433,662	$ 3,921,407	$ 512,255

4. Deferred development costs:

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

5. Other intangible assets

June 30, 2006	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 944,913	$ 798,342	$ 146,571
Purchased customer list	34,418	30,976	3,442
Licensing rights	428,453	428,453	–
	$ 1,407,784	$ 1,257,771	$ 150,013

6. Convertible debt:

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

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

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

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

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

The amount of $435,608 contributed to the warrants was calculated taking the total cash proceeds of the convertible loan on a pro-rata basis with the fair value of the warrants and the face value of the convertible loan. The fair value of the warrants issued was calculated using the Black-Scholes pricing model using the assumptions stated below:

Risk free interest rate	5.5%
Volatility	71%
Life of the warrant	3 Years
Dividend yield	0%

The amount allocated as debt discount will be amortized over 5 years and charged to income.

Face value of loan	$	1,000,000
Unamortized debt discount		413,434
	$	586,566

7. Share capital

	Number of shares	Consideration
Balance March 31, 2006	9,229,785	$ 46,904,751
Issued for cash on exercise of options	71,300	107,265
Reclassification from contributed surplus on exercise of stock options	–	44,611
Financing costs	–	(15,718)
Balance June 30, 2006	9,301,085	$ 47,040,909

8. Contributed surplus

Balance March 31, 2006	$ 1,452,558
Increase due to stock based compensation	51,231
Decrease due to stock options exercised	(44,611)
Balance June 30, 2006	$ 1,459,178

9. Stock option plan

During the three month period ended June 30, 2006, the Company granted 30,000 options (2005 – 30,000) to directors and 50,000 options (2005 – nil) to employees with exercise prices at or greater than the market price of the Company's stock on the date of grant. For the three month period ended June 30, 2006 $13,102 (2005 – nil) of compensation cost related to options granted to directors has been recognized, and $38,129 (2005 – $47,691) of compensation cost related to options granted to employees has been recognized. For the six month period ended June 30, 2006 $ 80,728 (2005 – nil) of compensation cost related to options granted to directors has been recognized, and $42,484 (2005 – $69,728) of compensation cost related to options granted to employees has been recognized. In 2005 an additional $18,822 has been recognized as compensation costs related to options issued to non-employees. The compensation costs related to options issued to non-employees has been capitalized to software and production tooling.

No compensation cost was recorded in the Company's statement of operations and deficit for options granted in 2002 to employees, directors and officers. Had compensation cost for stock options granted in 2002 been determined based on the fair value method, the Company's pro-forma net loss for the three months ended June 30, 2005 would have been increased by $9,417 to $490,577. The net loss for the six months ended June 30, 2005 would have been increased by $18,835 to $875,142.

	Number of shares	Exercise price per share	Weighted average exercise price
Balance March 31, 2006	924,733	$ 0.47 – 4.56	$ 1.45
Granted	80,000	$ 4.20 – 5.02	4.51
Exercised	(71,300)	$ 1.04 – 2.40	1.68
Balance June 30, 2006	933,433	$ 0.47 – 5.02	$ 1.71

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

	Options Outstanding			Options Exercisable	
Range of Exercise prices	Number Outstanding at June 30, 2006	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at June 30, 2006	Weighted-Average Exercise Price
$ 0.47 – 1.65	583,500	2.8	$ 0.95	583,500	$ 0.95
2.05 – 2.40	219,933	5.7	2.24	117,700	2.11
3.50 – 3.57	45,000	3.2	3.55	45,000	3.55
4.20 – 5.02	85,000	3.5	4.51	11,000	4.36
	933,433	3.6	$ 1.71	757,200	$ 1.34

10. Loss per share

Basic loss per share	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
Net loss	$ (391,640)	$ (481,160)	$ (591,822)	$ (856,307)
Weighted average number of shares outstanding	8,771,595	8,448,744	8,978,779	8,435,336
Loss per share	$ (0.04)	$ (0.06)	$ (0.07)	$ (0.10)

Diluted loss per share	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
Net loss	$ (391,640)	$ (481,160)	$ (591,822)	$ (856,307)
Weighted average number of shares outstanding	8,771,595	8,448,744	8,978,779	8,435,336
Weighted average number of stock options potentially exercisable	605,979	735,054	578,269	809,544
Weighted number of warrants potentially exercisable	24,801	369,924	–	401,294
Weighted average number of diluted shares outstanding	9,402,375	9,553,722	9,557,048	9,646,174
Diluted loss per share	$ (0.04)	$ (0.06)	$ (0.07)	$ (0.10)

In calculating the weighted average number of diluted shares for the three month periods ended June 30 above, the Company excluded nil (2005 – 5,000) stock options and 214,130 (2005 – 735,869) warrants because the exercise price was greater than the average market price for the period. For the six month periods ended June 30 above, 5,000 (2005 – nil) stock options and 614,130 (2005 – 735,869) warrants were excluded because the exercise price was greater than the average market price for the period.

11. Supplementary cash flow information

Changes in non-cash working capital balances	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
Accounts receivable	$ 386,425	$ (212,776)	$ (124,984)	$ (464,486)
Inventory	(12,640)	11,371	(9,454)	52,927
Deposits and prepaid expenses	(14,416)	10,977	(50,674)	(63,064)
Accounts payable and accrued liabilities	20,102	(67,412)	(84,521)	(42,071)
Deferred revenue	(2,079)	(20,560)	(6,607)	(11,609)
	$ 377,392	$ (278,400)	$ (276,240)	$ (528,303)
Interest received in cash	$ 17,585	$ 13,440	$ 26,062	$ 26,806
Withholding taxes paid in cash	$ 9,142	$ 5,668	$ 13,477	$ 21,553

12. Segmented information

For the three month period ended June 30, 2006	Audio	E-Commerce	Telephony	Total
Revenues	$ 382,462	$ 40,319	$ 7,387	$ 430,168
Interest revenue	23,623	–	991	24,614
Amortization	28,079	7,137	63,418	98,634
Segment loss before other items	(267,384)	(22,147)	(74,991)	(364,522)
Segment assets	3,800,931	109,317	292,465	4,202,713
Expenditures for segment property and equipment	14,588	–	–	14,588
Expenditures for segment other intangible assets	2,381	–	–	2,381

For the three month period ended June 30, 2005	**Audio**	**E-Commerce**	**Telephony**	**Total**
Revenues	$ 338,686	$ 48,189	$ 14,169	$ 401,044
Interest revenue	17,072	–	494	17,566
Amortization	55,037	6,760	42,732	104,529
Segment loss before other items	(202,495)	(46,822)	(243,703)	(493,020)
Segment assets	3,320,140	92,002	1,014,482	4,426,624
Expenditures for segment property and equipment	17,608	17,460	14,519	49,587
Expenditures for segment other intangible assets	6,963	–	–	6,963

For the six month period ended June 30, 2006	**Audio**	**E-Commerce**	**Telephony**	**Total**
Revenues	$ 1,004,280	$ 83,121	$ 16,537	$ 1,103,938
Interest revenue	30,369	–	1,907	32,276
Amortization	141,031	14,274	126,835	282,140
Segment loss before other items	(376,617)	(39,825)	(150,621)	(567,063)
Expenditures for segment property and equipment	23,695	316	–	24,011
Expenditures for segment other intangible assets	16,006	–	–	16,006

For the six month period ended June 30, 2005	**Audio**	**E-Commerce**	**Telephony**	**Total**
Revenues	$ 749,162	$ 100,833	$ 27,793	$ 877,788
Interest revenue	28,094	–	925	29,019
Amortization	107,229	13,520	85,464	206,213
Segment loss before other items	(299,324)	(81,572)	(479,671)	(860,567)
Expenditures for segment property and equipment	67,377	17,716	47,148	132,241
Expenditures for segment other intangible assets	21,853	–	–	21,853

12. Segmented information (continued)

Geographic Information	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
Canada	$ 8,336	$ 5,543	$ 10,847	$ 6,232
United States	144,050	204,293	323,844	530,760
Asia	272,382	185,978	761,347	301,540
Europe	–	–	–	34,026
Other	5,400	5,230	7,900	5,230
	$ 430,168	$ 401,044	$ 1,103,938	$ 877,788

13. Reconciliation to United States accounting principles:

	For the three months ended June 30, 2006	For the three months ended June 30, 2005	For the six months ended June 30, 2006	For the six months ended June 30, 2005
Net loss for the period as reported in accordance with Canadian GAAP	$ (391,640)	$ (481,160)	$ (591,822)	$ (856,307)
Amortization of deferred development costs	–	–	20,218	–
Amortization of debt discount	21,631	–	22,174	–
Change in fair value of convertible debt conversion feature	19,717	–	19,717	–
Excess fair value of convertible debt at transaction date	–	–	(224,633)	–
Net loss under US GAAP	$ (350,292)	$ (481,160)	$ (754,346)	$ (856,307)
Loss per share (basic and diluted) under US GAAP	$ (0.04)	$ (0.06)	$ (0.08)	$ (0.10)

June 30, 2006	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,173,342	$ –	$ 3,173,342
Note receivable	53,165	–	53,165
Property and equipment	512,255		512,255
Deferred development costs	313,938	(60,653)	253,285
Intangible assets	150,013	–	150,013
	$ 4,202,713	$ (60,653)	$ 4,142,060
Current liabilities	$ 239,669	$ –	$ 239,669
Convertible debt	586,566	182,742	769,308
Shareholders' equity:			
Share capital	47,040,909	202,058	47,242,967
Warrants	1,720,489	–	1,720,489
Contributed surplus	1,459,178		1,459,178
Deficit	(46,844,098)	(445,453)	(47,289,551)
	$ 4,202,713	$ (60,653)	$ 4,142,060

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