QSoundLabs

2005 Third Quarter Report

Management's Discussion and Analysis

Three and nine month periods ended September 30, 2005

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the three and nine month periods ended September 30, 2005 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarters ended March 31 and June 30, 2005, and the annual audited financial statements of the company for the fiscal year ended December 31, 2004. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2004 and the quarters ended March 31and June 30, 2005.

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

Operations

Below we provide information on the significant line items in our statement of operations for the three and nine month periods ended September 30, 2005 and 2004, as well as analysis of the changes period to period.

	Q3 2005	YTD 2005	Q3 2004	YTD 2004
Royalties and license fees revenues	$ 167,087	$ 758,591	$ 383,773	$ 977,794
Product sales revenues				
Audio segment	$ 37,264	$ 194,922	$ 122,199	$ 411,645
E-Commerce segment	44,724	145,557	59,027	193,782
Telephony segment	13,362	41,155	35,278	135,742
Total	$ 95,350	$ 381,634	$ 216,504	$ 741,169

In the past three years, the company has focused primarily on the mobile device market and as a result "non-mobile" revenue in 2005 has declined 58% when compared to 2004. Revenue from the mobile device market has not grown fast enough to replenish this loss, hence the overall decline in revenues in 2005. For the year, 44% of our audio business segment revenues have resulted from licensees in the mobile device market. The majority of this revenue, 91%, has been in the form of one-off engineering fees and upfront license payments. Recurring royalty revenue to date from mobile device licensees has been minimal and has been derived entirely from Smartphone design wins. Moving forward, through our semiconductor licensees, we expect to expand into higher volume feature and value phone segments and accordingly see growth in this recurring revenue base.

The second area of investment for the company has been the development of new solutions for the VoIP market. The first of these, a software solution targeted at entertainment devices, is now available and management expects to see revenues within the next few months. A second hardware project has been terminated and this resulted in the write-down incurred during this quarter.

		Q3 2005		YTD 2005		Q3 2004		YTD 2004
Marketing expenses	$	256,592	$	754,891	$	245,400	$	982,889
Operating expenses	$	53,305	$	150,951	$	50,065	$	171,725

We experienced an increase in marketing and operating expenses in 2003 when we established our IP Telephony business unit. We cut back on these expenditures in March 2004 and again in January 2005 so as to bring them more into line with revenues being generated from the IP Telephony business unit. This is reflected in the decreased marketing and operating expenses in 2005.

		Q3 2005		YTD 2005		Q3 2004		YTD 2004
Product engineering expenses	$	226,433	$	710,807	$	228,211	$	698,798

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. The audio segment has seen a general increase in staff, 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.

		Q3 2005		YTD 2005		Q3 2004		YTD 2004
Administration and foreign exchange	$	236,714	$	620,847	$	201,422	$	630,226

The difference between 2005 and 2004 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 Q1 2004 than in Q1 2005.

Financial Condition
The company had a working capital surplus of $1,910,133 at September 30, 2005 as compared to $3,457,107 as at December 31, 2004.

Cash resources at the end of the third quarter of 2005 were $1,657,236 as compared to $3,327,543 at December 31, 2004. Liabilities at the end of the third quarter of 2005 were $333,111, which consisted of $278,921 in accounts payable and accrued liabilities and $54,190 in deferred revenue. Liabilities at December 31, 2004 were $305,409 which consisted of $245,664 in accounts payable and accrued liabilities and $59,745 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 2005.

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 $323,021 in the quarter in new computer equipment and software, trademarks and patents.

The Management's Discussion and Analysis contains forward-looking statements as defined in the U.S. federal securities laws. Our actual results or industry results could differ materially from those in the forward-looking statements. Investors are advised to read the risks and uncertainties set out under "Risk Factor" in our Annual Report on Form 20-F filed with the Securities and Exchange Commission. Forward-looking statements are based on the current expectations and opinions of QSound's management.

Consolidated

Balance sheets

As at September 30, 2005 and December 31, 2004
(Expressed in United States dollars)

	September 30, 2005	December 31, 2004
	(unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 1,657,236	$ 3,327,543
Accounts receivable	444,009	210,967
Inventory	59,499	162,568
Deposits and prepaid expenses	82,500	61,438
	2,243,244	3,762,516
Capital assets (note 2)	949,403	1,302,598
Other intangible assets (note 3)	157,753	162,720
	$ 3,350,400	$ 5,227,834
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 278,921	$ 245,664
Deferred revenue	54,190	59,745
	333,111	305,409
Shareholders' equity		
Share capital (note 4)	45,859,378	45,792,526
Warrants	1,502,331	1,502,331
Contributed surplus	1,432,633	1,329,136
Deficit	(45,777,053)	(43,701,568)
	3,017,289	4,922,425
	$ 3,350,400	$ 5,227,834

See accompanying notes to consolidated financial statements.

Consolidated
Statements of Operations and Deficit
For the periods ended September 30, 2005 and 2004
(Expressed in United States dollars)

	For the three months ended September 30, 2005 (unaudited)	For the three months ended September 30, 2004 (unaudited)	For the nine months ended September 30, 2005 (unaudited)	For the nine months ended September 30, 2004 (unaudited)
REVENUE				
Royalties and license fees	$ 167,087	$ 383,773	$ 758,591	$ 977,794
Product sales	95,350	216,504	381,634	741,169
	262,437	600,277	1,140,225	1,718,963
Cost of product sales	14,605	93,320	82,295	380,677
	247,832	506,957	1,057,930	1,338,286
EXPENSES				
Marketing	256,592	245,400	754,891	982,889
Operations	53,305	50,065	150,951	171,725
Product engineering	226,433	228,211	710,807	698,798
Administration	230,812	198,315	617,514	627,207
Foreign exchange loss (gain)	5,902	3,107	3,333	3,019
Depreciation and amortization	71,080	101,433	277,293	311,085
	844,124	826,531	2,514,789	2,794,723
Operating loss	(596,292)	(319,574)	(1,456,859)	(1,456,437)
OTHER ITEMS				
Interest and other income	11,939	2,843	40,958	7,068
Loss on sale of capital assets	–	(13,236)	–	(13,236)
Other	(634,825)	(6,887)	(659,584)	(15,334)
	(622,886)	(17,280)	(618,626)	(21,502)
Net loss for period	(1,219,178)	(336,854)	(2,075,485)	(1,477,939)
Deficit, beginning of period	(44,557,875)	(42,916,707)	(43,701,568)	(41,775,622)
Deficit, end of period	$ (45,777,053)	$ (43,253,561)	$ (45,777,053)	$ (43,253,561)
Loss per common share	$ (0.14)	$ (0.04)	$ (0.25)	$ (0.20)

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Cash Flows

For the periods ended September 30, 2005 and 2004
(Expressed in United States dollars)

	For the three months ended September 30, 2005 (unaudited)	For the three months ended September 30, 2004 (unaudited)	For the nine months ended September 30, 2005 (unaudited)	For the nine months ended September 30, 2004 (unaudited)
Cash provided by (used in)				
OPERATIONS				
Loss for the period	$ (1,219,178)	$ (336,854)	$ (2,075,485)	$ (1,477,939)
Items not requiring cash:				
Depreciation and amortization	71,080	101,433	277,293	311,085
Compensation cost of options issued	28,086	44,230	97,814	262,233
Loss on sale of capital assets	–	13,236	–	13,236
Impairment of assets	556,332	–	556,332	–
Changes in working capital balances (note 6)	122,567	116,132	(405,736)	(181,876)
	(441,113)	(61,823)	(1,549,782)	(1,073,261)
FINANCING				
Issuance of common shares, net	14,664	68,099	53,713	1,022,775
	14,664	68,099	53,713	1,022,775
INVESTMENTS				
Purchase of capital assets	(3,191)	(227,704)	(135,432)	(468,792)
Purchase of intangible assets	(16,953)	(29,597)	(38,806)	(39,261)
Proceeds from sale of capital assets	–	140	–	192
	(20,144)	(257,161)	(174,238)	(507,861)
Decrease in cash and cash equivalents	(446,593)	(250,885)	(1,670,307)	(558,347)
Cash and cash equivalents, beginning of period	2,103,829	1,753,631	3,327,543	2,061,093
Cash and cash equivalents, end of period	$ 1,657,236	$ 1,502,746	$ 1,657,236	$ 1,502,746

See accompanying notes to consolidated financial statements

Notes
to Consolidated Financial Statements
For the Three Month Period Ended September 30, 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, 2004. These interim financial statements should be read in conjunction with the Company's December 31, 2004 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

2. Capital assets

September 30, 2005	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 545,463	$ 528,269	$ 17,194
Real time systems	905,534	900,906	4,628
Furniture and fixtures	230,668	214,970	15,698
Computer equipment	1,089,488	793,252	296,236
Software and production tooling	2,210,202	1,594,555	615,647
	$ 4,981,355	$ 4,031,952	$ 949,403

3. Other intangible assets

September 30, 2005		Cost		Accumulated amortization		Net book value
Patents and trademarks	$	916,736	$	767,587	$	149,149
Purchased customer list		34,418		25,814		8,604
	$	951,154	$	793,401	$	157,753

4. Share capital

	Number of shares		Consideration
Balance at June 30, 2005	8,467,585	$	45,847,445
Issued for cash on exercise of options	20,400		13,220
Financing costs	–		1,444
Additional paid-in capital stock options	–		(2,731)
Balance September 30, 2005	8,487,985	$	45,859,378

5. Stock option plan

For the three month period ended September 30, 2005 $64,769 of compensation cost related to options granted to employees has been recognized. For the nine month period ended September 30, 2005 $82,922 of compensation cost related to options granted to employees has been recognized.

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 September 30, 2005 would have been increased by $3,147 to $1,147,075. The net loss for the nine months ended September 30, 2005 would have been increased by $21,982 to $2,022,217.

	Number of shares	Exercise price per share	Weighted average exercise price
Balance at June 30, 2005	1,124,000	$ 0.47 – 4.56	$ 1.35
Cancelled	(103,000)	$ 2.05 – 4.56	3.34
Exercised	(20,400)	$ 0.62 – 2.05	0.65
Balance at September 30, 2005	1,000,600	$ 0.47 – 4.56	$ 1.16

The following table summarizes the information about stock options outstanding at September 30, 2005

	Options Outstanding			Options Exercisable	
Range of Exercise prices	Number Outstanding at September 30, 2005	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at September 30, 2005	Weighted-Average Exercise Price
$ 0.47 – 0.62	389,307	2.1	$ 0.54	389,307	$ 0.54
1.04 – 1.75	413,693	1.2	1.21	413,693	1.21
1.88 – 2.05	162,600	2.9	2.00	162,600	2.00
3.57 – 4.56	35,000	4.6	3.71	5,000	4.56
	1,000,600	2.0	$ 1.16	970,600	$ 1.09

6. Changes in non-cash working capital balances

	For the three months ended September 30, 2005	For the three months ended September 30, 2004	For the nine months ended September 30, 2005	For the nine months ended September 30, 2004
Accounts receivable	$ 16,944	$ 17,650	$ (447,542)	$ (228,272)
Inventory	6,098	(7,557)	59,025	7,721
Deposits and prepaid expenses	18,143	23,848	(44,921)	7,082
Accounts payable and accrued liabilities	75,328	80,244	33,257	(4,020)
Deferred revenue	6,054	1,947	(5,555)	35,613
	$ 122,567	$ 116,132	$ (405,736)	$ (181,876)

7. Segmented information

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

For the three month period ended September 30, 2004				
Revenues	$ 505,972	$ 59,027	$ 35,278	$ 600,277
Interest revenue	2,819	1	23	2,843
Amortization of capital assets	34,248	7,059	42,732	84,039
Segment operating loss	(89,572)	(30,377)	(199,625)	(319,574)
Segment assets	2,482,411	109,171	1,061,278	3,652,860
Expenditures for segment capital assets	39,132	–	207,381	246,513

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

For the nine month period ended September 30, 2004				
Revenues	$ 1,389,439	$ 193,782	$ 135,742	$ 1,718,963
Interest revenue	6,973	1	94	7,068
Amortization of capital assets	109,530	21,179	128,196	258,905
Segment operating loss	(443,875)	(84,486)	(924,076)	(1,456,437)
Expenditures for segment capital assets	89,366	–	417,044	506,410

Geographic Information	For the three months ended September 30, 2005	For the three months ended September 30, 2004	For the nine months ended September 30, 2005	For the nine months ended September 30, 2004
Canada	$ 4,240	$ 62,175	$ 10,472	$ 70,822
United States	190,514	224,721	721,274	982,038
Asia	64,668	281,754	366,208	567,809
Europe	–	5,477	34,026	72,144
Other	3,015	26,150	8,245	26,150
	$ 262,437	$ 600,277	$ 1,140,225	$ 1,718,963

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