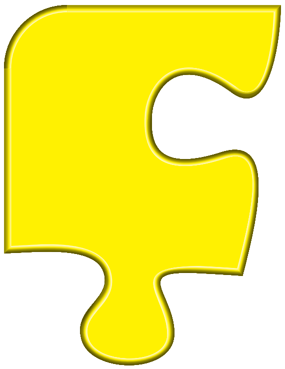
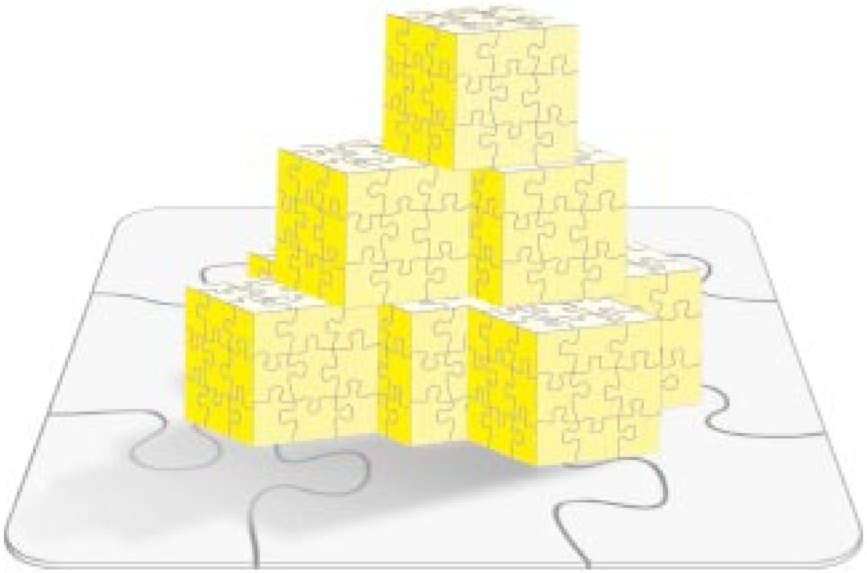




Piecing together the picture of our future.

corporate profile

QSound Labs, Inc. has continued to maintain its leadership role in the 3D audio industry through successful marketing of its QSound™ technology in 1995. The company has placed itself in the enviable position of providing a 3D audio solution for every major market that recognizes a need for either stereo enhancement or specific sound placement technology, from the professional recording, home video game, PC/multimedia, and consumer electronics industries to the hearing aid industry.

QSound Labs' intellectual property includes:

- "Q1" speaker based sound placement technology
- "QXpander" stereo enhancement technology as either an analog chip or software implementation
- "Q2" technology for enhanced stereo headphone sound reproduction
- Wavetable sound library and algorithms
- Binaural hearing aid algorithms

As consumer demand for improved audio increases, QSound Labs will continue to capitalize on its strong intellectual property base for the future.

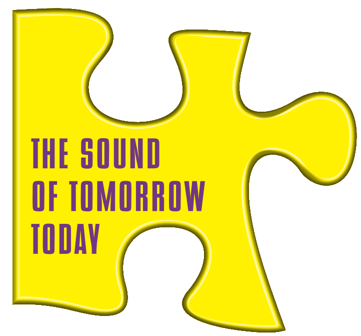
Our commitment to quality can be measured by the widespread acceptance of QSound Labs' technology, and our marketing efforts have resulted in the adoption of QSound by such industry leading manufacturers and software developers as Acer, Activision, Electronic Arts, IBM, Intel, Mitsumi, NEC, Sega, Sony Interactive, Yamaha, and many more.

Our research and development team, located at the corporate head office in Calgary, Canada, continues to bring new products to market every year. A total of 30 skilled and dedicated people around the world are responsible for bringing QSound Labs' 3D audio solutions from our laboratory to the ears of the world.

corporate information

QSound Labs, Inc., officers

DAVID GALLAGHER	PRESIDENT & CHIEF EXECUTIVE OFFICER
JAMES P. REID	VICE-PRESIDENT, SALES
JAMES BONFIGLIO	SENIOR VICE-PRESIDENT, CORPORATE BUSINESS DEVELOPMENT
JOANNA VARVOS	CORPORATE SECRETARY



directors

DAN LOWE	CHAIRMAN
DAVID GALLAGHER	DIRECTOR
JAMES BONFIGLIO	DIRECTOR
GEORGE FOLSEY, JR.	DIRECTOR

QKidz Inc., officers

JEFFREY W. MCCARTHY	CHIEF EXECUTIVE OFFICER
JON GILL	CHIEF OPERATING OFFICER
FRANK KING	VICE PRESIDENT, MARKETING & PRODUCT DEVELOPMENT
JOANNA VARVOS	CORPORATE SECRETARY

stock exchange listings/ stock symbols

The Toronto Stock Exchange: QSL

NASDAQ Small Cap Market: QSNDF

patent counsel

Cooper & Durham
1185 Avenue of the Americas
New York, New York 10036

bankers

The Royal Bank of Canada
3439 - 26th Avenue N.E.
Calgary, Alberta T1Y 6L4

Bank of America
275 South Valencia Avenue
Brea, California 92621

auditors

KPMG Peat Marwick Thorne
Suite 1200,
Bow Valley Square II
205 - 5th Avenue S.W.
Calgary, Alberta T2P 4B9

registrar and transfer agent

Montreal Trust
#600, 530 - 8th Avenue S.W.
Calgary, Alberta T2P 3S8

corporate head office

QSound Labs, Inc.
2748 - 37th Avenue N.E.
Calgary, Alberta T1Y 5L3
Tel: (403) 291-2492
Fax: (403) 250-1521

NOTICE OF MEETING:
The annual meeting of shareholders will be held in the Kathryn Stinson Room of the Chateau Airport Hotel, Calgary, Alberta, on June 28, 1996 at 10: 00 AM.

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

11. UNITED STATES ACCOUNTING POLICIES (CONTINUED)

The effect of the differences between Canadian and United States accounting principles and differences in reporting standards for cash flow would be to restate the cash flows from operating, financing and investing activities as follows:

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993	1995	1994	1993
Operating activities	$ (3,939,100)	$ (1,400,676)	$ (2,530,310)
Financing activities	6,678,836	1,443,066	3,449,225
Investing activities	(286,731)	(85,962)	27,074

Not included in the above cash flows are non-cash transactions as follows:

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993	1995	1994	1993
Issuance of common shares on conversion of debt	$ 2,719,873	$ —	$ 4,129,190
Settlement of debt with common shares	2,719,873	—	4,129,190
Common shares approved, not issued	—	2,870,000	—
Settlement of class action suit liabilities with common shares	—	2,870,000	—
Issuance of common shares for professional services rendered	435,258	—	—
Settlement of accounts payable with common shares	435,258	—	—

Supplemental information regarding cash flows is as follows:

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993	1995	1994	1993
Interest paid	$ 287,430	$ 429,444	$ 556,660
Income and withholding taxes paid	97,594	71,748	256,195

12. SEGMENTED INFORMATION:

Management has determined that the Company operates in one dominant industry segment which involves the developing and marketing of sound localization technology for use in the electronics and entertainment industries. Substantially all of the Company's operations, assets and employees are located in Canada. Substantially all of the Company's revenues are derived from export sales.

message from the president

We are encouraged by the growing number and value of licensing agreements signed with major manufacturers and software publishers around the world. 1995 saw revenues consistent with 1994, even though royalty revenues from the arcade industry declined significantly. Revenue levels were maintained by the company's efforts to diversify its revenue base by marketing to all major 3D audio industries.

QSound Labs will continue to build on its already strong foundation and increase its revenue stream through the coming years. We are confident that we will maintain our status as the revenue leader in this newly born industry.

Our success in marketing QSound technology in the past year was characterized by significant milestones in the video home entertainment and personal computer industry:

- Licensing agreements with Acer America and IBM provided the consumer with Q-enhanced multimedia computers by the end of 1995.
- Yamaha, NEC, and Crystal Semiconductor agreements will produce audio chipsets for the PC/multimedia industry during the second quarter of 1996.
- Major publishers and developers such as Activision, Electronic Arts, Looking Glass Technologies, Sega, Sony Interactive and Virgin became licensees. Several major titles are already in the marketplace, and many more are under development.
- Along with our US-based sales force, the addition of sales representatives in the far east will ensure the widest possible exposure for our "QXpander" chip in the PC/multimedia and consumer electronics industry.

To assist us in expanding our global consumer base, we created a new subsidiary – QKidz – which is focused on distribution and marketing of consumer products for the youth market. We have named Mr. Jeff McCarthy and Mr. Jon Gill, both superbly qualified people, to management positions. Their experience in the entertainment and toy business, from previous positions with Sega of Canada, will serve our shareholders well.

Lastly, the joint venture with House Ear Institute of Los Angeles has completed the research and development stage of its binaural hearing aid project. The joint venture has successfully transferred the technology to Starkey Laboratories, who are in the process of manufacturing a product based on this technology. It is expected that Starkey will officially announce the introduction of this product early in 1997. We are very pleased to be part of such a worthwhile effort, and anticipate that this product will contribute to increasing shareholder value.

The continued support of our shareholders and employees during the process of establishing QSound Labs as the dominant force in the emerging 3D audio industry is greatly appreciated by management. We thank you for your dedication and look forward to sharing with you the benefits of our increasingly successful marketing efforts.

David Gallagher
President and Chief Executive Officer

11. UNITED STATES ACCOUNTING POLICIES (CONTINUED)

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

DECEMBER 31, 1995	AS REPORTED	DIFFERENCES	UNDER UNITED STATES ACCOUNTING PRINCIPLES
Current assets	$ 5,802,803	$ —	$ 5,802,803
Deferred expenditures	602,797	(602,797)	—
Property and equipment	1,660,681	—	1,660,681
Other assets	625,324	(625,324)	—
	$ 8,691,605	$ (1,228,121)	$ 7,463,484
Current liabilities	$ 1,936,099	$ —	$ 1,936,099
Deferred revenue	843,965		843,965
Long-term debt	326,415		326,415
SHAREHOLDERS' EQUITY			
Common shares approved, not issued	2,870,000		2,870,000
Common shares	36,372,617	(661,226)	35,711,391
Deficit	(33,657,491)	(566,895)	(34,224,386)
	$ 8,691,605	$ (1,228,121)	$ 7,463,484

DECEMBER 31, 1994	AS REPORTED	DIFFERENCES	UNDER UNITED STATES ACCOUNTING PRINCIPLES
Current assets	$ 3,118,209	$ —	$ 3,118,209
Deferred expenditures	1,689,306	(1,689,306)	—
Property and equipment	1,622,499	—	1,622,499
Other assets	720,320	(619,250)	101,070
	$ 7,150,334	$ (2,308,556)	$ 4,841,778
Current liabilities	$ 1,749,600	$ —	$ 1,749,600
Deferred revenue	1,229,040	—	1,229,040
Long-term debt	3,097,615	—	3,097,615
SHARE CAPITAL AND DEFICIT			
Common shares approved, not issued	2,870,000	—	2,870,000
Common shares	27,044,796	(614,049)	26,430,747
Deficit	(28,840,717)	(1,694,507)	(30,535,224)
	$ 7,150,334	$ (2,308,556)	$ 4,841,778

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

11. UNITED STATES ACCOUNTING POLICIES

The financial statements have been prepared in accordance with generally accepted accounting principles in Canada. Under generally accepted accounting principles in the United States (i) the deferred expenditures recorded on the acquisition of QSound technology would be recorded at the transferor's historical cost determined in accordance with generally accepted accounting principles in the United States; (ii) other deferred expenditures would be expensed as incurred; (iii) the share purchase loan receivable and related accrued interest included in other assets would be presented as a deduction from shareholders' equity; (iv) deferred unrealized foreign exchange losses would be expensed; and (v) the class action settlement would be recorded as a current expense in the period of settlement.

The Company uses the proportionate consolidation method of joint venture accounting which complies with Canadian generally accepted accounting principles but does not comply with U.S. generally accepted accounting principles. The Company's joint venture activity is disclosed in Note 10.

The effect on the loss for each of the years in the three year period ended December 31, 1995 of the differences between Canadian and United States accounting principles is summarized as follows:

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993	1995	1994	1993
Loss for the year as reported	$ (4,816,774)	$ (3,408,199)	$ (1,953,539)
Expenditures capitalized under Canadian accounting principles	(122,395)	(180,246)	(159,484)
Amortization of deferred expenditures	1,208,904	1,205,997	1,170,801
Foreign exchange losses deferred or included in share capital under Canadian accounting principles	41,103	70,487	(134,779)
Class action settlement recorded as a prior period adjustment under Canadian accounting principles	—	(2,870,000)	—
Loss under United States accounting principles	$ (3,689,162)	$ (5,181,961)	$ (1,077,001)
Loss per share under United States accounting principles	$ (0.20)	$ (0.34)	$ (0.08)

The weighted average number of shares outstanding for the year ended December 31, 1995 under United States generally accepted accounting principles was 18,576,303 (1994 - 15,409,141, 1993 - 13,580,760).

QSOUND management profiles

DAVID GALLAGHER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

Mr. Gallagher has served as President and Chief Executive Officer since 1992. He has 22 years of business experience, including 10 years in the software development and licensing industry.

JAMES P. REID
VICE-PRESIDENT, SALES

Mr. Reid has more than 15 years' experience in the electronics and semiconductor field, including sales responsibilities with Fujitsu Microelectronics, Adaptec Corporation, and LSI Logic, among others.

JAMES BONFIGLIO
SENIOR VICE-PRESIDENT, CORPORATE DEVELOPMENT

Mr. Bonfiglio was appointed Senior Vice-President, Corporate Business Development in 1995, to help guide the company through the critical process of becoming a market-driven, quality-oriented organization.

JOANNA VARVOS
CORPORATE SECRETARY

Ms. Varvos is a barrister and solicitor, admitted to the Alberta Law Society in 1979. She has provided legal services to the company since 1989.

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

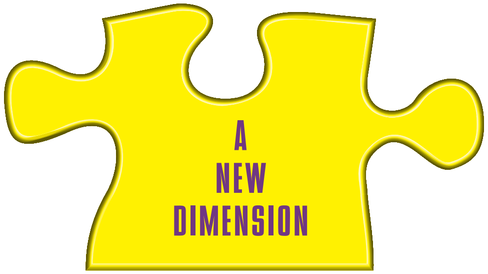
QKIDZ management profiles

JEFFREY W. MCCARTHY
CHIEF EXECUTIVE OFFICER

Mr. McCarthy has 25 years' experience in the marketing and development of toys and entertainment for children. Before accepting his position with QKidz, Mr. McCarthy was president of Brookhaven Consulting, involved in the entertainment and toy industries world-wide. Prior to that, he served in executive positions at Sega of Canada, Charan Toy of Canada, and others.

JON GILL
CHIEF OPERATING OFFICER

Mr. Gill has gained experience in finance, operations, and strategic management through his work with start-up, turn-around, and high-growth companies. He has held positions with Sega Entertainment, McLeod Young Weir, and Richardson Greenshields, among others.



FRANK KING
VICE PRESIDENT, MARKETING AND PRODUCT DEVELOPMENT

Mr. King's strong marketing and product development skills come from 20 years of management experience in the retail industry. He has held positions with Consumers Distributing, Inc. and Sears Canada Ltd. among others.

10. JOINT VENTURES

In May, 1994 the Company entered into a joint venture agreement with a computer hardware development company to develop and distribute products to the multimedia computer industry. At that time the joint venture entered into an agreement with a large multinational computer manufacturer to develop and distribute chipsets for incorporation into personal computer multimedia products.

The Company has an ongoing joint venture with the House Ear Institute to develop, manufacture and sell binaural hearing aid products. The cost sharing portion of the agreement concluded September 30, 1994.

Both of the above mentioned joint ventures are research and development in nature and the Company records its proportionate share of revenues and expenses as incurred.

The Company's proportionate share of revenues, expenses and property and equipment of the joint ventures is as follows:

	1995	1994	1993
Property and equipment, net	$ 29,754	$ 36,158	$ 21,134
Revenues	67,163	689,000	346,000
Expenses	516,671	1,086,000	716,000
Loss for the year from joint ventures	$ (449,508)	$ (397,000)	$ (370,000)
Cash decrease from operations	$ (436,756)	$ (381,503)	$ (360,942)
Cash decrease from investing	$ (6,348)	$ (30,521)	$ (17,951)

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

7. PRIOR PERIOD ADJUSTMENT

In 1994, the United States District Court approved an out-of-court settlement of the class action claim against the Company and certain current and former officers, directors and others. The claims alleged violation of U.S. federal securities laws and state law claims for fraud, deceit and negligent misrepresentation. The Company believes it had meritorious defenses to this claim and denied any wrongdoing but believes that settling was in the Company's best interest.

The settlement calls for a cash payment by the Company's director and officer liability insurance carrier and the issuance by the Company of 1,025,000 common shares. At the time of settlement, the authorization for issuance of the common shares represented an increase in the number of shares issued of approximately 5% on a fully diluted basis. Distributions under the settlement are expected to be concluded in the second quarter of 1996.

The settlement was recorded as a prior period adjustment during 1994 and the common shares issued and to be issued have been valued at the date of court approval, December 5, 1994, which resulted in recording $2,870,000 in common shares (1,025,000 common shares) authorized for issuance and an increase of the same amount to deficit at January 1, 1991.

8. TRANSACTIONS WITH RELATED PARTIES

In 1995 the Company was charged $224,230 (1994 - $145,740; 1993 - $245,000) for management services provided by directors and officers pursuant to consulting arrangements.

As at December 31, 1995 a loan, including accrued interest of $625,324 (1994 - $578,147), was due from a director (note 4).

9. INCOME TAXES

At December 31, 1995, QSound Labs, Inc., QSound Electronics, Inc., QSound Ltd. and QKidz, Inc. have the following approximate aggregate amounts available to reduce future years' income for tax purposes, the tax effect of which has not been recorded in the accounts.

Losses carried forward for tax purposes available until various dates between 1996 and 2008	$ 30,000,000
Investment tax credits available at various dates until 2004	$ 3,000,000
Foreign tax credit available to various dates between 1997 and 2000	$ 500,000

QSOUND directors

DAN LOWE
CHAIRMAN

Mr. Lowe is the co-inventor of QSound technology and a founder of the company. He has been Chairman of the Board since January 1993.

DAVID GALLAGHER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

Mr. Gallagher has served as President and Chief Executive Officer since 1992. He has 22 years of business experience, including 10 years in the software development and licensing industry.

JAMES BONFIGLIO
DIRECTOR

Mr. Bonfiglio was elected to the Board of Directors in 1993. He is a former President and Chief Executive Officer of Kroy Inc., a multi-national manufacturer and distributor of presentation products, labelling, lettering, and bar-code equipment.

GEORGE FOLSEY, JR.
DIRECTOR

Mr. Folsey is a prominent movie producer who has been a member of the Board of Directors since 1987. He served as Chairman of the Board from June 1988 to June 1991.

Mr. Dan Lowe, co-inventor of QSound technology and a founder of the Company, has decided to focus his energies on new business enterprises and is not seeking re-election as a director. QSound Labs wishes to thank Mr. Lowe, who has served as an officer and director since 1987, for his many contributions to the Company. The Company and Mr. Lowe continue to work together to develop new products which are synergystic to QSound 3D audio and Mr. Lowe's new business ventures.

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

auditors' report to the shareholders

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 1995 and 1994 and the consolidated statements of operations and deficit and changes in financial position for each of the years in the three year period ended December 31, 1995. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance 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.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1995 and 1994 and the results of its operations and the changes in its financial position for each of the years in the three year period ended December 31, 1995 in accordance with generally accepted accounting principles.

KPMG Peat Marwick Thorne

Chartered Accountants

Calgary, Canada
May 7, 1996

comments by auditors for U.S. readers on Canada U.S. reporting conflict

In the United States, reporting standards for auditors require the addition of an explanatory paragraph following the opinion paragraph when there are substantial uncertainties about the company's ability to continue as a going concern, as referred to in Note 1 of these consolidated financial statements. Our report to the shareholders dated May 7, 1996 is expressed in accordance with Canadian reporting standards which do not permit a reference to such matters in the auditors' report when the facts are adequately disclosed in the financial statements.

KPMG Peat Marwick Thorne

Chartered Accountants

Calgary, Canada
May 7, 1996

Shares outstanding at December 31, 1991 have been restated to include 1,025,000 shares ($2,870,000) which will be issued pursuant to the agreement for settlement of a legal claim (note 7).

The legal stated capital of QSound as at December 31, 1995 is $38,813,009 (1994 - $29,485,188).

Reserved common shares:

At December 31, 1995 common shares were reserved for issuance as follows:

600,000 shares pursuant to the share purchase warrants issued in connection with a loan repaid in 1994. The warrants are exercisable at U.S. $1.83 per common share and expire on July 22, 1997.

1,550,500 shares pursuant to directors' and employees' options, exercisable from time to time to June 2000, at prices ranging from $0.76 to $4.70 per share, of which 749,300 were exercisable at December 31, 1995.

100,000 shares pursuant to share purchase warrants issued in connection with the refinancing of certain notes. The notes were repaid in 1992 and the warrants are exercisable at a price of U.S. $2.86 per share and expire on August 1, 1996.

200,000 shares pursuant to share purchase warrants in connection with financial advisory and investment banking services. The warrants are exercisable at a price of $6.25 per share and expire on September 12, 2000.

196,734 shares pursuant to share purchase warrants issued in connection with the Canadian dollar prime plus 1% convertible loan (note 5). The warrants are exercisable at a price of $5.85 per share and expire on May 24, 1996.

200,000 shares pursuant to share purchase warrants issued in connection with the U.S. dollar prime plus 1% convertible loan (note 5). The warrants are exercisable at a price of U.S.$3.75 per share and 100,000 warrants expire on May 24, 1999 and 100,000 warrants expire October 24, 1999.

Changes in options granted to directors and employees during the years ended December 31, 1995, 1994 and 1993 were as follows:

	1995	1994	1993
Balance, beginning of year	1,055,600	1,324,900	1,120,750
Granted	855,000	1,235,500	475,000
Exercised	(263,750)	(496,800)	(195,850)
Cancelled or expired	(96,350)	(1,008,000)	(75,000)
Balance, end of year	1,550,500	1,055,600	1,324,900

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)
DECEMBER 31, 1995 AND 1994 (EXPRESSED IN CANADIAN DOLLARS)

6. 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.

The Company is also authorized to issue 699,999 Series 1 Convertible First Preferred Shares (the "preferred shares"). The preferred shares are convertible at any time, at the option of the holder, into an equal number of common shares.

Common shares issued and authorized to be issued:

Changes in common shares during the years ended December 31, 1995, 1994 and 1993 were as follows:

	NUMBER OF SHARES	CONSIDERATION
Balance at December 31, 1992	13,759,209	$ 23,018,043
For cash on the exercise of directors' and employees' options	195,850	404,750
On conversion of debt (net of related deferred foreign exchange loss of $270,683)	2,066,666	3,858,507
Balance at December 31, 1993	16,021,725	27,281,300
ISSUED FOR CASH		
Private placement (net of issue costs of $55,200)	334,448	1,309,350
On exercise of directors' and employees' options	496,800	1,324,146
Balance at December 31, 1994	16,852,973	29,914,796
ISSUED FOR CASH:		
On exercise of warrants	1,950,000	4,937,642
On exercise of directors' and employees' options	263,750	531,199
Private placement	227,048	703,849
On conversion of long-term debt	759,741	2,719,873
For services	104,632	435,258
Balance at December 31, 1995	20,158,144	$ 39,242,617

	1995	1994
assets		
CURRENT ASSETS		
Cash and short-term deposits	$ 3,532,543	$ 1,126,715
Accounts receivable	572,754	341,694
Royalties receivable (NOTE 5)	1,371,011	1,510,779
Inventory	214,759	—
Prepaid expenses	111,736	139,021
	5,802,803	3,118,209
Deferred expenditures (NOTE 2)	602,797	1,689,306
Property and equipment (NOTE 3)	1,660,681	1,622,499
Other assets (NOTE 4)	625,324	720,320
	$ 8,691,605	$ 7,150,334
liabilities and shareholders' equity		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 936,318	$ 638,000
Interest payable on long-term debt	3,039	116,146
Current maturities on long-term debt	12,678	995,454
Other liability (NOTE 5)	984,064	—
	1,936,099	1,749,600
Long-term debt (NOTE 5)	326,415	3,097,615
Deferred revenue	843,965	1,229,040
Shareholders' equity:		
Common shares (NOTE 6)	39,242,617	29,914,796
Deficit	(33,657,491)	(28,840,717)
	5,585,126	1,074,079
Future operations (NOTE 1)		
	$ 8,691,605	$ 7,150,334

See accompanying notes to consolidated financial statements.

Approved by the Board:

David Gallagher

DIRECTOR

DIRECTOR

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

	1995	1994	1993
revenue:			
Royalties	$ 1,270,364	$ 1,906,110	$ 1,783,513
Development and license fees	988,289	778,174	1,990,241
Product sales	690,336	171,910	—
Rentals and other	33,632	59,702	65,925
	2,982,621	2,915,896	3,839,679
expenses			
Marketing	2,383,029	1,446,907	1,234,471
Product research and development	1,210,735	1,778,320	1,599,209
Administration	1,406,037	1,070,083	895,074
Patent litigation	576,060	56,331	—
Cost of products sales	578,704	102,061	—
Interest on long-term debt	156,935	336,786	562,328
Amortization	1,309,974	1,205,997	1,170,801
Depreciation	248,549	298,599	364,782
Foreign exchange loss	90,975	122,658	85,219
Interest income	(161,603)	(93,647)	(118,666)
	7,799,395	6,324,095	5,793,218
Loss for the year	(4,816,774)	(3,408,199)	(1,953,539)
Deficit, beginning of year (NOTE 7)	(28,840,717)	(25,432,518)	(23,478,979)
Deficit, end of year	$(33,657,491)	$(28,840,717)	$(25,432,518)
Loss per common share	$ (0.27)	$ (0.22)	$ (0.14)

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

5. LONG-TERM DEBT

	1995	1994
11% mortgage, secured by a first charge on land and building	$ 339,093	$ 350,655
U.S. dollar prime plus 1% convertible loan (1994 - U.S.$1,000,000) (NOTE 6)	—	1,401,800
Canadian dollar prime plus 1% convertible loan (NOTE 6)	—	1,356,550
Capcom bridge loan (1994 -U.S. $702,000)	—	984,064
	339,093	4,093,069
Less principal included in current liabilities	12,678	995,454
	$ 326,415	$ 3,097,615

The building mortgage was renewed December 1, 1994 for a three year term.

The U.S. dollar prime plus 1% convertible loan was fully converted into common shares of the Company at a rate of $3.58 per common share during 1995 (note 6). In connection with this loan, the Company granted to the lender, non-transferrable warrants to purchase 200,000 common shares at the exercise price of U.S. $3.75 per common share, of which 100,000 expire on May 24, 1999 and 100,000 expire on October 24, 1999.

The Canadian dollar prime plus 1% convertible loan was fully converted into common shares of the Company at a rate of $3.58 per common share during 1995 (note 6). In connection with this loan, the Company granted to the lender, non-transferrable warrants to purchase 137,714 common shares at the exercise price of $4.20 per common share which expired June 24, 1995 and warrants to purchase 196,734 common shares at $5.85 per common share expiring May 24, 1996.

In connection with the above convertible loans, a floating first charge subject to the mortgage on the building was discharged effective September 1, 1995 with the conversion of the loans and repayment of accrued interest.

On January 12, 1993 Capcom Co., Ltd. advanced a U.S. $702,000 bridge loan at 6% interest repayable on or before April 1, 1995. The Company had issued a U.S. $20,000,000 debenture to Capcom covering substantially all of the assets of the Company as security for this and other previous loans. The debenture was discharged effective October 25, 1994 with the repayment to Capcom of the previous loans. Interest of U.S. $84,021 was paid to Capcom April 1, 1995. The unsecured loan appears on the balance sheet as other liability at December 31, 1995. The Company expects to settle this obligation with an amount of $984,064 receivable from Capcom, which appears on the balance sheet in royalties receivable at December 31, 1995.

Annual minimum repayments of long-term debt, as at December 31, 1995, are as follows:

1996	$ 12,678
1997	326,415

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

3. PROPERTY AND EQUIPMENT

1995	COST	ACCUMULATED DEPRECIATION	NET BOOK VALUE
Land	$ 120,000	$ —	$ 120,000
Building	755,656	141,157	614,499
Sound source and control equipment	1,194,274	958,615	235,659
Real time systems	1,282,784	1,073,183	209,601
Furniture and fixtures	448,869	223,750	225,119
Computer equipment	489,455	233,652	255,803
	$ 4,291,038	$ 2,630,357	$ 1,660,681

1994	COST	ACCUMULATED DEPRECIATION	NET BOOK VALUE
Land	$ 120,000	$ —	$ 120,000
Building	733,596	122,720	610,876
Sound source and control equipment	1,186,961	900,862	286,099
Real time systems	1,247,862	985,596	262,266
Furniture and fixtures	355,944	197,492	158,452
Computer equipment	359,305	180,251	179,054
Automobile	12,836	7,084	5,752
	$ 4,016,504	$ 2,394,005	$ 1,622,499

4. OTHER ASSETS

	1995	1994
Share purchase loan	$ 455,000	$ 455,000
Accrued interest on share purchase loan	170,324	123,147
Deferred foreign exchange loss	—	41,103
Deferred financing	—	101,070
	$ 625,324	$ 720,320

In 1991 the Company entered into a loan agreement with a director to provide financing to enable the director to exercise stock options to acquire 140,000 common shares. The loan of $455,000 is payable in December 1996, bears interest at 8% per annum compounded semi-annually and is secured by 140,000 common shares of the Company held in trust.

CASH PROVIDED BY (USED IN)	1995	1994	1993
operations			
Loss for the year	$ (4,816,774)	$ (3,408,199)	$ (1,953,539)
Items not requiring (providing) cash:			
Deferred revenue	(941,260)	(1,715,985)	(792,450)
Depreciation and amortization	1,457,453	1,504,596	1,535,583
Amortization of deferred foreign exchange loss	142,173	170,660	42,010
Expenses paid with common shares	435,258	—	—
CHANGES IN WORKING CAPITAL BALANCES:			
Accounts receivable	(231,060)	(95,316)	(87,536)
Royalties receivable	139,768	1,918,060	(629,250)
Prepaid expenses	27,285	(66,733)	(18,043)
Inventory	(214,759)	—	—
Accounts payable and accrued liabilities	298,318	175,052	(329,409)
Interest payable on long-term debt	(113,107)	(49,651)	38,597
	(3,816,705)	(1,567,516)	(2,194,037)
financing			
Common shares, net	8,892,563	2,633,496	4,263,257
Other assets	(47,177)	(156,253)	(36,599)
Advances of long-term debt	—	2,713,100	3,733,740
Repayments of long-term debt	(2,769,912)	(3,747,277)	(4,687,962)
Royalties receivable	—	—	(891,540)
Deferred revenue	556,185	337,500	891,540
	6,631,659	1,780,566	3,272,436
investments			
Purchase of equipment, net of dispositions	(286,731)	(85,962)	(97,152)
Sale of equipment	—	—	124,226
Deferred expenditures	(122,395)	(180,246)	(159,484)
	(409,126)	(266,208)	(132,410)
Increase (decrease) in cash	2,405,828	(53,158)	945,989
Cash, beginning of year	1,126,715	1,179,873	233,884
Cash, end of year	$ 3,532,543	$ 1,126,715	$ 1,179,873

See accompanying notes to consolidated financial statements.

YEARS ENDED DECEMBER 31, 1995, 1994 AND 1993 (EXPRESSED IN CANADIAN DOLLARS)

significant accounting policies

BASIS OF PRESENTATION

These consolidated financial statements include the accounts of QSound Labs, Inc. (the "Company") a public company organized under the laws of the Province of Alberta, Canada and its wholly-owned subsidiaries QSound Ltd., QSound Electronics, Inc. and QKidz, Inc.

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada which in the case of the Company conform in all significant respects with those in the United States, except as outlined in note 11.

REVENUE RECOGNITION

Amounts received for royalties are recorded as deferred revenue and revenue is recognized when the royalty is earned through the sale of units by the licensee and collection is reasonably assured.

Amounts received for license fees and rights are recorded as deferred revenue and revenue is recognized after the software and/or hardware has been delivered and the Company has no further significant obligations to the purchaser.

Revenue from product sales is recognized when products are shipped.

DEFERRED EXPENDITURES

Deferred expenditures represent direct acquisition, development, patent and trademark costs pertaining to the QSound technology. The costs are amortized over a period of not greater than five years.

PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost and are amortized over the expected useful life of the assets as follows:

ASSETS	BASIS	RATE
Building	Straight-line	2-1/2%
Electronic equipment	Declining balance	20%
Real time systems	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Computer equipment	Declining balance	30%
Automotive	Declining balance	30%

JOINT VENTURE OPERATIONS

The Company carries out certain research and development activities through joint ventures, which are accounted for by the proportionate consolidation method.

significant accounting policies (continued)

INVENTORY

Inventory is stated at the lower of cost (first-in, first-out method) and market.

FOREIGN CURRENCY TRANSLATION

The Company uses the temporal method for translation of its accounts into Canadian dollars under which monetary items are translated at the rate of exchange in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets are acquired or obligations incurred. Revenues and expenses are translated at average rates in effect during the period except for amortization of capital assets and deferred expenditures which are translated at the same rate as the related assets. Foreign exchange gains and losses on monetary items with a fixed or ascertainable life extending beyond the end of the following year are deferred and amortized to income over the remaining life of the monetary item. Other foreign exchange gains and losses are included in the statement of operations as incurred.

PER SHARE AMOUNTS

Loss per share has been calculated using the weighted average number of common shares outstanding during the year. The weighted average number of shares outstanding for the year ended December 31, 1995 was 17,551,303 (1994 - 15,336,127, 1993 - 13,560,760).

1. FUTURE OPERATIONS

During 1995, the Company substantially maintained a positive working capital position and although it has not yet achieved profitability, the Company continues to enter into new license arrangements, and has entered into new arrangements for product sales which are expected to result in improved future revenues and results of operations. Although there can be no certainty, management believes that working capital at December 31, 1995 of $3,866,704, combined with proceeds from the potential exercise of share purchase warrants and other financing sources, will allow the Company to meet its obligations as they come due and carry out its business plan for 1996.

The financial statements have been prepared on the going concern basis. The application of the going concern concept is dependent on Company's ability to realize its assets and discharge its liabilities in the normal course of business. The financial statements do not include any adjustments to the amounts and classification of assets and liabilities that might be necessary if the Company is not able to continue as a going concern.

2. DEFERRED EXPENDITURES

	1995	1994	1993
Balance, beginning of year	$ 1,689,306	$ 2,715,057	$ 3,726,374
Patent and trademark costs	122,395	180,246	159,484
Amortization	(1,208,904)	(1,205,997)	(1,170,801)
Balance, end of year	$ 602,797	$ 1,689,306	$ 2,715,057