Get in touch with us ...

QSound Labs, Inc.

2748 - 37 Avenue N.E.

Calgary, Alberta,

Canada T1Y 5L3

Tel: (403) 291-2492

Fax: (403) 250-1521

www.qsound.com

QSOUND®

1997 Annual Report

Committed to the Design,
of Advanced 3D Audio Sol

Development & Marketing
utions

QSound Labs, Inc., a world leader in quality 3D audio solutions, has long been synonymous with audio excellence when it first established roots in the professional recording industry. QSound® introduced a high quality audio solution that offered a unique and practical solution to the ongoing dilemma faced by discriminating audio engineers–how to achieve maximum audio placement while maintaining the highest standards of audio. Meeting the challenges of this dynamic industry paved the way for the development of QSound's unique and patented 3D audio technologies.

Today, QSound continues that tradition by offering the most comprehensive and highest quality family of 3D audio technologies with applications in nearly every conceivable market, including the home entertainment, PC/Multimedia, consumer electronics, professional audio, and hearing aid industries.

Message from the President

"We are very excited about the Cetera Hearing Aid. Thanks to our partners, Cetera will deliver a truly innovative algorithm that distinguishes it from any other digital system."

Over the years, QSound has maintained a commitment to the research, development and marketing of breakthrough 3D audio technologies. And 1997 proved to be the year this legacy was realized to its fullest. QSound has kept pace with the ever-changing face of technology by continuing to develop products suitable for newly created markets. Business development strategies continue to focus on maintaining existing relationships as well as generating new and promising partnerships throughout 1998.

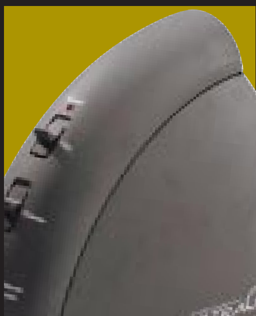
In 1997, QSound signed a record number of new partnerships and joint ventures representative of the company's strategic initiative to stay on the cutting edge of technology and industry leadership. QSound also made its debut in the world of end-user consumer technology with the release of UltraQ™ and iQ™. The marketing strategies for these two products have been very successful. UltraQ is working its way through retail distribution channels and iQ is being sold successfully through the Internet. Significant progress has also been made in the development of the Cetera Hearing Aid, the joint venture between Starkey Labs, House Ear Institute and QSound. The smaller, more efficient Cetera is scheduled for release in fourth quarter 1998.

As the company has matured, we have substantially redefined our strategic plans to meet industry demand. But change is not without challenge. I would like to express my appreciation to the QSound employees and Board of Directors who have embraced change and have remained committed to the company. We welcome new employees and thank the employees who have dedicated years of service to the success of QSound. We also thank our shareholders for their continued support as we move into our best year ever. With these commitments, QSound is well positioned to move into 1998 with confidence.

David Gallagher

David Gallagher
President and Chief Executive Officer

Developing Breakthrough Audio Solutions of Changing Industry and Newly Created



"With the flick of a switch, your sound is blown out about 20 feet to the right and left of the listener. Amazing device!"

John Dvorak,
PC Magazine

Consumer Electronics

In November 1997, QSound released two new consumer products, the UltraQ and iQ, at the Fall COMDEX in Las Vegas. Both UltraQ and iQ utilize the company's patented technology, QXpander™, a stereo expansion process that converts mono signals to stereo and stereo to a stunning 3D soundfield. UltraQ was QSound's first consumer product, designed to enhance any sound source, such as a PC, stereo, or VCR using a simple connection and just two ordinary speakers. iQ is a downloadable software product that enhances any streaming audio—especially audio over the Internet.

UltraQ is currently working its way through retail distribution channels in the both the USA and Canada with European distribution slated for fourth quarter 1998. Reviews of the product in several major computer publications have offered QSound the boost it needed to launch its first consumer hardware product. iQ is currently being sold successfully through the Internet. A strong partnership with RealNetworks (RealAudio) has enabled QSound to provide the 3D solution for one of the most popular Internet audio players. iQ is also sold through other web sites involved in QSound's Internet Affiliate Program where revenue share provides the incentive for partners.

that Meet the Needs Markets

VCRs, DVDs and virtual home theatres continue to add to the growing number of products now available with QSound technology. In September, AIWA, a world leader in consumer electronics, began offering QSound-enhanced products to the North American marketplace. AIWA chose QSound Labs' technology to be featured in many of its impressive line of portable products to deliver a value-added product with performance and convenience. Also in September, Go-Video, the world leader in dual-deck VCR's, began shipping two VCR models offering an upgraded look featuring QSound technology. In November, Sharp Corporation, one of the world's largest consumer electronics manufacturers, incorporated QSurround™ for its next generation of virtual home theatre and consumer audio products, including new lines of mini-component systems and audio receivers for DVD and Pro-Logic™ home theatre systems. Near the end of the year, Boston Acoustics, a leading manufacturer of fine audio systems, incorporated QSound's 3D audio technology into the company's newest home theatre system, SoundBar Cinema™.

The increase in popularity of multi-channel surround formats, such as Dolby® Digital, paved the way for the company's newest suite of 3D audio processes, QSurround™. The QSurround process utilizes a phantom center channel, enhances front-channel reproduction, and creates "virtual" surround speakers to render all channels in their correct positions. The result is an expansive soundfield that remains unmatched in the audio industry today.

iQ 3D AUDIO

"iQ stretches ordinary sound files beyond the regular limitations of computer speakers, creating what is essentially a surround-sound type environment on your desktop."

Meg Sullivan

ZDNet's LaunchPad

“In order to compete with consumer products, PCs need better audio. A natural complement and successor to 3D-graphics in 1997 is 3D positional audio. Q3D simultaneously provides quality and efficiency, therefore, a more cost-effective solution for OEMs.”

David Gallagher
President & CEO

PC/Multimedia

At the start of the new year, Zoran Corporation, the world’s leading supplier of Dolby Digital AC-3 Decoders, incorporated QSurround into the exploding home theatre, DVD and consumer multimedia market via Zoran’s ZR38600 chip. Samsung Electronics incorporated QSurround technology into their newest audio chip for PC OEMs, consumer electronics, and television manufacturers. And August proved to be an exciting month, when LuxSonor licensed QSurround to be incorporated in their LS220, a powerful and highly integrated DVD decoder solution for the PC market. Also in August, QSound worked with Motorola’s Semiconductor Products Sector to port QSurround to a Motorola 24-bit Digital Signal Processor (DSP) and AKM Semiconductor licensed QSurround for incorporation in their 7712 DSP-based codec family.

In early Spring, Siemens Nixdorf incorporated QXpander™, QSound’s stereo expansion technology, into a new line of multimedia desktop computers targeted to the multimedia specialist. In April, ASUSTeK Computer, a leading developer and manufacturer of high-end mainboard and add-on cards, licensed the 2130 QXpander chip for integration in a new line of motherboards. And in June, Micron Electronics, once again, chose the QXpander technology to be incorporated into the award winning TransPort XPE laptop computer. In February, OPTi, a leading independent supplier of multimedia and core logic silicon solutions, licensed QSurround, QXpander and QSound’s positional audio for speakers or headphones, to be incorporated into a number of OPTi’s multimedia devices.

QSound Labs continues to set the standard for 3D audio providing both hardware and software audio solutions. In fact, QSound licenses high-performance real-time 3D rendering directly to developers as well as manufacturers of PC sound cards and codecs. Developers are choosing QMixer™ to guarantee that their customers receive a superior 3D audio experience.

In August, QSound announced several new licensing agreements with developers and publishers for the company’s software 3D audio rendering engine, QMixer. Simis Eidos, SingleTrac Entertainment, The Digital Village, Remedy Entertainment, Interactive World Productions, Telstar Electronics, and Grolier Interactive UK joined QSound's impressive list of publishers. Other publishers who have licensed the technology include Activision, Electronic Arts, Looking Glass Technologies, Microsoft, Mindscape, Psygnosis, Sega, Sound Source, and Capcom.

Yamaha became the first licensee of Q3D™, with plans to incorporate the technology into a new codec driver. The new codec driver was designed to provide the next generation of multimedia home computers with positional 3D audio without the CPU overhead requirements of other solutions. Trident Microsystems unveiled their new, cost-effective SOUNDSUITE™, a unique audio technology that integrates audio enhancements into a single, more compact solution. QSound also entered into an agreement with Aztech Systems, a leader in the multimedia industry, in July, to incorporate Q3D technology into a new line of sound cards. And in August, LG Semicon (formerly Lucky Goldstar) licensed a customized version of Q3D for their new line of 3D audio chips for worldwide distribution. Following in October, ESS, the market leader in PC audio chipsets, licensed Q3D in its newly announced Solo™ and Maestro™ PCI audio product lines, both of which offer complete DOS game compatibility on the PCI bus with advanced audio acceleration, including 3D positional audio effects.

Pro-Audio

In April, QSound and Cakewalk Pro Audio announced a new Windows-based audio plug-in, QTools/AX™ for Cakewalk Pro Audio 6.0 allowing musicians, producers, and audio engineers to apply QSound 3D audio effects right from the Cakewalk editing menu. Cakewalk became the exclusive distributor of the new plug-in, providing extensive marketing experience and proven sales techniques.

Financials

Auditors' Report to the Shareholders

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 1997 and 1996 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, 1997. 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, 1997 and 1996 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, 1997 in accordance with generally accepted accounting principles.

KPMG.

Chartered Accountants
Calgary, Canada
March 6, 1998

QSOUND LABS, INC.
Consolidated Financial Statements
Years ended December 31, 1997, 1996 and 1995

Consolidated Balance Sheets *(Expressed in Canadian dollars)*

December 31,	**1997**	1996
Assets		
Current assets:		
Cash and cash equivalents	**$ 2,987,286**	$ 2,786,734
Accounts receivable	**974,571**	1,700,884
Accrued revenue	**983,776**	7,980
Royalties receivable	**183,728**	340,018
Inventory	**576,340**	539,209
Prepaid expenses	**114,220**	77,895
	5,819,921	5,452,720
Capital assets *(note 1)*	**2,108,403**	1,989,593
	$ 7,928,324	$ 7,442,313
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 514,755**	$ 908,035
Accrued liabilities	**68,652**	558,931
Interest payable on long-term debt	**2,004**	2,926
Current maturities on long-term debt	**18,535**	14,111
	603,946	1,484,003
Long-term debt *(note 2)*	**293,770**	312,304
Deferred revenue	**–**	277,874
Shareholders' equity:		
Preferred shares *(note 3)*	**268,692**	1,977,465
Common shares *(note 3)*	**45,381,247**	41,314,648
Deficit	**(38,619,331)**	(37,923,981)
	7,030,608	5,368,132
Commitments and contingencies *(note 9)*		
	$ 7,928,324	$ 7,442,313

See accompanying notes to consolidated financial statements.

Approved by the Board: David Gallagher Director James R. Bonfiglio Director

Consolidated Statements of Operations and Deficit *(Expressed in Canadian dollars)*

Years ended December 31, 1997, 1996 and 1995	**1997**	1996	1995
Revenue:			
Product sales	**$ 1,985,227**	$ 2,643,161	$ 690,336
Royalties and license fees	**2,952,303**	2,180,592	2,258,653
Rentals and other	**28,502**	22,082	33,632
	4,966,032	4,845,835	2,982,621
Cost of product sales	**1,016,581**	1,972,240	578,704
	3,949,451	2,873,595	2,403,917
Expenses:			
Marketing	**2,361,836**	3,145,011	2,383,029
Administration	**771,349**	1,206,101	1,406,037
Product research and development	**1,273,764**	1,626,631	1,210,735
Patent litigation	**171,701**	589,905	576,060
Depreciation and amortization	**388,159**	600,006	1,558,523
Interest on long-term debt	**34,427**	35,779	156,935
Foreign exchange (gain) loss	**(146,431)**	23,759	90,975
Interest and other income	**(210,004)**	(87,107)	(161,603)
	4,644,801	7,140,085	7,220,691
Loss for the year	**(695,350)**	(4,266,490)	(4,816,774)
Deficit, beginning of year	**(37,923,981)**	(33,657,491)	(28,840,717)
Deficit, end of year	**$ (38,619,331)**	$ (37,923,981)	$ (33,657,491)
Loss per common share	**$ (0.03)**	$ (0.21)	$ (0.27)

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position *(Expressed in Canadian dollars)*

Years ended December 31, 1997, 1996 and 1995	**1997**	1996	1995
Cash provided by (used in):			
Operations:			
Loss for the year	**$ (695,350)**	$ (4,266,490)	$ (4,816,774)
Items not requiring (providing) cash:			
Deferred revenue	**(277,874)**	(566,091)	(941,260)
Depreciation and amortization	**388,159**	600,006	1,457,453
Expenses paid with common shares	**–**	292,987	435,258
Amortization of deferred foreign exchange loss	**–**	–	142,173
Changes in working capital balances:			
Accounts receivable	**726,313**	(1,128,130)	(231,060)
Accrued revenue	**(975,796)**	(7,980)	–
Royalties receivable	**156,290**	1,030,993	139,768
Prepaid expenses	**(36,325)**	33,841	27,285
Inventory	**(37,131)**	(324,450)	(214,759)
Accounts payable	**(393,280)**	178,499	216,908
Accrued liabilities	**(490,279)**	352,149	81,410
Interest payable on long-term debt	**(922)**	(113)	(113,107)
Other liabilities	**–**	(984,064)	–
	(1,636,195)	(4,788,843)	(3,816,705)
Financing:			
Common and preferred shares, net	**2,357,826**	3,756,509	8,892,563
Other assets	**–**	625,324	(47,177)
Repayments of long-term debt	**(14,110)**	(12,678)	(2,769,912)
Deferred revenue	**–**	–	556,185
	2,343,716	4,369,155	6,631,659
Investments:			
Purchase of capital assets, net of dispositions	**(506,969)**	(326,121)	(409,126)
Increase (decrease) in cash	**200,552**	(745,809)	2,405,828
Cash and cash equivalents, beginning of year	**2,786,734**	3,532,543	1,126,715
Cash and cash equivalents, end of year	**$ 2,987,286**	$ 2,786,734	$ 3,532,543

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements *(Expressed in Canadian dollars)*

Years ended December 31, 1997, 1996 and 1995

Significant accounting policies:

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with those in the United States, except as outlined in note 10. All amounts are expressed in Canadian dollars unless otherwise indicated.

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

The Company's significant accounting policies are as follows:

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.

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.

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. In the event that distributors do not achieve guaranteed minimum sales volumes required under contract, the related amount is recognized as revenue at the end of the guarantee period.

Capital assets:

Capital assets 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%
Sound wave and control equipment	Declining balance	20%
Real time systems	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Computer equipment	Declining balance	30%
Production tooling	Declining balance	30%
Patent and trademarks	Declining balance	20%

Joint venture operations:

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

Inventory:

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

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 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, 1997 was 22,159,563 (1996 - 20,579,571, 1995 - 17,551,303).

Income taxes:

The Company has adopted the income tax standard approved in 1997 by the Accounting Standards Board of the Canadian Institute of Chartered Accountants, on a retroactive basis to January 1, 1995. This standard, in the case of the Company, is similar in all material respects to standards established by Statement of Financial Accounting Standards No. 109 in the United States. 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 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 of a change in tax rates is recognized as part of the provision for income taxes in the period that includes the enactment date.

Comparative figures:

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

1. Capital assets:

1997		Cost		Accumulated depreciation		Net book value
Land	$	120,000	$	–	$	120,000
Building		755,656		178,940		576,716
Sound source and control equipment		1,185,470		1,048,195		137,275
Real time systems		1,282,784		1,180,079		102,705
Furniture and fixtures		455,523		304,824		150,699
Computer equipment		676,957		421,067		255,890
Production tooling		491,922		78,343		413,579
Patents and trademarks		600,793		249,254		351,539
	$	5,569,105	$	3,460,702	$	2,108,403

1996		Cost		Accumulated depreciation		Net book value
Land	$	120,000	$	–	$	120,000
Building		755,656		160,048		595,608
Sound source and control equipment		1,195,200		1,008,381		186,819
Real time systems		1,282,784		1,136,062		146,722
Furniture and fixtures		453,378		268,792		184,586
Computer equipment		607,853		343,897		263,956
Production tooling		177,811		–		177,811
Patents and trademarks		469,454		155,363		314,091
	$	5,062,136	$	3,072,543	$	1,989,593

2. Long-term debt:

		1997		1996
Mortgage, 7.7%, secured by a first charge on land and building	**$**	**312,304**	$	326,415
Less principal included in current liabilities		**18,534**		14,111
	$	**293,770**	$	312,304

The building mortgage is due December 1, 1999 and the current portion has been calculated on the basis that the mortgage will be renewed on a long term basis.

3. 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 preferred shares. The preferred shares are convertible at any time, at the option of the holder, into the greater of an equal number of common shares or the number of common shares calculated at a rate related to the average NASDAQ bid and ask price of the Company's common shares near the conversion date.

Preferred shares issued:

	Number of Shares		Consideration
Issued for cash:			
Private placement (Series 2)	621,621	$	1,303,750
Private placement (Series 3)	270,270		673,715
Balance at December 31, 1996	891,891		1,977,465
Converted to common shares:			
Private placement (Series 2)	(513,513)		(1,035,058)
Private placement (Series 3)	(270,270)		(673,715)
Balance at December 31, 1997	108,108	$	268,692

Common shares issued:

	Number of Shares	Consideration
Balance at December 31, 1994	16,852,973	$ 29,914,796
Issued for cash:		
On exercise of warrants and options	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
Issued for cash:		
On exercise of warrants and options	600,000	1,521,684
On exercise of directors' and employees' options	76,600	257,360
For services	71,432	292,987
Balance at December 31, 1996	20,906,176	41,314,648
Issued for cash:		
On exercise of warrants and options	1,061,911	1,986,990
On exercise of directors' and employees' options	143,900	389,027
Preferred share conversion (Series 2)	973,787	1,035,058
Preferred share conversion (Series 3)	383,282	673,715
Preferred share conversion costs	–	(18,191)
Balance at December 31, 1997	23,469,056	$ 45,381,247

The legal stated capital of QSound as at December 31, 1997 is 45,238,522 (1996 - $42,862,505).

Reserved common shares:

At December 31, 1997 common shares were reserved for issuance as follows:

2,807,500	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 1,049,250 were exercisable at December 31, 1997.
200,000	shares pursuant to share purchase warrants issued in May and October 1994 in connection with a convertible loan which was repaid in 1994. The warrants are exercisable at a price of U.S.$3.75 per share of which 100,000 warrants expire on May 24, 1999 and on October 24, 1999.
155,402	shares pursuant to share purchase warrants issued in 1996 in connection with the preferred share issuance. The warrants are exercisable at a price of U.S. $2.03 per common share and 121,619 expire December 31, 1998 and 33,783 expire December 28, 1998.
50,000	shares pursuant to share purchase warrants issued in 1996 in connection with services performed by a third party. The warrants are exercisable at a price of U.S. $2.19 and expire November 26, 2001.
148,000	shares pursuant to share options issued to third parties in 1997 for services performed, of which 63,000 are exercisable at U.S. $2.19 and expire on September 16, 2001, and 85,000 are exercisable at U.S. 1.25 and expire on May 8, 2001.

Changes in options granted to directors and employees during the years ended December 31, 1997, 1996 and 1995 were as follows:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance, at December 31, 1994	1,055,600	$0.76 - $5.18	$ 3.06
Granted	855,000	3.85 - 4.70	4.31
Exercised	(263,750)	0.76 - 4.00	2.01
Cancelled or expired	(96,350)	3.00 - 5.18	4.46
Balance at December 31, 1995	1,550,500	$0.76 - $4.70	$ 3.84
Granted	965,000	3.10 - 3.50	$ 3.28
Exercised	(76,600)	3.35 - 3.50	3.36
Cancelled or expired	(398,000)	3.00 - 4.05	3.57
Repriced - previous	(175,000)	3.90 - 4.05	4.00
- new	175,000	3.00 - 3.50	3.41

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at December 31, 1996	2,040,900	$0.76 - $4.70	$ 3.59
Granted	955,400	2.07 - 4.17	3.30
Exercised	(143,900)	0.76 - 3.60	3.48
Cancelled or expired	(44,900)	2.00 - 3.85	3.35
Repriced - previous	(966,850)	3.35 - 4.70	4.01
- new	966,850	2.04 - 2.76	2.75
Balance at December 31, 1997	**2,807,500**	**$0.76 - $4.70**	**$ 3.07**

4. Transactions with related parties:

In 1997 the Company was charged $136,220 (1996 - $219,780; 1995 - $224,230) for management services provided by directors and officers pursuant to consulting arrangements.

Under Canadian accounting principles, the Company's ongoing joint venture with the House Ear Institute is considered a related party. Details of transactions with the joint venture are disclosed in note 6. The transactions are considered part of the normal course of operations for the joint venture activity.

5. Income taxes:

The Company uses the liability method of accounting for income taxes. The tax effects of temporary differences that give rise to significant portions of future income tax assets are as follows:

	1997	1996
Future income tax assets:		
Property and equipment	$ 1,483,220	$1,312,439
Share issue costs	121,880	113,960
Operating loss carryforwards	5,189,954	5,601,247
Scientific Research and experimental development expenditures	6,721,788	6,161,332
Cumulative eligible capital	248,600	248,600
	13,765,442	13,437,578
Less: Valuation allowance	13,765,442	13,437,578
Net future tax asset	$ –	–

The company's non-capital losses expire at various dates between1999 and 2004. The Company also has available investment tax credits of $4,320,000 (1996 - $4,133,000) which expire at various dates between 2000 and 2007.

6. Joint venture:

The Company has an ongoing joint venture with the House Ear Institute to develop, manufacture and sell binaural hearing aid products.

The Company's proportionate share of accounts receivable, property and equipment, revenue and expenses of the joint venture is as follows:

		1997		1996		1995
Accounts receivable	**$**	**100,000**	$	–	$	–
Property and equipment, net		**–**		–		29,754
Revenue		**100,000**		1,995		67,163
Expenses		**(134,763)**		(12,450)		516,671
Loss for the year from joint ventures	**$**	**(34,763)**	$	(10,455)	$	(449,508)
Cash used in operations	**$**	**(34,763)**	$	(10,455)	$	(436,756)
Cash used in investing	**$**	**–**	$	–	$	(6,348)

The revenue and expenses above are substantially incurred or earned by the Company on behalf of the joint venture.

7. 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.

8. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their fair values at December 31, 1997.

The Company is exposed to foreign currency fluctuations on its U.S. dollar denominated cash, receivables and payables. Foreign currency risk arising from a decline in the relative value of the Canadian dollar is managed to the extent that U.S. dollar denominated cash and receivables are equal to or exceed U.S. dollar payables.

The Company is exposed to interest rate risk on its fixed interest rate cash equivalent and its long term debt. Cash equivalents are short term investments with original maturities of less than 90 days for which cost approximates market value. Long term debt matures December 1, 1999.

The Company is exposed to credit risk on its cash and short-term deposits and accounts receivable. Cash and short-term deposits are in place at major financial institutions. Accounts receivable and accrued revenue are primarily concentrated among two large customers, one located in the United States, and one in Asia. The Company also has many smaller customers, located in Canada, United States, and Asia. During 1997, 22% of total revenue arose from one customer. For 1996 and 1995, 54 % and 70%, respectively, of total revenue arose from three customers, each of which individually resulted in greater than 10% of total revenues.

9. Commitments and Contingencies:

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

Under the terms of its lease agreements for office equipment, the Company is obligated at December 31, 1997 to make payments of $23,218 per year over the next four years and a payment of $21,283 in the fifth year.

10. United States accounting principles:

The financial statements have been prepared in accordance with generally accepted accounting principles (“GAAP”) in Canada. Under United States’ GAAP (i) the deferred expenditures recorded on the acquisition of the 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) deferred unrealized foreign exchange losses would be expensed; (iv) compensation expense would be recognized on share options granted to third parties, in accordance with SFAS No. 123. (v) non-cash items would be excluded from the statement of changes in financial position; and (vi) patents and trademarks included in capital assets would be disclosed separately as intangible assets.

The Company uses the proportionate consolidation method of joint venture accounting which complies with Canadian GAAP but is not in accordance with US GAAP. The Company’s joint venture activity is disclosed in note 6.

The effect on the loss for each of the years in the three year period ended December 31, 1997 of the differences between Canadian and United States accounting principles is summarized as follows:

Years ended December,	**1997**	1996	1995
Loss for the year as reported	**$ (695,350)**	$ (4,266,490)	$ (4,816,774)
Expenditures capitalized under Canadian accounting principles	**–**	–	(122,395)
Amortization of deferred expenditures	**–**	313,183	1,208,904
Foreign exchange losses deferred or included in share capital under Canadian accounting principles	**–**	–	41,103
Compensation expense under SFAS No. 123	**(275,000)**	–	–
Loss under United States accounting principles	**$ (970,350)**	$ (3,953,307)	$ (3,689,162)
Loss per share under United States accounting principles	**$ (0.04)**	$ (0.19)	$ (0.20)

The weighted average number of shares outstanding for the year ended December 31, 1997 under United States generally accepted accounting principles was 22,159,563 (1996 - 20,579,571, 1995 - 18,576,303). The Company has adopted SFAS No. 128 for purposes of calculating per share amounts which did not affect previously reported per share amounts for United States GAAP purposes.

There was no difference in total shareholders equity as at December 31, 1997 and 1996 under Canadian and United States accounting principles.

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

Years ended December,	**1997**	1996	1995
Operating activities	**$ (1,636,195)**	$ (4,788,843)	$ (3,939,100)
Financing activities	**$ 2,343,716**	$ 4,369,155	$ 6,678,836
Investing activities	**$ (506,969)**	$ (326,121)	$ (286,731)

Corporate Information

Directors

David Gallagher, President and CEO

George Fosley, Jr.

James Bonfiglio

Ian Tweedie

Stock Exchange Listings/Stock Symbols

NASDAQ SmallCap Market: QSNDF

Patent Counsel

Fulbright & Jaworski
#2800, 2200 Ross Avenue
Dallas, Texas 75201

Bankers

The Royal Bank of Canada
3439 – 26th Avenue NE
Calgary, Alberta T1Y 6L4

Bank of America
333 South Beaudry Avenue
Los Angeles, California 90017

Auditors

KPMG
Suite 1200, Bow Valley Square II
205 – 5th Avenue SW
Calgary, Alberta T2P 4B9

Register and Transfer Agent

Montreal Trust
#600, 530 – 8th Avenue SW
Calgary, Alberta T2P 3S8

Head Office & Technical Research Facility

QSound Labs, Inc.
2748 - 37th Avenue NE
Calgary, Alberta, Canada T1Y 5L3
Tel: 403-291-2492
Fax: 403-250-1521

Sales Office
#403 - 2010 North First Street
San Jose, CA, USA 95131
Tel: 408-894-8100
Fax: 408-894-8116

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Notice of Meeting

The annual meeting of shareholders will be held at the Sheraton Cavalier, South Room, Calgary, Alberta on June 25, 1998, at 10:00AM

QSound Team

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