QSound Labs, Inc.

QSOUND

Annual Report 1998

Strategy for growth

provide enabling

technologies

for convergent markets

president's message

For the past ten years, QSound has faced numerous challenges as the audio enhancement marketplace evolved and competitors emerged. 1998 was a significant year, as we saw substantial signs of success for the Company's definitive strategy of building on its core competencies of software development, technology development and transfer. Today, QSound is a leading, world-wide supplier of efficient, high quality analog and digital audio solutions for four major industries, PC and home video games, consumer electronics, Internet streaming media and hearing aids.

1998 saw notable increases in revenue derived from software downloads via the Internet and the adoption by AIWA of QSound's technology in their mini-component stereo systems. These events highlight successful implementations of management's strategy to lever our core technology, superior engineering and technical support skills into revenue growth opportunities.

There were also disappointments: in particular, the postponed introduction of Starkey, Laboratories' first digital hearing aid, Cetera™, now scheduled for the first half of 1999, and the lack of growth in royalty revenue from the PC/Multimedia industry.

Looking forward to 1999, the Internet, whose users now number over 112 million worldwide,[1] represents a significant growth opportunity, not only for audio enhancement products, but also for e-commerce solutions developed internally to sell such products. The QSound Affiliate Program was launched in August, 1998 and has proved to be a successful business model for capturing traffic, selling product and conducting e-commerce. At the core of this program is affiliateDirect, a software tool designed to track and monitor banner ads and affiliates as well as conduct e-commerce. This software program will be available for license in 1999.

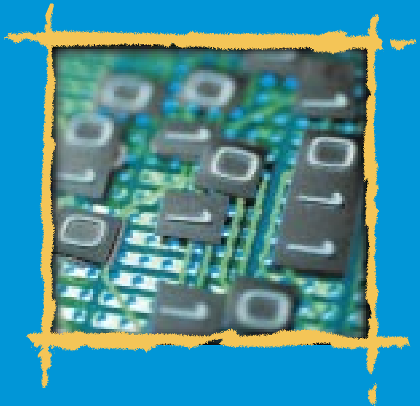
I would like to thank the shareholders for their continued support and our employees for their dedication and loyalty. We are confident that, with the exploding Internet market, the introduction of Starkey's Cetera™ hearing-aid and the increased worldwide acceptance and adoption of audio enhancement in general, QSound's shareholders will be provided with a profitable 1999.

David Gallagher

David Gallagher
President and Chief Executive Officer

[1]Myratech Advice and Answers-Internet Statistics – http://myratech.net/stats.htm

the technology



Offering a continually growing suite of audio technologies, QSound features highly efficient and effective 3D audio processing. These technologies, protected by a total of 17 patents, are incorporated directly into the Company’s end-user products, and are provided to commercial customers in the form of integrated circuits and algorithms applicable to a variety of industries.

Q3D™ 2.0 – Positional 3D Audio

Licensed to manufacturers of computers and computer sound components, as well as to software developers, Q3D addresses the demands of today's immersive 3D games. Q3D places multiple sounds in 3D space interactively and in real time. It has additional applications in simulation, audio production (hobbyist to professional) and communications.

QSurround™ – Virtual Surround

Creates "virtual speakers" to enhance and reproduce multi-channel audio delivery formats such as Dolby® Digital, (AC-3) and Dolby Pro Logic® with as few as two physical speakers. Certified by Dolby Labs Licensing Corp., QSurround has applications in PC audio and home theatre systems.

QXpander™ – Stereo Enhancement

Is a stereo-to-3D enhancement process, with the available option of mono-to-3D soundfield synthesis. QXpander is widely licensed to manufacturers of consumer electronics, as it adds value to virtually any stereo sound system.

Cetera™ – Digital Binaural Hearing Aids

Is technology developed by HEAR, a joint venture between QSound Labs and the House Ear Institute of Los Angeles, which has led to three patents for advanced digital hearing aid algorithms and fitting systems for audiologists.

affiliateDirect™

Is a turnkey solution for establishing and managing the multi-level marketing on the World Wide Web. Using a standard database, any on-line merchant can take their sales to the next level by using the affiliateDirect system and applying traditional multi-level sales techniques to their marketing plan.

the markets

PC/Multimedia

Faster machines, evolving operating systems, and the demand for more affordable computers have all contributed to a very different computer marketplace than the one that existed even 2 years ago. PC OEM's are focused on cost as consumers expect lower prices. QSound's "soft audio" solutions are ideal for this market. In the aftermarket, soundcard manufacturers are concerned with offering the latest features and upgrades and again, QSound has the ideal solution in Q3D 2.0.

Consumer Electronics

QSound's presence in the Consumer Electronics field is rapidly increasing, due primarily to the increased number of product models being shipped by AIWA world-wide. AIWA's commitment to the continued use of QSound in their products will see an even greater penetration in the world marketplace in 1999.

Significant inroads have also been make with other leading manufacturers including Boston Acoustics, Daewoo, Go-Video, Sharp, and Sanyo. These companies manufacture a variety of multi-function audio systems, VCR's, DVD systems, speakers and televisions that include the QSound technology.

The Asian marketplace provides an area of major expansion for QSound. During 1998, the Company aggressively promoted its technology in China, Korea and Hong Kong. We believe that these countries will provide both increased revenues and exposure in the future. China in particular presents a unique opportunity for growth as technical production capabilities and demand for high quality products have increased dramatically in the past 10 years.

The Internet – Media

Music videos, live concerts, talk shows, audio books, full length CDs, even sports events are now being viewed and listened to every day via the Internet. Recognizing this as an untapped market with tremendous potential for growth, QSound applied its expertise to the production of several software-based solutions that enhance the audio quality of this medium.

Our first product, iQ™, has been very successful since its introduction at the 1997 Fall Comdex show. Additional programs, iQfx™ and QCreator™ have followed to offer a variety of audio options to the web user. Further products are currently under development and will be introduced in the coming year. To date, QSound has sold these products on its own Web site and has partnered with such major sites as Broadcast.com, Discjockey.com, Geocities, RealNetworks, RollingStone.com and Spinner.com. These partners provide not only increased selling power but add prominent exposure for QSound to the Web community.

Internet – e-commerce

Even though e-commerce is still considered to be in its infancy, 78 million people used the World Wide Web during the first six months of 1998 and over 20 million made purchases.[2] The sale of computer software is among the top three categories of goods sold (behind books and computer equipment). Over 4 million people purchased computer software via the Web from September 1997 to June 1998, an increase of over 12 million customers from the previous 6 months.E-commerce is expected to grow rapidly to a $220 billion dollar industry by 2002 – a ten-fold increase from the estimated $23 billion being spent today.[3]

affiliateDirect

Purchasing products on-line has become an every day occurrence. To facilitate the sale of these products, QSound has developed affiliateDirect, a turnkey solution that allows any company to promote and distribute its products on-line while taking care of all related administrative details. Developed to have universal appeal, affiliateDirect will be marketed to web merchants as a complete e-commerce solution.

Hearing Aid

The introduction of the Cetera™ digital hearing aid by Starkey Laboratories in late April, 1999, gave QSound its first Health Care industry product. The innovative technology incorporated in Cetera is the result of years of research by the House Ear

[2] Nielsen Media Research & Commerce Net – http://sellitontheweb.com/ezine/news0148.shtml
[3] Headscape – heet://headscape.com/factsandstats.htm

Institute and QSound Labs (HEAR Joint Venture) and has received three patents to date.

The exclusive manufacturer and distributor of this product, Starkey is targeting the largest segment of the world's population with hearing loss–those who have mild to moderate hearing impairments. With its impressive record as the world's second largest supplier of "in-the-ear" and "in-the-canal" hearing instruments, the potential for this product is very exciting. In 1998 there were 1.6 million users of this type of product in the United States alone. Europe and Japan are also seen as markets with great potential. As the candidates for a completely in the canal hearing instrument are younger, more active and upwardly mobile,[4] this product is expected to be both well positioned and highly successful.

[4]Knowles Electronics – http://www.knowlesinc.com/KMelec/html/f6_3.htm

financial

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 1998 and 1997 and the consolidated statements of operations and deficit and cash flows for each of the years in the three year period ended December 31, 1998. 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 Canadian 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, 1998 and 1997 and the results of its operations and cash flows for each of the years in the three year period ended December 31, 1998 in accordance with Canadian generally accepted accounting principles.

Chartered Accountants KPMG LLP

Calgary, Canada
February 26, 1999

Consolidated Balance Sheets

AS AT DECEMBER 31 (EXPRESSED IN UNITED STATES DOLLARS)	1998 $	1997 $
ASSETS		
Current assets:		
Cash and cash equivalents	2,125,613	2,090,327
Accounts receivable	408,506	681,947
Royalties receivable	375,135	128,562
Accrued revenue	655,243	688,388
Inventory	225,706	403,289
Prepaid expenses	75,280	79,924
	3,865,483	4,072,437
Capital assets (note 1)	934,454	1,475,337
	4,799,937	5,547,774
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	137,221	360,196
Accrued liabilities	34,649	49,441
Current portion of long-term debt	—	12,969
Deferred revenue	44,622	—
	216,492	422,606
Long-term debt (note 2)	—	205,562
Shareholders' equity:		
Preferred shares (note 3)	—	188,015
Common shares (note 3)	32,939,632	31,755,124
Deficit	(28,356,187)	(27,023,533)
	4,583,445	4,919,606
Commitments and contingencies (note 9)		
	4,799,937	5,547,774

See accompanying notes to consolidated financial statements.

Approved by the Board:

Director David Gallagher

Director James R. Bonfiglio

Consolidated Statements of Operations and Deficit

FOR THE YEARS ENDED DECEMBER 31 (EXPRESSED IN UNITED STATES DOLLARS)	**1998** **$**	1997 $	1996 $
Revenue:			
Product sales	**1,034,043**	1,389,145	1,849,527
Royalties and license fees	**1,078,002**	2,065,848	1,525,850
Rentals and other	**13,327**	19,944	15,452
	2,125,372	3,474,937	3,390,829
Cost of product sales	**(283,352)**	(711,344)	(1,380,057)
	1,842,020	2,763,593	2,010,772
Expenses:			
Marketing	**1,301,990**	1,652,674	2,200,693
Product research and development	**1,292,313**	891,305	1,138,200
Administration	**447,855**	539,744	843,958
Patent litigation	**—**	120,146	412,781
Depreciation and amortization	**262,815**	271,611	419,849
Interest on long-term debt	**12,382**	24,090	25,036
Foreign exchange (gain) loss	**6,627**	(102,464)	16,645
Interest and other income	**(93,664)**	(146,948)	(60,952)
Gain on sale of capital assets	**(150,889)**	—	—
	3,079,429	3,250,158	4,996,210
Loss for the year	**(1,237,409)**	(486,565)	(2,985,438)
Deficit, beginning of year	**(27,023,533)**	(26,536,968)	(23,551,530)
Repurchase of common shares (note 3)	**(95,245)**	—	—
Deficit, end of year	**(28,356,187)**	(27,023,533)	(26,536,968)
Loss per common share	**(0.05)**	(0.02)	(0.15)

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

FOR THE YEARS ENDED DECEMBER 31 (EXPRESSED IN UNITED STATES DOLLARS)	1998 $	1997 $	1996 $
Cash provided by (used in):			
Operations:			
Loss for the year	(1,237,409)	(486,565)	(2,985,438)
Items not requiring (providing) cash:			
Depreciation and amortization	262,815	271,611	419,849
Gain on sale of capital assets	(150,889)	—	—
Expenses paid with common shares	—	—	205,015
Changes in working capital balances:			
Accounts receivable	485,137	508,231	(789,399)
Royalties receivable	(246,573)	109,363	721,428
Accrued revenue	33,145	(682,805)	(5,584)
Inventory	177,583	(25,982)	(227,031)
Prepaid expenses	4,644	(25,418)	23,680
Accounts payable	(222,975)	(275,194)	124,903
Accrued liabilities	(14,792)	(343,713)	246,334
Other liabilities	—	—	(688,590)
Deferred revenue	44,622	(194,440)	(396,117)
	(864,692)	(1,144,912)	(3,350,950)
Financing:			
Repurchase of common shares, net	(334,737)	—	—
Issuance of common shares	1,235,985	1,649,868	2,628,584
Other assets	—	—	437,565
Repayments of long-term debt	(9,212)	(9,874)	(8,871)
	892,036	1,639,994	3,057,278
Investments:			
Purchase of capital assets	(240,645)	(354,747)	(228,200)
Proceeds from sale of capital assets	248,587	—	—
	7,942	(354,747)	(228,200)
Increase (decrease) in cash and cash equivalents	35,286	140,335	(521,872)
Cash and cash equivalents, beginning of year	2,090,327	1,949,992	2,471,864
Cash and cash equivalents, end of year	2,125,613	2,090,327	1,949,992

See accompanying notes to consolidated financial statements.

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 QSound Labs, Inc. (the "Company"), conform in all material respects with those in the United States, except as outlined in note 10. All amounts are expressed in United States 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:

(a) 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 QSound Ltd., QSound Electronics, Inc. and QKidz, Inc.

Effective January 1, 1998, as a result of consistent and increasing activity in U.S. dollars, the Company adopted the U.S. dollar as its currency of measurement and display. Prior year amounts have been translated using the translation of convenience method whereby amounts appearing for prior years were restated from Canadian dollars to United States dollars using the exchange rate in effect at December 31,1997.

(b) Cash and cash equivalents:

Cash equivalents are short term deposits with original maturities of less than 90 days for which cost approximates market value.

Excluded from the statement of cash flows are $211,696 receivable from the sale of the building and the assumption of the related mortgage of $209,319 by the acquirer.

The Company has available by letter of credit and/or overdraft loan up to $410,000. The facility bears interest at prime or base rate plus 0.50% per annum. The Company also has available a forward foreign exchange line supporting USD/YEN conversion up to $400,000 U.S. Amounts are repayable on demand and secured by short-term deposits. There were no amounts owing on the facilities at December 31, 1998.

(c) Accrued revenue:

Accrued revenue represents fees due to the Company under license agreements.

(d) Inventory:

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

(e) Capital assets:

Capital assets are recorded at cost and are amortized annually beginning the year after acquisition over the expected useful life of the assets as follows:

Assets	Basis	Rate
Sound source and control equipment	Declining balance	20%
Real time systems	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Computer equipment	Declining balance	30%
Production tooling	Declining balance	30%
Patents and trademarks	Straight-line	20%
Building	Straight-line	2-1/2%

(f) Foreign currency translation:

The Company translates monetary assets and liabilities at the rate of exchange in effect as at the balance sheet date, and revenues and expenses at the average rates in effect during the year.

(g) 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 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.

The Company complies with the American Institute of Certified Public Accountants' Statement of Position (SOP) 97-2 with respect to software revenue recognition. Pursuant to SOP 97-2, four specific criteria must be met prior to recognizing revenue for a single-element arrangement or for amounts allocated to individual elements in a multiple-element arrangement. These four criteria are (a) persuasive evidence of an arrangement exists; (b) delivery has occurred; (c) the vendor's fee is fixed or determinable; and (d) collectibility is probable. Application of SOP 97-2 has not affected revenues.

(h) 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, 1998 was 23,867,841 (1997 - 22,159,563, 1996 - 20,579,571).

(i) Income taxes:

The Company uses the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using enacted 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.

1. CAPITAL ASSETS:

1998	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 524,399	$ 474,928	$ 49,471
Real time systems	905,534	854,783	50,751
Furniture and fixtures	325,571	235,747	89,824
Computer equipment	536,504	350,177	186,327
Production tooling	408,109	142,890	265,219
Patents and trademarks	518,446	225,584	292,862
	$ 3,218,563	$ 2,284,109	$ 934,454

1997	Cost	Accumulated depreciation	Net book value
Land	$ 83,969	$ —	$ 83,969
Building	528,764	125,212	403,552
Sound source and control equipment	829,522	733,465	96,057
Real time systems	897,617	825,750	71,867
Furniture and fixtures	318,748	213,298	105,450
Computer equipment	473,695	294,638	179,057
Production tooling	344,218	54,820	289,398
Patents and trademarks	420,400	174,413	245,987
	$ 3,896,933	$ 2,421,596	$ 1,475,337

2. LONG-TERM DEBT:

	1998	1997
Mortgage, 7.7%, secured by a first charge on land and building	$ —	$ 218,531
Less current portion	—	12,969
	$ —	$ 205,562

During 1998, the Company's land and building were sold for proceeds of $214,101 cash, a receivable of $211,696, and assumption of the related mortgage of $209,319 by the acquiror

3. SHARE CAPITAL:

(a) 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.

(b) Preferred shares issued and outstanding:

	Number of Shares	Consideration
Issued for cash:		
Private placement (Series 2)	621,621	$ 912,288
Private placement (Series 3)	270,270	471,426
Balance at December 31, 1996	891,891	1,383,714
Converted to common shares:		
Private placement (Series 2)	(513,513)	(724,273)
Private placement (Series 3)	(270,270)	(471,426)
Balance at December 31, 1997	108,108	188,015
Converted to common shares:		
Private placement (Series 2)	(108,108)	(188,015)
Balance at December 31, 1998	—	$ —

3. SHARE CAPITAL: (continued)

The preferred shares issued in the Series 2 and Series 3 private placements were 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.

(c) Common shares issued and outstanding:

	Number of Shares	Consideration
Balance at December 31, 1995	20,158,144	$ 27,459,672
Issued for cash:		
On exercise of warrants and options	600,000	1,064,785
On exercise of options granted to directors and employees	76,600	180,085
For services	71,432	205,015
Balance at December 31, 1996	20,906,176	28,909,557
Issued for cash:		
On exercise of warrants and options	1,061,911	1,390,379
On exercise of options granted to directors and employees	143,900	272,218
Preferred share conversion (Series 2)	973,787	724,273
Preferred share conversion (Series 3)	383,282	471,426
Preferred share conversion costs	–	(12,729)
Balance at December 31, 1997	23,469,056	31,755,124
Issued for cash:		
On exercise of warrants and options	159,890	297,323
On exercise of directors' and employees' options	423,500	938,662
Preferred share conversion (Series 2)	140,540	188,015
Repurchase of common shares	(175,000)	(239,492)
Balance at December 31, 1998	24,017,986	$ 32,939,632

During 1998 the Company repurchased 175,000 common shares for an aggregate consideration of $334,737.

3. SHARE CAPITAL: (continued)

(d) Reserved common shares:

At December 31, 1998 common shares were reserved for issuance as follows:

2,402,000 shares pursuant to directors' and employees' options, exercisable ranging from March 31, 1999 to May 1, 2003, at prices ranging from $1.55 to $3.15 per share, of which 1,767,250 were exercisable at December 31, 1998.

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 $3.75 per share and 100,000 warrants expire on each of May 24, 1999 and October 24, 1999.

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 $2.19 and expire on November 26, 2001.

250,500 shares pursuant to share options issued to third parties for services performed of which 63,000 are exercisable at $2.19 and expire on September 16, 2001, 50,000 are exercisable at $1.25 and expire on May 8, 2001, 50,000 are exercisable at $2.45 and expire on April 25, 1999, 25,000 are exercisable at $1.25 and expire on June 11, 2002, 37,500 are exercisable at $3.15 and expire on June 7, 1999, and 25,000 are exercisable at $1.75 and expire on July 1, 2001.

Changes in options granted to directors and employees during the years ended December 31, 1998, 1997 and 1996 were as follows:

3. SHARE CAPITAL: (continued)

(d) Reserved common shares:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance, at December 31, 1995	1,550,500	$ 0.53 - $3.29	$ 2.69
Granted	965,000	2.17 - 2.45	2.30
Exercised	(76,600)	2.34 - 2.45	2.35
Cancelled or expired	(398,000)	2.10 - 2.83	2.50
Repriced - previous	(175,000)	2.73 - 2.83	2.80
- new	175,000	2.10 - 2.45	2.39
Balance at December 31, 1996	2,040,900	0.53 - 3.29	2.52
Granted	955,400	1.45 - 2.92	2.31
Exercised	(143,900)	0.53 - 2.52	2.44
Cancelled or expired	(44,900)	1.40 - 2.69	2.34
Repriced - previous	(966,850)	2.34 - 3.29	2.81
- new	966,850	1.43 - 1.93	1.92
Balance at December 31, 1997	2,807,500	1.50 - 3.15	2.15
Granted	777,000	1.75 - 3.00	2.78
Exercised	(423,500)	1.67 - 2.16	2.21
Cancelled or expired	(759,000)	1.50 - 3.06	2.45
Balance at December 31, 1998	2,402,000	$ 1.55 - 3.15	$ 2.25

4. TRANSACTIONS WITH RELATED PARTIES:

In 1998 the Company was charged $70,049 (1997 - $95,119; 1996 - $153,789) for management services provided by directors and officers pursuant to consulting arrangements.

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:

5. INCOME TAXES: (continued)

	1998	1997
Future income tax assets:		
Capital assets	$ 874,000	$ 956,900
Share issue costs	35,000	52,000
Loss carryforwards	8,242,000	7,825,000
Cumulative eligible capital	139,000	120,000
	9,290,000	8,953,900
Less: Valuation allowance	(9,290,000)	(8,953,900)
Net future tax asset	$ —	$ —

The Company's non-capital losses expire at various dates between 1999 and 2005. The Company also has available investment tax credits of $2,673,000 which expire at various dates between 2000 and 2007.

6. JOINT VENTURE:

The Company was involved through a joint venture in the development, manufacturing and marketing of binaural hearing aid products. In 1998, the project entered its marketing phase and, concurrently with the substantial completion of the development phase of the project, the activity of the joint venture became limited to earning royalties on the sale of hearing aids by the joint venture's licensee. As a result, the Company ceased accounting for its activity related to this joint venture by the proportionate consolidation method. At December 31, 1998, no royalties had been earned.

The Company's proportionate share of accounts receivable, revenue and expenses for 1997 and 1996 was as follows:

	1997	1996
Accounts receivable	$ 69,974	$ —
Revenue	69,974	1,396
Expenses	(94,299)	(8,712)
Loss for the year from joint ventures	$ (24,325)	$ (7,316)
Cash used in operations	$ (24,325)	$ (7,316)

The revenue and expenses above were 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 operating segment which involves the developing and marketing of sound localization technology for use in various industries. Substantially all of the Company's assets and employees are located in Canada. Substantially all of the Company's revenues are derived from export sales to the United States and Asia.

7. SEGMENTED INFORMATION: (continued)

During 1998, 49% of total revenue arose from two customers, each of which individually resulted in greater than 10% of total revenues. For 1997, 22% of total revenue arose from one customer. For 1996, 54% of total revenue arose from three customers, each of which individually resulted in greater than 10% of total revenues.

8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 1998.

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

The Company is exposed to credit risk on its cash and short term deposits, accounts receivable, royalties receivable and accrued revenue. Accounts receivable concentration arises from two entities, which comprise 52% and 25% of the balance at December 31, 1998. Neither of these entities were in accounts receivable at December 31, 1997. Royalties receivable concentration arises from one entity which comprises 52% of the balance and was not in royalty receivable at December 31, 1997. Accrued revenue concentration is among three entities, which comprise 76%, 13% and 11% of the balance at December 31, 1998 and one of which comprised 86% of the balance at December 31, 1997. The entities are primarily located in the United States and Asia.

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, 1998 to make payments of $66,093 per year over the next four years and a payment of $55,078 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) marketing expense would be recognized on share options and warrants granted to third parties, in accordance with SFAS No. 123; and (ii) patents and trademarks included in capital assets would be disclosed separately as intangible assets.

The effect on the loss for each of the years in the three year period ended December 31, 1998 of the differences between Canadian and United States accounting principles is summarized as follows:

10. UNITED STATES ACCOUNTING PRINCIPLES: (continued)

Years ended December 31, 1998, 1997 and 1996	1998	1997	1996
Loss for the year as reported	$ (1,237,409)	$ (486,565)	$ (2,985,438)
Amortization of deferred expenditures	—	—	219,147
Marketing expense under SFAS No. 123	—	(192,429)	—
Loss under United States accounting principles	$ (1,237,409)	$ (678,994)	$ (2,766,291)
Loss per share under United States accounting principles	$ (0.05)	$ (0.03)	$ (0.13)

There was no difference in the weighted average number of shares outstanding in the years ended December 31, 1998, 1997 and 1996 under Canadian and United States accounting principles. 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, 1998 and 1997 under Canadian and United States accounting principles.

In June 1997, the FASB issued SFAS No. 130, Reporting Comprehensive Income, which establishes standards for reporting and disclosure of comprehensive income and its components (revenues, expenses, gains and losses) in a full set of general purpose financial statements. SFAS No. 130 is effective for fiscal years beginning after December 15, 1997 and requires classification of financial statements for earlier years to be provided for comparative purposes. The Company adopted SFAS No. 130 on January 1, 1998, however, no incremental disclosures are required as the Company does not have any elements of comprehensive income except for the net loss reported in the statements of operations and deficit.

11. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE:

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant system failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

QSound's Head Office-Fourth Floor

Directors

David Gallagher,
George Fosley, Jr.
James Bonfiglio
Ian Tweedie

Stock Exchange Listings/Stock Symbols

NASDAQ SmallCap Market:
QSND

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

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

Head Office & Technical Research Facility

QSound Labs, Inc.
#400, 3115-12th St NE
Calgary, Alberta, Canada T2E 7J2
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

Notice of Meeting

The annual meeting of shareholders will be held at QSound Labs' Head Office, Calgary, Alberta, on June 18th, 1999, at 10:00AM

www.qsound.com

QSound Labs, Inc.
#400, 3115-12 St NE
Calgary, Alberta,
Canada T2E 7J2

QSOUND