ANNUAL REPORT 1999

Notice of Meeting

The annual meeting of shareholders will be held at QSound Labs' Head Office, Calgary, Alberta, on June 22, 2000 at 10:00 a.m.

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QSound Labs experienced an exciting year in 1999 as the Company saw strong revenue growth, significant new product introductions and the continued shift from its traditional OEM licensing business to Internet-based opportunities. By building on the Company's extensive stable of 3D audio technologies, QSound has positioned itself as a world leader in Internet audio software solutions and is poised to take advantage of this leadership position in the coming years.

During 1999, QSound released several new Internet audio software products including iQms™ for Microsoft's Windows Media Player™, Qmp3D™, exclusively for the Winamp™ Player, and iQLinux™ for the Linux operating system. The Company also launched AudioPix™, its first multimedia software product, and its Web site www.audiopix.com at the Fall Comdex Show in Las Vegas. AudioPix enables web users to combine images with music to create the ultimate multimedia application.

The Internet will continue to provide significant growth opportunities for QSound in the Year 2000 and beyond as new software releases add to our QSound Affiliate Program and our distribution relationship with Real Networks.

In August, we finalized the purchase of Virtual Spin, Inc., a company that pioneered e-commerce site development services for small and medium sized businesses. We believe that our re-branding campaign of the company to QCommerce, Inc. has been successful and as part of this effort, the QCommerce Web site, www.qcommerce.com was launched in December. It is expected that QCommerce will experience substantial growth in 2000 as new strategic partnerships and reseller arrangements are developed, and as the need for e-commerce solutions in the marketplace continues to expand dramatically.

President's Message

Other 1999 accomplishments included the launch of Starkey's Cetera™ hearing aid, the advancement of engineering work on Soft Audio solutions, the continuation of the Company's strategic partnership with Philips and the signing of several new OEM licensing deals in key markets such as DVD players.

Financially, QSound saw significant growth as total revenues from all of our major business segments, PC, consumer electronics and the Internet, increased by 71% over 1998. In particular, Internet based revenues continued to trend upwards and now account for 45% of the total Company revenues. Management was also able to keep operating costs down as expenditures declined.

A key objective for the Year 2000 will be establishing new ways to unlock shareholder value for all of the Company's core businesses. QSound has taken the first steps toward this goal by considering several companies as possible acquisition or merger candidates. We expect to move forward with these efforts in a timely and responsible manner.

I would like to thank our shareholders and employees for their continued commitment and dedication. We look forward to the challenges that the new millennium will bring and are confident the Company is well positioned for success.

David Gallagher

David Gallagher
President and
Chief Executive Officer

Auditor’s Report To The Shareholders

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 1999 and 1998 and the related consolidated statements of operations and deficit and cash flows for the years ended December 31, 1999, 1998 and 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 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 and subsidiaries as at December 31, 1999 and 1998 and the results of its operations and its cash flows for the years ended December 31, 1999, 1998 and 1997 in accordance with Canadian generally accepted accounting principles.

Accounting principals generally accepted in Canada vary in certain significant respects from accounting principles generally accepted in the United States. Application of accounting principles generally accepted in the Untied States would have affected results of operations for each of the years in the three year period ended December 31, 1999 and shareholders’ equity as at December 31, 1999 and 1998 to the extent summarized in note 13 to the consolidated financial statements.

KPMG LLP

Chartered Accountants

Calgary, Canada
April 20, 2000

Consolidated Balance Sheets

December 31, 1999 and 1998
(Expressed in United States dollars)

	1999	1998
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,524,363	$ 2,125,613
Accounts receivable	1,090,049	783,641
Accrued revenue	—	655,243
Inventory	215,471	225,706
Deposits and prepaid expenses	335,575	75,280
	3,165,458	3,865,483
Investments (note 2)	1,745,700	—
Capital assets (note 3)	1,345,039	934,454
Goodwill (note 4)	5,616,748	—
	$ 11,872,945	$ 4,799,937
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued liabilities	$ 567,563	$ 171,870
Deferred revenue	928,118	44,622
	1,495,681	216,492
Shareholders' equity		
Share capital (note 5)	39,635,463	32,939,632
Deficit	(29,258,199)	(28,356,187)
	10,377,264	4,583,445
Commitments and contingencies (note 12)		
Subsequent events (notes 9 and 14)		
	$ 11,872,945	$ 4,799,937

See accompanying notes to consolidated financial statements.

Approved by the Board:

David Gallagher
Director

James Bonfiglio
Director

Consolidated Statements of Operations and Deficit

Years ended December 31, 1999, 1998, and 1997
(Expressed in United States dollars)

	1999	1998	1997
Revenue			
Royalties, license fees and product sales	$ 3,625,623	$ 2,125,372	$ 3,474,937
Cost of product sales	359,613	283,352	711,344
	3,266,010	1,842,020	2,763,593
Expenses			
Marketing	1,630,674	1,301,990	1,652,674
Product research and development	1,444,389	1,292,313	891,305
Administration	557,402	454,482	437,280
	3,632,465	3,048,785	2,981,259
Operating profit (loss)	(366,455)	(1,206,765)	(217,666)
Depreciation and amortization	(632,387)	(262,815)	(271,611)
Interest and other income	73,116	93,664	146,948
Gain on sale of capital assets	23,714	150,889	—
Interest on long-term debt	—	(12,382)	(24,090)
Patent litigation	—	—	(120,146)
	(535,557)	(30,644)	(268,899)
Net Loss for the year	(902,012)	(1,237,409)	(486,565)
Deficit, beginning of year	(28,356,187)	(27,023,533)	(26,536,968)
Repurchase of common shares	—	(95,245)	—
Deficit, end of year	$ (29,258,199)	$ (28,356,187)	$ (27,023,533)
Loss per common share	$ (0.04)	$ (0.05)	$ (0.02)

See accompanying notes to consolidated financial statements

Consolidated Statements of Cash Flows

Years ended December 31, 1999, 1998, and 1997
(Expressed in United States dollars)

	1999	1998	1997
Cash provided by (used in:)			
Operations:			
Net loss for the year	$ (902,012)	$ (1,237,409)	$ (486,565)
Items not requiring (providing) cash:			
Depreciation and amortization	632,387	262,815	271,611
Gain on sale of capital assets	(23,714)	(150,889)	—
Changes in working capital balances (note 7)	1,377,964	260,791	(929,958)
	1,084,625	(864,692)	(1,144,912)
Financing:			
Issuance of common shares	1,918,844	1,235,985	1,649,868
Share subscriptions received	150,340	—	—
Repurchase of common shares, net	—	(334,737)	—
Repayments of long-term debt	—	(9,212)	(9,874)
	2,069,184	892,036	1,639,994
Investments:			
Investments	(1,745,700)	—	—
Purchase of capital assets	(687,482)	(240,645)	(354,747)
Goodwill	(1,345,591)	—	—
Proceeds from sale of capital assets	23,714	248,587	—
	(3,755,059)	7,942	(354,747)
Increase (decrease) in cash and cash equivalents	(601,250)	35,286	140,335
Cash and cash equivalents, beginning of year	2,125,613	2,090,327	1,949,992
Cash and cash equivalents, end of year	$ 1,524,363	$ 2,125,613	$ 2,090,327

See accompanying notes to consolidated financial statements

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 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.

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. a public company organized under the laws of the Province of Alberta, Canada and its wholly-owned subsidiaries QCommerce, Inc., 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.

Cash and cash equivalents:

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

Accounts receivable:

Accounts receivable includes fees due to the Company under license agreements.

Significant accounting policies (continued):

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.

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%

Goodwill:

Goodwill is recorded at cost and is amortized on a straight-line basis over seven years, beginning in the year of acquisition. The Company assesses the recoverability of this intangible asset by determining whether the amortization of the goodwill balance over its remaining life can be recovered through undiscounted future operating cash flows of the acquired operation. The amount of goodwill impairment, if any, is measured based on projected discounted future operating cash flows using a discount rate reflecting the Company's average cost of funds. The assessment of the recoverability of goodwill will be impacted if estimated future operating cash flows are not achieved.

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.

Revenue recognition:

Revenue from royalties is recorded as royalties are earned. Amounts received for prepaid royalties are recorded as deferred revenue and revenue is recognized when the royalty is earned through the sale of units by the licensee.

Significant accounting policies (continued):

Amounts received on a prepaid basis 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. For long-term contracts revenue from license fees is recognized on a percentage of completion basis.

Revenue from product sales is recognized when products are shipped.

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, 1999 was 25,040,039 (1998 - 23,867,841; 1997 - 22,159,563).

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.

Stock option plan:

The Company has a stock-based compensation plan, which is described in note 6. No compensation expense is recognized for these plans when stock or stock options are issued to employees. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. If stock or stock options are repurchased from employees, the excess of the consideration paid over the carrying amount of the stock or stock option canceled is charged to retained earnings.

1. Business acquisition:

On August 3, 1999 the Company acquired all the assets and liabilities of Virtual Spin, Inc. for consideration of $6,090,586, consisting of 1,663,739 common shares of the company, assumed liabilities of $1,456,439 and $129,131 in stock options of the Company. Virtual Spin, Inc. is located in Seattle, Washington and provides E-commence site development services for small and medium sized businesses. The acquisition has been accounted for by the purchase method, and accordingly

1. Business acquisition: (continued):

the results of the operations of Virtual Spin, Inc. have been included in these financial statements from August 3, 1999. The excess of the purchase price over the fair value of net identifiable assets acquired was allocated to goodwill in the amount of $5,972,237 which is being amortized on a straight-line basis over seven years.

2. Investments:

Investments consist of equity securities acquired in two companies as consideration for license fees and are recorded at cost. It is management's intention to hold these securities until such time that there is an active market for them and they can be liquidated on a prompt basis. The market value for one of the securities with a cost of $1,295,700 was $924,800 at December 31, 1999. This value decline is considered temporary. The second security, with a cost of $450,000, is not yet publicly traded and its fair value is considered equal to its cost.

3. Capital assets:

	Cost	Accumulated depreciation	Net book value
1999			
Sound source and control equipment	$ 528,850	$ 486,537	$ 42,313
Real time systems	905,534	870,008	35,526
Furniture and fixtures	363,766	253,093	110,673
Computer equipment	706,503	399,640	306,863
Production tooling	780,311	222,455	557,856
Patents and trademarks	621,081	329,273	291,808
	$ 3,906,045	$ 2,561,006	$ 1,345,039
1998			
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

4. Goodwill:

	Cost	Accumulated depreciation	Net book value
1999			
Goodwill	$ 5,972,237	$ 355,489	$ 5,616,748

5. 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.

Common shares issued and outstanding:

	Number of Shares	Consideration
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 options granted to directors and employees	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
Issued for cash:		
On exercise of warrants and options	137,500	292,818
On exercise of options granted to directors and employees	177,300	329,966
Private placement	671,174	1,296,060
Purchase of subsidiary (note 1)	1,663,739	4,497,516
Additional paid-in-capital stock options	—	129,131
Share subscription paid	—	150,340
Balance at December 31, 1999	26,667,699	$ 39,635,463

6. Stock option plan:

The Company has a Stock Option Plan under which the Board of Directors may grant stock options to directors, officers, consultants and employees for the purchase of authorized but unissued common shares. At December 31, 1999 stock options to purchase 4,947,134 common shares were outstanding. The stock options are exercisable at prices ranging from $1.25 to $3.50 per share and expire on various dates between 2000 and 2004.

6. Stock option plan (continued):

During the years ended December 31, 1999 and 1998 the Company granted fixed and variable options to employees, directors and officers. During 1999, 3,075,536 fixed plan options (1998 - 777,000) and 293,500 variable plan options (1998 - nil) were granted with exercise prices at or greater than the market price of the Company's stock on the date of grant. No compensation cost is recorded in the Company's statement of operations and deficit.

In addition to the above, during 1999 the Company issued stock options to purchase 13,948 (1998 - 113,000) shares of authorized but unissued common stock in connection with services performed by third parties. These options are exercisable at $3.06 and expire July 28, 2003.

The fair value of the options issued on the acquisition of Virtual Spin, Inc. (note 1) has been estimated at $129,131 and has been included as part of the purchase consideration.

Changes in options granted to directors and employees during the years ended December 31, 1999, 1998 and 1997 were as follows:

	Number of Shares	Exercise price per share	Weighted average exercise price
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 - 2.40	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
Granted	3,369,036	1.94 - 3.50	2.55
Exercised	(177,300)	1.75 - 2.08	1.86
Cancelled or expired	(773,550)	2.00 - 3.00	2.39
Balance at December 31, 1999	4,820,186	$1.25 - $3.50	$2.42

6. Stock option plan (continued):

The following table summarizes the information about stock options outstanding at December 31, 1999:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at December 31, 1999	Weighted-Average remaining Contractual cycle	Weighted-Average Exercise Price	Number Exercisable at December 31, 1999	Weighted-Average Exercise Price
$ 1.25 to 1.94	533,900	2.2	$ 1.75	333,900	$ 1.64
2.00 to 2.19	2,351,250	2.7	2.03	1,295,916	2.04
2.50 to 2.97	419,000	4.5	2.86	87,500	2.77
3.00 to 3.50	1,642,984	2.8	3.05	1,642,984	3.05
	4,947,134			3,360,300	

7. Changes in working capital balances:

	1999	1998	1997
Accounts receivable	$ (306,408)	$ 238,564	$ 617,594
Accrued revenue	655,243	33,145	(682,805)
Inventory	10,235	177,583	(25,982)
Deposits and prepaid expenses	(260,295)	4,644	(25,418)
Accounts payable and accrued liabilities	395,693	(237,767)	(618,907)
Deferred revenue	883,496	44,622	(194,440)
	$ 1,377,964	$ 260,791	$ (929,958)

Excluded from the 1998 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.

8. Transactions with related parties:

In 1999 the Company was charged $64,847 (1998 - $70,049; 1997 - $95,119) for management services provided by directors and officers pursuant to consulting arrangements.

9. Income taxes:

Income tax expense differs from the amount that would be computed by applying the basic combined Canadian Federal and Provincial statutory income tax rate to the loss for the year. The reasons for the differences are as follows:

	1999	1998	1997
Loss for the year	$ (902,013)	$(1,237,409)	$ (468,565)
Combined Canadian Federal and Provincial statutory rate	44.62%	44.62%	44.62%
Computed recovery	(402,478)	(552,132)	(217,105)
Increase resulting from:			
Loss for which an income tax benefit has not been recognized	367,460	552,132	217,105
Income taxes at different rates in the United States	35,018	—	—
Actual expense	$ —	$ —	$ —

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:

	Canada	United States	Total 1999	1998
Future income tax assets:				
Capital assets	$ 246,000	$ —	$ 246,000	$ 874,000
Share issue costs	3,000	—	3,000	35,000
Loss carry-forwards	6,241,000	1,844,000	8,085,000	8,242,000
Intangible assets	735,000	—	735,000	139,000
	7,225,000	1,844,000	9,069,000	9,290,000
Less: Valuation allowance	(7,225,000)	(1,844,000)	(9,069,000)	(9,290,000)
Net future tax assets	$ —	$ —	$ —	$ —

9. Income taxes (continued):

The Company has Canadian non-capital loss carry-forwards in the amount of $11,076,000 which expire at various dates between 2000 and 2006 and Canadian Scientific Research and Experimental Development expenditures carry-forward in the amount of $3,725,000 which have no expiry. The Company also has United States net operating loss carry-forwards in the amount of $5,423,000 which expire at various dates between 2004 and 2014.

On April 19, 2000, the Competent Authorities representing the income tax administrations of Canada and the United States arrived at a Settlement over jurisdiction and locus of approximately $8.4 million of losses from operations incurred by the Company for the 1989 through 1992 taxation years. It remains for local tax authorities of both jurisdictions to apply adjustments to these amounts in accordance with domestic income tax law with respect to classification and timing of these losses, before a determination can be made of the impact of the Settlement on the current income tax position of the Company. As the loss carry-forward period under Canadian income tax law is 7 taxation periods in comparison with 15 periods under United States tax law, management is revisiting tax filing positions taken with respect to elective deductions and elective income inclusions since 1989 with Canadian tax authorities with a view to minimizing the expiry of losses allocated to Canada for those periods. The following is a summary of the income tax amounts included above in this note to the financial statements as the result of this settlement.

	Canada	United States
Operating losses allocated	$ 3,339,000	$ 5,093,000
Losses expired, subject to review of elective deductions	(3,339,000)	—
Included in note 9 to financial statements above	$ —	$ 5,093,000

10. Segmented information:

Management has determined that for 1999 the Company operated in two operating segments. These segments consist of Audio Projects (“Audio”) which involves the developing and marketing of sound localization technology for use in various industries, and E-Commerce Products (“E-Commerce”) which involves the developing and marketing of internet business services. Substantially all of the Company’s Audio product assets and employees are located in Canada. Substantially all of the Company’s E-Commerce product assets and employees are located in the United States. Substantially all of the Company’s Audio product revenues are derived from export sales to the United States and Asia. Substantially all of the Company’s E-Commerce product revenues are derived from the United States.

10. Segmented information (continued):

For Audio products, during 1999, 18% of total revenue arose from one customer. For 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.

	Audio	E-Commerce	Total
Revenue:			
Royalties, license fees and product sales	$ 2,678,328	$ 947,295	$ 3,625,623
Cost of product sales	353,565	6,048	359,613
	2,324,763	941,247	3,266,010
Expenses:			
Marketing	1,290,253	340,421	1,630,674
Product research and develoment	1,132,113	312,276	1,444,389
Administration	527,596	29,806	557,402
	2,949,962	682,503	3,632,465
Operating profit (loss)	(625,199)	258,744	(366,455)
Depreciation and amortization	(277,111)	(355,876)	(632,387)
Interest and other income	73,116	—	73,116
Gain on sale of capital assets	23,714	—	23,714
	(180,281)	(355,876)	(535,557)
Net loss for the year	$ (805,480)	$ (96,532)	$ (902,012)
Segment assets	$ 5,803,332	$ 6,069,613	$ 11,872,945

11. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 1999.

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 Canadian 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 accounts receivable, royalties receivable and accrued revenue. As at December 31, 1999 there were no entities with

11. Financial instruments and risk management (continued):

greater than 10% of the total accounts receivable balance. As at December 31, 1998 there were outstanding accounts receivable balances from two entities which comprised 52% and 25% of the total balance. Accrued revenue concentration is among three entities, which comprise 76%, 13% and 11% of the balance at December 31, 1998. The entities are primarily located in the United States and Asia.

12. 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 space and equipment, the Company is obligated at December 31, 1999 to make the following minimum lease payments over the next four years:

2000	$ 213,878
2001	173,134
2002	111,508
2003	84,297
	$ 582,817

13. United States accounting principles:

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canada GAAP”). Any differences in United States generally accepted accounting principles (“US GAAP”) as they pertain to the Company’s financial statements are not material except as follows:

(a) The Company follows SFAS 115, “Accounting for Certain Investments in Debt and Equity Securities” for purposes of reconciling to US GAAP. Long-term investments consist of equity securities. The Company has classified its equity securities as available-for-sale.

Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized.

13. United States accounting principles (continued):

Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis.

A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned.

(b) The Company follows SFAS 130 regarding comprehensive income for purposes of reconciliation to US GAAP. Under to US GAAP, items defined as other comprehensive income are separately classified in the financial statements and the accumulated balance of other comprehensive income (loss) is reported separately in shareholders' equity on the balance sheet. The Company has recorded unrealized holding gains and related unrealized future tax expense on investments classified as "available for sale" securities to US GAAP.

(c) The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations, in accounting for its stock options issued to employees, directors and officers of the Company for purposes of reconciliation to US GAAP. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, "Accounting for Stock-Based Compensation", established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value-based method of accounting described above and has adopted the disclosure requirements of SFAS No. 123. Stock options issued to consultants and other third parties are accounted for at their fair values in accordance with SFAS No. 123.

(d) Under US GAAP a portion of the excess of the purchase price over the fair value of net identifiable assets acquired upon the acquisition of Virtual Spin, Inc. (note1) were allocated to assets to be used in research and development activities and were expensed at the date of the business combination. Under Canadian GAAP these amounts are allocated to goodwill.

13. United States accounting principles (continued):

The effect on the loss for each of the years in the three year period ended December 31, 1999 of the differences between Canadian and United States accounting principles is summarized as follows:

	Years ended December 31, 1999	1998	1997
Loss for the year as reported in accordance with Canadian GAAP	$ (902,013)	$ (1,237,409)	$ (486,565)
Write-off of acquired in-process research and development	(1,489,460)	—	—
Amortization of acquired in-process research and development	88,659	—	—
Estimated fair value of options	(9,629)	—	(192,429)
Loss under US GAAP	$ (2,312,443)	$ (1,237,409)	$ (678,994)
Loss per share under US GAAP	$ (0.09)	$ (0.05)	$ (0.03)

There was no difference in the weighted average number of shares outstanding in the years ended December 31, 1999, 1998 and 1997 under Canadian and United States accounting principles.

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

December 31, 1999	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,165,458	$ —	$ 3,165,458
Investments	1,745,700	(370,900)	1,374,800
Capital assets	1,345,039	(291,808)	1,053,231
Intangible assets	5,616,748	(1,108,994)	4,507,754
	$ 11,872,945	$ (1,771,702)	$ 10,101,243

13. United States accounting principles (continued):

December 31, 1999	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current liabilities	$ 1,495,681	$ —	$ 1,495,681
Shareholder's equity:			
Common shares	39,635,463	202,058	39,837,521
Deficit	(29,258,199)	(1,602,860)	(30,861,059)
Accumulated other comprehensive income	—	(370,900)	(370,900)
	$ 11,872,945	$ (1,771,702)	$ 10,101,243

There was no difference in total shareholders' equity as at December 31, 1998 and 1997 under Canadian and United States accounting principles.

During the years ended December 31, 1999 and 1998 the Company granted fixed and variable options to employees, directors and officers which, for the purposes of reconciling to US GAAP, have been accounted for in compliance with APB Opinion 25. During 1999, 3,075,536 fixed plan options (1998 - 777,000) and 293,500 variable plan options (1998 - nil) were granted with exercise prices at or greater than the market price of the Company's stock on the date of grant. Accordingly, no compensation cost is recorded in the Company's statement of operations and deficit.

The Company has calculated the fair value of stock options granted to employees using the Black Scholes option pricing model with the following weighted-average assumptions:

	1999	1998	1997
Risk free interest rate	5.5%	5.5%	3.0%
Volatility	35.0%	35.0%	35.0%
Expected option life (in years)	2.0	2.0	2.0
Dividend yield	0%	0%	0%

13. United States accounting principles (continued):

Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net income and loss per share would have been reduced to the pro forma amounts indicated below:

	1999	1998	1997
Net loss under US GAAP:			
As reported	$ (2,312,443)	$ (1,237,409)	$ (678,994)
Pro forma	(2,993,820)	(1,672,820)	(947,140)
Basic loss per common share:			
As reported	$ (0.09)	$ (0.05)	$ (0.03)
Pro forma	(0.11)	(0.07)	(0.04)

In addition to the above, during 1999 the Company has issued stock options to purchase 13,948 (1998 - 113,000) shares of authorized but unissued common stock in connection with services performed by third parties. These options are exercisable at $3.06 and expire July 28, 2003. The Company accounts for the fair value of grants to consultants in accordance with FASB Statement 123. The fair value of the options granted is estimated on the day of grant using the Black Scholes option pricing model with the same weighted average assumptions outlined in the table above. $9,629 has been charged to income for these options in 1999. The estimated fair value of options granted in 1997 was $192,429.

14. Subsequent events:

(a) In March 2000, the Company announced its intention to acquire 100% of the outstanding stock of StreamMagic, Inc., a Los Angeles based provider of Internet video streaming services. Under the proposal the Company would issue 26.5 million preferred shares with each preferred share being convertible into one common share of the Company, 40% of which would be convertible on the effective date of the transaction. The remaining 60% would become convertible over the next 270 days. In addition, QSound would convert outstanding StreamMagic options into approximately 5 million options of the Company.

The acquisition which, if consummated, will be accounted for by the purchase method, will be subject to certain closing conditions including satisfactory completion of due diligence by each party, satisfaction with the tax consequences of the transaction, approval of each party's board of directors, approval of QSound's shareholders, any necessary regulatory approvals, and execution of a Definitive Agreement.

14. Subsequent events (continued):

(b) In March 2000 the Company and QCommerce reached an agreement to acquire the Choicemall website property from Looksmart, Ltd. In addition the parties have formed a strategic partnership through which Choicemall, and other Company properties, will receive, for seven years, premium positioning on the Looksmart website properties. Under the terms of the agreement the Company will issue one million common shares. Furthermore, the parties will enter into a two year multimedia advertising agreement to which QCommerce will commit $1.5 million per year. The acquisition will be accounted for by the purchase method and is subject to certain closing conditions including satisfactory completion of due diligence by each party and approval of each party's board of directors.

(c) Subsequent to the year-end the Company completed a series of private placements whereby 723,636 common shares were issued for gross proceeds of $2,050,000.

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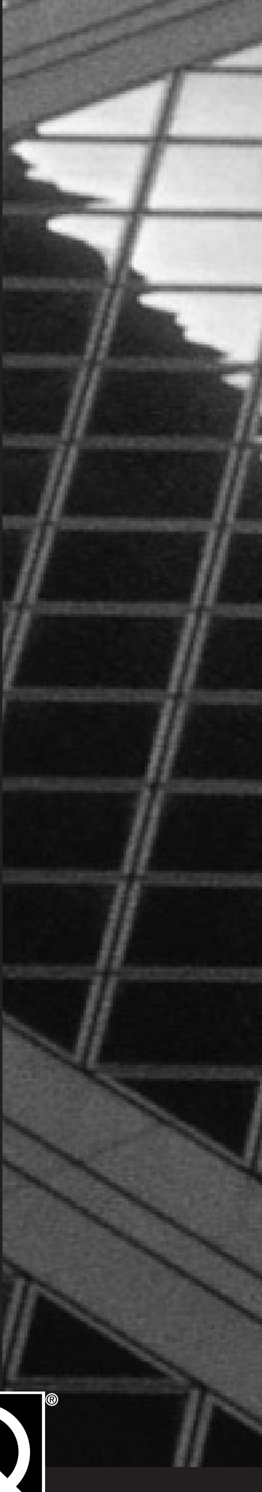

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