QSOUND LABS INC. ANNUAL REPORT 2000

Table of Contents

President's Message

During the Fiscal Year 2000, management successfully focused on three main objectives:

1) growing and supporting our OEM audio licensing business,
2) developing new products and distribution channels for our audio software product lines, and
3) consolidating and rationalizing our e-commerce ASP (Application Service Provider) business following the acquisitions made in late FY1999 and early FY2000.

These objectives were set in the context of our long-standing strategy to build upon our core competencies of software development and leveraging strategic relationships into a diversity of markets. In conjunction with these activities, management evaluated several merger opportunities as a means to accelerate an increase in shareholder value, but in all cases, after due diligence reviews, management determined none of the proposed transactions would achieve this goal.

The Audio Business Unit showed an operating profit throughout the year 2000 with strong contributions from both our OEM licensees, principally Starkey and Mitsubishi, and our Internet distribution partners, most notably, RealNetworks. During 2001, we expect downloadable software sales to grow as new products become available for distribution and as new OEM licensees, such as Philips, bring products to market. Released towards the end of FY2000, the Philips' Acoustic Edge soundcard has received critical acclaim and several editors' choice awards from the media.

During FY2000, management took aggressive steps to restructure and streamline its QCommerce Business Unit, with a view to achieving sustainable profitability in FY2001. While management expects overall revenue growth to be nominal for QCommerce in FY2001, the new reduced cost infrastructure will assist in achieving our goals of positive cash flow and earnings. The revenue base is now comprised of customers paying a monthly subscription fee and as such, is recurring as opposed to FY2000, when the majority of the revenue was derived from one-time payments.

External factors played a major role in FY2000. The digital audio revolution finally reached the consumer, driven primarily by the Internet's ability to deliver digital media directly to the consumer from literally anywhere. As QSound has been developing and delivering digital audio solutions to a wide variety of industries since its inception, we can only benefit from this phenomenon. Ironically however there was a "popping of the dot.com bubble" that triggered a meltdown in the valuation of most technology stocks that has been unseen in over a decade. This has continued into FY2001.

For FY2001, management intends to stay focused on the opportunities at hand, in the sincere belief that these opportunities will bring greater shareholder value.

I would like to thank our shareholders and the Board of Directors for their continued support and our employees whose dedication and hard work have made surmounting the challenges we face possible.

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, 2000 and 1999 and the consolidated statements of operations and deficit and cash flows for each of the years in the three year period ended December 31, 2000. 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 and United States 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, 2000 and 1999 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2000, in accordance with Canadian generally accepted accounting principles.

Accounting principles 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 United States would have affected results of operations for each of the years in the three year period ended December 31, 2000 and total assets and shareholders' equity as at December 31, 2000 and 1999 to the extent summarized in note 14 to the consolidated financial statements.

KPMG LLP

Chartered Accountants

Calgary, Canada
April 20, 2001

FINANCIALS

Consolidated balance sheets

December 31, 2000 and 1999
(Expressed in United States dollars)

	2000	1999
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2,264,639	$ 1,524,363
Accounts receivable	1,166,941	1,090,049
Inventory	48,431	215,471
Deposits and prepaid expenses	108,752	335,575
	3,588,763	3,165,458
Investments (note 2)	194,500	1,745,700
Capital assets (note 3)	1,301,464	1,345,039
Goodwill (note 4)	2,644,100	5,616,748
	$ 7,728,827	$ 11,872,945
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued liabilities	$ 352,865	$ 567,563
Consideration payable on acquisition	550,000	—
Deferred revenue	9,253	928,118
	912,118	1,495,681
Shareholders' equity:		
Share capital (note 5)	45,277,094	39,635,463
Contributed surplus (note 5)	5,648	—
Deficit	(38,466,033)	(29,258,199)
	6,816,709	10,377,264
Commitments and contingencies (note 12)		
	$ 7,728,827	$ 11,872,945

See accompanying notes to consolidated financial statements.

Approved by the Board:

David Gallagher
Director

Consolidated statements of operations and deficit

Years ended December 31, 2000, 1999 and 1998
(Expressed in United States dollars)

	2000	1999	1998
REVENUE			
Royalties, license fees and product sales	$ 4,469,002	$ 3,625,623	$ 2,125,372
Cost of product sales	208,298	359,613	283,352
	4,260,704	3,266,010	1,842,020
EXPENSES			
Marketing	1,735,698	1,630,674	1,301,990
Product research and development	1,610,436	1,444,389	1,292,313
Administration	802,582	557,402	454,482
	4,148,716	3,632,465	3,048,785
Operating profit (loss)	111,988	(366,455)	(1,206,765)
Depreciation and amortization	(2,535,856)	(632,387)	(262,815)
Impairment of assets	(5,163,504)	—	—
Write-down of investments	(1,515,568)	—	—
Interest and other income	154,788	73,116	93,664
Gain (loss) on sale of capital assets	(34,634)	23,714	150,889
Other	(225,048)	—	—
Interest on long-term debt	—	—	(12,382)
	(9,319,822)	(535,557)	(30,644)
Net loss for the year	(9,207,834)	(902,012)	(1,237,409)
Deficit, beginning of year	(29,258,199)	(28,356,187)	(27,023,533)
Repurchase of common shares	—	—	(95,245)
Deficit, end of year	$ (38,466,033)	$ (29,258,199)	$ (28,356,187)
Loss per common share	$ (0.32)	$ (0.04)	$ (0.05)

See accompanying notes to consolidated financial statements.

Consolidated statements of cash flows

Years ended December 31, 2000, 1999 and 1998
(Expressed in United States dollars)

	2000	1999	1998
Cash provided by (used in):			
Operations:			
Net loss for the year	$ (9,207,834)	$ (902,012)	$ (1,237,409)
Items not requiring (providing) cash:			
Depreciation and amortization	2,535,856	632,387	262,815
Impairment of assets	5,163,504	—	—
Loss (gain) on sale of capital assets	34,634	(23,714)	(150,889)
Write-down of investment	1,515,568	—	—
Changes in non-cash working capital balances (note 7)	(524,678)	1,359,312	260,791
	(482,950)	1,065,973	(864,692)
Financing:			
Issuance of common shares	2,757,233	2,069,184	1,235,985
Repurchase of common shares, net	(152,989)	—	(334,737)
Repayments of debt	(750,000)	(1,456,439)	(9,212)
	1,854,244	612,745	892,036
Investments:			
Investments, net	23,638	(1,745,700)	—
Purchase of capital assets	(529,863)	(550,482)	(240,645)
Goodwill	(130,168)	(7,500)	—
Proceeds from sale of capital assets	5,375	23,714	248,587
	(631,018)	(2,279,968)	7,942
Increase (decrease) in cash and cash equivalents	740,276	(601,250)	35,286
Cash and cash equivalents, beginning of year	1,524,363	2,125,613	2,090,327
Cash and cash equivalents, end of year	$ 2,264,639	$ 1,524,363	$ 2,125,613

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 QSound Labs, Inc. (the "Company"), conform in all material respects with those in the United States, except as outlined in note 14. 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. All significant inter-company transactions and balances have been eliminated.

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.

Cash and cash equivalents:

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

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%
Software and production tooling	Declining balance	30%
Patents and trademarks	Straight-line	20%

The Company assesses impairment of capital assets by determining whether their fair value is less than their amortized value. When impairment is considered permanent, the amount of impairment is charged to period earnings and is included in depreciation and amortization.

Goodwill:

Goodwill is recorded at cost and is amortized on a straight-line basis over one to 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. Foreign exchange gains and losses are included in the determination of loss.

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.

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 obliga-

Significant accounting policies (continued):

tions 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 pursuant to sales arrangements with customers and when collectibility is reasonably assured.

Research and development costs:

Research and development costs are expensed as incurred except if development costs are recoverable and directly related to development of new products, processes or systems. The Company strictly interprets the assessment of whether development costs should be capitalized.

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, 2000 was 28,403,259 (1999 - 25,040,039; 1998 - 23,867,841). Fully diluted loss per share has not been separately presented as the impact of outstanding options is anti-dilutive.

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 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 cancelled is charged to retained earnings.

1. Business acquisitions:

On May 10, 2000 the Company acquired the Choicemall website property for consideration of $3,393,800, consisting of 1,000,000 common shares of the Company and debt of $1,300,000. The acquisition has been accounted for by the purchase method, and accordingly the results of the operations of the Choicemall website have been included in these financial statements from May 10, 2000. The excess of the purchase price over the fair value of net identifiable assets acquired was allocated to goodwill in the amount of $3,393,800 which is being amortized on a straight-line basis over seven years.

On May 17, 2000 the Company acquired the Webtailer website property for consideration of $415,486, consisting of 222,222 common shares of the company valued at their market price of $1.87 per share. The acquisition has been accounted for by the purchase method, and accordingly the results of the operations of the Webtailer website have been included in these financial statements from May 17, 2000. The entire purchase price was allocated to goodwill.

On November 24, 2000 the Company acquired the iNet Mall and Anthill.com website properties and an account receivable valued at $225,000, for consideration of $375,000, consisting of 500,000 common shares valued at $1.00 per share which approximated the fair value at that date and $100,000 cash. The 500,000 common shares issued pursuant to the acquisition were to be held in escrow and released based on the achievement of performance milestones specified in the acquisition agreement. At December 31, 2000, 225,000 of the common shares remained in escrow. Due to the contingent nature of the contract, no consideration has been recorded with respect to the 225,000 escrowed shares. If and when the milestones are achieved and the shares are released from escrow the consideration will be recognized at that time. The acquisition has been accounted for by the purchase method, and accordingly the results of the operations of the iNet Mall and Anthill.com website properties have been included in these financial statements from November 24, 2000. The excess of the purchase price over the fair value of net identifiable assets acquired was allocated to goodwill in the amount of $150,000 which is being amortized on a straight-line basis over seven years.

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 valued at their price of $2.70 per share, assumed liabilities of $1,456,439 and $129,131 in stock options of the Company. Virtual Spin, Inc. was located in Seattle, Washington and provided E-commence site development services for small and medium sized businesses. The acquisition has been accounted for by the purchase method, and accordingly 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. In the opinion of management the market value of the securities had experienced a permanent decline in value therefore the Company recorded a charge of $1,515,568 to write down the value of the investments. The market value for one of the securities with a carrying value of $194,500 was $42,557 at December 31, 2000. This value decline is considered temporary. The second security with a carrying value of nil, is not yet publicly traded.

3. Capital assets:

2000	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 538,769	$ 496,714	$ 42,055
Real time systems	905,534	880,666	24,868
Furniture and fixtures	336,660	270,608	66,052
Computer equipment	738,283	490,139	248,144
Software and production tooling	1,464,061	773,562	690,499
Patents and trademarks	683,335	453,489	229,846
	$ 4,666,642	$ 3,365,178	$ 1,301,464

Included in the accumulated depreciation above for software and production tooling is an asset impairment charge of $383,750. The impairment charge was measured based on projected discounted future operating cash flows of purchased software.

1999	Cost	Accumulated depreciation	Net book value
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
Software and 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

4. Goodwill:

2000		Cost		Accumulated amortization		Net book value
Goodwill	$	9,894,777	$	7,250,677	$	2,644,100

Goodwill was acquired in four separate business acquisition transactions which were completed in 1999 and 2000. In each acquisition, the goodwill related to trade names, customer contracts and anticipated revenues from electronic storefront development and usage. As a result of significant shortfalls in revenue from the levels expected from the Virtual Spin and ChoiceMall properties, and management's opinion that attaining the required levels of revenue was remote, it was concluded that the goodwill of each of these properties was impaired and that their respective values should be written down. The impairment charges of $2,117,483 and $2,216,617 for Virtual Spin and ChoiceMall were calculated based on discounted expected future cash flows. The Webtailer property was found to have little value thus that operation was abandoned and the full purchase price of $445,654 was written off.

1999		Cost		Accumulated amortization		Net book value
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.

5. Share capital (continued):

Common shares issued and outstanding:

	Number of Shares	Consideration
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
Business acquisition (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
Issued for cash:		
On exercise of warrants and options	63,000	137,970
On exercise of options granted to directors and employees	330,500	739,603
Private placement	723,636	2,030,000
Business acquisitions (note 1)	1,497,222	2,784,286
Acquisition of assets	115,000	258,750
Repurchase of common shares	(90,000)	(158,638)
Share subscription paid	—	(150,340)
Shares held in escrow (note 1)	225,000	—
Balance at December 31, 2000	29,532,057	$ 45,277,094

The excess of the assigned value over the purchase price of repurchased common shares has been assigned to contributed surplus.

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, 2000, stock options to purchase 3,477,594 common shares were outstanding. The stock options are exercisable at prices ranging from $1.25 to $3.06 per share and expire on various dates between 2001 and 2005.

During the years ended December 31, 2000 and 1999 the Company granted fixed and variable options to employees, directors and officers. During 2000, 99,000 fixed plan options (1999 - 3,075,536) and 491,444 variable plan options (1999 - 293,500) 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 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.

6. Stock Option Plan (continued):

Changes in options granted during the years ended December 31, 2000, 1999 and 1998 were as follows:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at December 31, 1997	2,955,500	$ 1.50 - 3.15	$ 1.82
Granted	914,500	1.75 - 3.15	2.71
Exercised	(458,500)	1.67 - 2.45	2.23
Cancelled or expired	(759,000)	1.50 - 3.06	2.45
Balance at December 31, 1998	2,652,500	1.53 - 3.15	1.87
Granted	3,382,984	1.94 - 3.50	2.55
Exercised	(314,800)	1.25 - 3.11	2.03
Cancelled or expired	(773,550)	2.00 - 3.00	2.39
Balance at December 31, 1999	4,947,134	1.53 - 3.50	2.27
Granted	590,444	1.50 - 2.25	2.11
Exercised	(393,500)	1.53 - 3.06	2.19
Cancelled or expired	(1,666,484)	1.50 - 3.06	2.39
Repriced			
Previous	(526,500)	2.50 - 3.50	3.01
New	526,500	2.25 - 2.25	2.25
Balance at December 31, 2000	3,477,594	$ 1.50 - 2.25	$ 2.08

The following table summarizes the information about stock options outstanding at December 31, 2000:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at Dec. 31, 2000	Weighted-Average Remaining Contractual Cycle	Weighted-Average Exercise Price	Number Exercisable at Dec. 31, 2000	Weighted-Average Exercise Price
$ 1.25 to 1.94	332,900	2.5	$ 1.60	332,900	$ 1.60
2.00 to 2.19	1,737,000	2.6	2.03	1,530,997	2.03
2.20 to 2.99	1,393,746	2.5	2.25	1,218,746	2.25
3.00 to 3.06	13,948	2.6	3.06	13,948	3.06
	3,477,594			3,096,591	

7. Changes in non-cash working capital balances:

	2000	1999	1998
Accounts receivable	$ 148,108	$ (288,230)	$ 238,564
Accrued revenue	—	655,243	33,145
Inventory	167,040	10,235	177,583
Deposits and prepaid expenses	226,823	(260,295)	4,644
Accounts payable and accrued liabilities	(147,784)	395,693	(237,767)
Deferred revenue	(918,865)	846,666	44,622
	$ (524,678)	$ 1,359,312	$ 260,791

Excluded from the 2000 statement of cash flows is the account receivable valued at $225,000 and acquired as part of the iNet Mall and Anthill.com website properties acquisition. Excluded from the 1999 statement of cash flows are net current liabilities of $18,652 which were assumed on the acquisition of Virtual Spin. Excluded from the 1998 statement of cash flows are the $211,696 account 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 2000 there were no charges for management services provided by directors and officers pursuant to consulting arrangements. In 1999 and 1998 the Company was charged $64,847 and $70,049 respectively for such services.

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:

	2000	1999	1998
Loss for the year	$ (9,207,834)	$ (902,013)	$ (1,237,409)
Combined Canadian federal and provincial statutory rate	44.62%	44.62%	44.62%
Computed recovery	(4,108,536)	(402,478)	(552,132)
Increase resulting from:			
Unrealized benefit of future tax assets	2,749,000	367,460	552,132
Income taxes computed at different rates in the United States	1,424,498	35,018	—
Reduction of unrealized future tax assets for enacted changes in income tax rates	(690,000)	—	—
Non deductible amortization	625,038	—	—
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	2000	1999
Future income tax assets:				
Capital assets	$ 372,000	$ —	$ 372,000	$ 246,000
Share issue costs	6,000	—	6,000	3,000
Loss and SRED carryforwards	5,353,000	2,932,000	8,285,000	8,085,000
Intangible assets	138,000	1,760,000	1,898,000	735,000
Investments	—	567,000	567,000	—
	5,869,000	5,259,000	11,128,000	9,069,000
Less: Valuation allowance	(5,869,000)	(5,259,000)	(11,128,000)	(9,069,000)
Net future tax assets	$ —	$ —	$ —	$ —

The Company has Canadian non-capital loss carry-forwards in the amount of $9,392,000 which expire at various dates between 2001 and 2007 and Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of $3,518,000 which have no expiry. The Company also has United States net operating loss carry-forwards in the amount of $8,625,000 which expire at various dates between 2004 and 2020.

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 2000, 63% of total revenue arose from three customers, each of which individually resulted in greater than 10% of total revenues. For 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 E-Commerce products, during 2000, 64% of total revenue arose from two customers, each of which individually resulted in greater than 10% total revenues.

2000	Audio	E-Commerce	Total
Revenue			
Royalties, license fees and product sales	$ 3,025,102	$ 1,443,900	$ 4,469,002
Cost of product sales	208,298	—	208,298
	2,816,804	1,443,900	4,260,704
Expenses:			
Marketing	1,111,815	623,883	1,735,698
Product research and development	787,800	822,636	1,610,436
Administration	688,424	114,158	802,582
	2,588,039	1,560,677	4,148,716
Operating profit (loss)	228,765	(116,777)	111,988
Depreciation and amortization	(315,136)	(2,220,720)	(2,535,856)
Impairment of assets	(383,750)	(4,779,754)	(5,163,504)
Write down of investment	—	(1,515,568)	(1,515,568)
Interest and other income	146,771	8,017	154,788
Gain on sale of capital assets	255	(34,889)	(34,634)
Other	(199,780)	(25,268)	(225,048)
	(751,640)	(8,568,182)	(9,319,822)
Net loss for the year	$ (522,875)	$ (8,684,959)	$ (9,207,834)
Segment assets	$ 4,284,459	$ 3,444,368	$ 7,728,827

1999	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 development	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)	(355,276)	(632,387)
Interest and other income	73,116	—	73,116
Gain on sale of capital assets	23,714	—	23,714
	(180,281)	(355,276)	(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, 2000.

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 man-

11. Financial instruments and risk management (continued):

aged to the extent that Canadian dollar denominated cash and receivables are equal to or exceed Canadian dollar payables. The Company has not, at December 31, 2000, entered into foreign currency derivatives to hedge its exposure to foreign exchange risk.

The Company is exposed to credit risk on its accounts receivable, royalties receivable and accrued revenue. As at December 31, 2000 there were outstanding accounts receivable balances from two entities which comprised 24% and 19% of the total balance. The entities are primarily located in the United States. As at December 31, 1999 there were no entities with greater than 10% of the total accounts receivable balance.

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, 2000 to make the following minimum lease payments over the next three years:

2001	$	173,134
2002		111,508
2003		84,297
	$	368,939

13. Reclassification of 1999 figures:

The 1999 statement of cash flows has been revised to reflect reclassification of $1,456,439 of debt assumed in the acquisition of Virtual Spin.

14. 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 which are listed on a recognized public stock exchange 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. 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 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 income tax expense on investments classified as "available-for-sale" securities under 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. In addition, variable accounting would be applied to stock options that have been repriced, whereby compensation expense would be recorded or recovered on the date of reporting

14. United States accounting principles (continued):

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. (note 1) 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.

The effect on the loss for each of the years in the three year period ended December 31, 2000 of the differences between Canadian and United States accounting principles is summarized as follows:

Years ended December 31,	2000	1999	1998
Loss for the year as reported in accordance with Canadian GAAP	$ (9,207,834)	$ (902,012)	$ (1,237,409)
Write-off of acquired in-process research and development	—	(1,489,460)	—
Amortization of acquired in-process research and development	1,400,802	88,659	—
Estimated fair value of options	—	(9,629)	—
Loss under US GAAP	$ (7,807,032)	$ (2,312,442)	$ (1,237,409)
Loss per share under US GAAP	$ (0.27)	$ (0.09)	$ (0.05)

Years ended December 31,	2000	1999	1998
Loss under US GAAP	$ (7,807,032)	$ (2,312,442)	$ (1,237,409)
Other comprehensive income (loss):			
Change in fair values of available			
for sale long-term investments	(151,943)	(370,900)	—
Write down of investment			
through net loss	370,900	—	—
Comprehensive income (loss)	$ (7,588,075)	$ (2,683,342)	$ (1,237,409)
Accumulated other comprehensive			
income (loss) beginning of year	$ (370,900)	$ —	$ —
Accumulated other comprehensive			
income (loss) end of year	$ (151,943)	$ (370,900)	$ —

For Canadian GAAP presentation of the statement of operations, depreciation and amortization, and impairment of asset charges, have been excluded from the calculation of operating profit (loss). United States GAAP requires that those charges be included in the calculation of operating profit (loss).

There was no difference in the weighted average number of shares outstanding in the years ended December 31, 2000, 1999 and 1998 under Canadian and United States accounting principles.

14. United States accounting principles (continued):

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

December 31, 2000	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,588,763	$ —	$ 3,588,763
Investments	194,500	(151,943)	42,557
Capital assets	1,301,464	(229,846)	1,071,618
Intangible assets	2,644,100	229,846	2,873,946
	$ 7,728,827	$ (151,943)	$ 7,576,884
Current liabilities	$ 912,118	$ —	$ 912,118
Shareholders' equity:			
Common shares	45,277,094	202,058	45,479,152
Contributed surplus	5,648	—	5,648
Deficit	(38,466,033)	(202,058)	(38,668,091)
Accumulated other comprehensive income	—	(151,943)	(151,943)
Balance at December 31, 2000	$ 7,728,827	$ (151,943)	$ 7,576,884

December 31, 2000	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
Current liabilities	$ 1,495,681	$ —	$ 1,495,681
Shareholders' 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)
Balance at December 31, 1999	$ 11,872,945	$ (1,771,702)	$ 10,101,243

During the years ended December 31, 2000 and 1999 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 2000, 99,000 fixed plan options (1999 - 3,075,536) and 491,444 variable plan options (1999 - 293,500) were granted with exercise prices at or greater than the market price of the Company's stock on the date of grant. In addition 526,500 stock options were re-priced at greater than the market price of the company's stock on the date of re-pricing and at year end. Accordingly, no compensation cost is recorded in the Company's statement of operations and deficit for either the granting of the options nor the re-pricing of the options.

14. United States accounting principles (continued):

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:

	2000	1999	1998
Risk free interest rate	5.0%	5.5%	5.5%
Volatility	120.0%	35.0%	35.0%
Expected option life (in years)	2.0	2.0	2.0
Dividend yield	0%	0%	0%

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 shares would have been reduced to the pro forma amounts indicated below:

	2000	1999	1998
Net loss under US GAAP:			
As reported	$ (7,807,032)	$ (2,312,442)	$ (1,237,409)
Pro forma	(7,966,758)	(2,993,820)	(1,672,820)
Basic loss per common share:			
As reported	$ (0.27)	$ (0.09)	$ (0.05)
Pro forma	(0.28)	(0.11)	(0.07)

During 2000 the Company did not issue any stock options in connection with services performed by third parties. During 1999 the Company issued stock options to purchase 13,948 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.

Corporate Information

DIRECTORS

David Gallagher
James Bonfiglio
Ian Tweedie

STOCK EXCHANGE/ STOCK SYMBOLS

NASDAQ SmallCap Market:
QSND

PATENT COUNSEL

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

BANKERS

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

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

AUDITORS

KPMG LLP
1200, Bow Valley Square II
205 - 5 Avenue SW
Calgary, Alberta T2P 4B9

TRANSFER AGENT

Computershare Investor Services
600, 530 - 8th Avenue SW
Calgary, Alberta T2P 3S8

QSOUND LABS, INC. HEAD OFFICE AND TECHNICAL RESEARCH FACILITY

400, 3115 - 12 Street NE
Calgary, Alberta, Canada T2E 7J2
Telephone: (403) 291-2492
Facsimile: (403) 250-1521
Website: www.qsound.com

QSOUND LABS, INC.

400, 3115 - 12 Street NE
Calgary, Alberta
Canada T2E 7J2

www.qsound.com

Printed in Canada