SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

(Mark One)

☐ REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2001.

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)

For the transition period from ____________________ to ____________________.

Commission File Number: 0-17212

QSOUND LABS, INC.
(Exact name of registrant as specified in its charter)

Alberta, Canada
(Jurisdiction of incorporation or organization)

#400, 3115 – 12th Street N.E.
Calgary, Alberta
T2E 7J2
CANADA
Tel (403) 291-2492
Fax (403) 250-1521
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class Name of each exchange on which registered

None

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Common Shares - without nominal or par value.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None.**
Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Common Shares at December 31, 2001: 7,085,574
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark which financial statement item the registrant has elect to follow.

Item 17 X Item 18

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Note: All references to dollar amounts in this annual report are stated in United States Dollars unless otherwise stated. On July 9, 2001 our shareholders approved a one-for-four share consolidation. Unless otherwise indicated, all share and option figures in this annual report have been adjusted retroactively to reflect the share consolidation.

The terms “QSound”, “our company”, “we”, “us” and “our” as used in this annual report on Form 20-F (this "annual report") refer to QSound Labs, Inc. and its subsidiaries, including QSound Ltd. and QCommerce Inc., as a combined entity, except where the context requires otherwise.

CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements that involve inherent risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. We use words such as "may", "expect," "anticipate," "project," "believe," "plan," "intend," "future," and other similar expressions to identify forward-looking statements. These forward-looking statements are not guarantees of future performance. Our actual results may differ materially from those anticipated in these forward-looking statements. Factors that could contribute to differences include, but are not limited to, those discussed in Item 3.D, entitled "Risk Factors", and elsewhere in this annual report. The information contained in this annual report is accurate only as of the date of this annual report.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

A. Directors and Senior Management

Not Applicable.

B. Advisors

Not Applicable.

C. Auditors

Not Applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

A. Offer Statistics

Not Applicable.

B. Method and Expected Timetable

Not Applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The following table sets forth certain selected consolidated financial information with respect to QSound for the periods indicated. It should be read in conjunction with Item 5. "Operating and Financial Review and Prospects" and our Consolidated Financial Statements.

The selected data presented below for, and as of the end of, each of the years in the five-year period ended December 31, 2001, are derived from the consolidated financial statements of QSound and subsidiaries, which financial statements have been audited by KPMG LLP, independent auditors. The consolidated financial statements as of December 31, 2001 and 2000, and for each of the years in the three-year period ended December 31, 2001, and the report thereon, are included elsewhere in this report. These financial statements have been prepared in accordance with generally accepted accounting principles in Canada which, except as indicated in Note 13. to the Consolidated Financial Statements, are also, in all material respects, in accordance with generally accepted accounting principles in the United States. The financial statements have been audited in accordance with both Canadian and United States Generally Accepted Auditing Standards.

The selected financial data presented below has been prepared in accordance with generally accepted accounting principles in the United States.

Selected Financial Data
Years ended December 31, 2001, 2000, 1999, 1998, and 1997
(Under United States GAAP in United States Dollars)

	2001	2000	1999	1998	1997
Revenue:					
Royalties, license fees and product sales	$ 3,025,994	$ 4,469,002	$ 3,625,623	$ 2,125,372	$ 3,474,937
Cost of product sales	(91,438)	(208,298)	(359,613)	(283,352)	(711,344)
	2,934,556	4,260,704	3,266,010	1,842,020	2,763,593
Expenses:					
Marketing	1,074,139	1,360,698	1,630,674	1,301,990	1,845,103
Operations	275,077	375,000	-	-	-
Product research and development	951,017	1,610,436	1,444,389	1,292,313	891,305
Administration	597,685	802,582	557,402	454,482	437,280
	2,897,918	4,148,716	3,632,465	3,048,785	3,173,688
Operating profit (loss)	36,638	111,988	(366,455)	(1,206,765)	(410,095)
Depreciation and amortization	(831,193)	(1,135,054)	(543,728)	(262,815)	(271,611)
Impairment of assets	-	(5,163,504)	-	-	-
Write-down of investments	(8,300)	(1,515,568)	-	-	-
Write-off of acquired in-process research and development	-	-	(1,489,460)		
Patent litigation	-	-	-	-	(120,146)
Interest and other income	73,568	154,788	73,116	93,664	146,948
Gain (loss) on sale of capital assets	6,492	(34,634)	23,714	150,889	-
Estimated fair value of options	-	-	(9,629)		
Other	(34,442)	(225,048)	-	-	-
Interest on long-term debt	-	-	-	(12,382)	(24,090)
	(769,548)	(7,919,020)	(1,945,987)	(30,644)	(268,899)
Net loss for the year	(732,910)	(7,807,032)	(2,312,442)	(1,237,409)	(678,994)
Deficit, beginning of year	(38,668,091)	(30,861,059)	(28,548,617)	(27,215,963)	(26,536,969)
Repurchase of common shares	-	-	-	(95,245)	-
Deficit, end of year	$(39,401,001)	$(38,668,091)	$(30,861,059)	$(28,548,617)	$(27,215,963)
Comprehensive income (loss)	$ (580,967)	$ (7,588,075)	$ (2,683,342)	$ (1,237,409)	$ (678,994)
Loss per common share	$ (0.10)	$ (1.06)	$ (0.19)	$ (0.21)	$ (0.12)
Total assets	$ 5,966,007	$ 7,576,884	$ 10,101,243	$ 4,799,937	$ 5,547,774
Net assets	$ 5,652,999	$ 6,664,766	$ 8,605,562	$ 4,583,445	$ 4,919,606

Share capital – preferred shares	$ -	$ -	$ -	$ -	$ 188,015
Share capital – common shares	$ 43,939,684	$ 45,479,152	$ 39,837,521	$ 33,141,690	$ 31,957,182
Contributed surplus	$ 1,114,316	$ 5,648	$ -	$ -	$ -
Share capital – preferred shares issued and outstanding	-	-	-	-	108,108
Share capital – common shares issued and outstanding	7,085,574	7,383,014	6,666,925	6,004,497	5,867,264

The high and low exchange rates, the average rates (average of the exchange rates on the last day of each month during the year) and the end of the period rates for Canadian dollars, expressed in U.S. dollars, from January 1, 1997 to June 10, 2001 based on the closing rates of the Bank of Canada were as follows:

At June 10, 2001 the exchange rate was U.S. $0.6495 per CDN. $1.00

	Month End	High	Low
May 2002	0.6454	0.6545	0.6364
April 2002	0.6376	0.6403	0.6255
March 2002	0.6273	0.6338	0.6263
February 2002	0.6242	0.6294	0.6213
January 2002	0.6300	0.6300	0.6202
December 2001	0.6278	0.6406	0.6259

	Year End	High	Low	Average
2001 Year	0.6278	0.6696	0.6237	0.6458
2000 Year	0.6669	0.6918	0.6510	0.6736
1999 Year	0.6929	0.6929	0.6618	0.6752
1998 Year	0.6522	0.7043	0.6376	0.6721
1997 Year	0.6991	0.7424	0.6991	0.7202

B. Capitalization and Indebtedness

Not Applicable

C. Reasons For the Offer and Use of Proceeds

Not Applicable

D. Risk Factors

The following is a summary of certain risks and uncertainties which we face in our business. This summary is not meant to be exhaustive. These risk factors should be read in conjunction with other cautionary statements which we make in this annual report and in our other public reports, registration statements and public announcements. If any of the following risks actually occur, our business, results of operations and financial condition could suffer significantly. In any such case, the market price of our common shares could decline, and you may lose all or part of the money you paid to buy our common shares.

Because we have been only marginally profitable to date, we have had to rely on the sale of our common shares, and in the past on debt financing, to fund our business operations. We may have to continue to rely on the sale of shares and on debt financings in the future.

Because we have been only marginally profitable to date, we have had to fund our operations through a combination of equity and debt financings, and we may need to raise additional funds to finance future operations. In 2001 we had revenues of $3,025,994 and expenses of $2,989,356 including cost of products sold of $91,438, resulting in an operating profit of $36,638. After depreciation and amortization of $831,193 and investment write-downs of $8,300, there was a resultant loss of $732,910 for the year. Our loss per share for 2001 was $0.10. For the first 3 months of 2002 we had revenues of $755,162 and expenses of $586,973. If we are not successful in increasing revenues, or if there is a material increase in our expenses, we may be unable to achieve profitability in the future. We cannot guarantee that we will increase sales of our products and technologies, or that we will successfully develop and market any additional products, or achieve or sustain future profitability, and we may have to continue to rely on the sale of shares and on debt financings in the future.

Because our revenues have not always been sufficient to fund our business operations in the past, we may need additional funding to finance operations.

Our revenues in the past have not always been sufficient to fund operations, and we may need to raise additional funds to finance future operations. At December 31, 2001 we had cash reserves of $2,047,892 and at March 31, 2002 our cash reserves were $1,904,315. If our available cash and existing sources of revenue are insufficient and we need additional funding, we may not be able to secure the funding. If we do secure the funding it may be on terms that are not acceptable.

The market price of our common shares has been and continues to be volatile.

The trading price of our common shares on the Nasdaq SmallCap Market has been and continues to be volatile. During the twelve months ending on June 15, 2002 our stock price has ranged from a high of $2.120 to a low of $0.420 (on a post-share consolidation basis). The market price may be affected by announcements of, among other things, new products by our competitors, fluctuations in our operating results, assertions of intellectual property infringement made by us against third parties or by third parties against us and changes in our financial position.

To succeed in the audio industry we must be able to identify emerging technological and market trends, to enhance our existing technologies and develop new technologies, and to achieve and maintain wide distribution of our products. If we are not successful we will be unable to become profitable in this industry.

The audio industry is characterized by a number of factors including:

- rapid technological changes
- short technology and product life cycles
- escalating pressure to provide improved audio solutions at increasingly lower prices
- frequent introduction of new technologies and products
- development of audio enhancement technologies in-house by potential customers

It is important for us to be able to identify emerging trends in the PC multimedia, consumer electronic and Internet audio environments, and to enhance our existing technologies and develop new technologies and products to meet these continually changing market requirements. The development of our products and technologies must continue to focus on technological superiority over the offerings of our competitors while meeting the needs of our customers and potential customers, including competitive pricing and expeditious completion of development. Additionally, there must be sufficient consumer interest in and demand for enhanced audio to motivate our customers to use our products and technologies in their offerings. If we do not continue to develop premium new technologies and products timely and cost effectively, we will not be able to achieve profitability in the audio industry.

Our success in the audio industry depends upon the performance of our licensees and customers.

Except for revenues from sales to consumers, revenues derived from our audio business are dependent upon the performance of our licensees, customers and partners. Factors that contribute to performance of these licensees, customers and partners include, among others:

- end-user demand for their products
- timeliness, quality and pricing of their products
- success or failure of their distribution and commercialization efforts
- adoption of new business models
- competition in their markets
- manufacturing uncertainties
- general or regional economic conditions

As a consequence of the effect that these and similar factors may have on our licensees and customers, we may from time to time experience significant fluctuations in our revenues.

Our audio industry revenues come from a limited number of accounts and a significant change in the performance of these accounts may have a material effect on our revenues.

The sources of our audio industry revenues are limited in number and a reduction in the performance of these accounts, or the securing of a new account of similar size, would have a material effect on our revenues. Although we continue to make efforts aimed at broadening our revenue sources, there is no assurance that we will be successful in acquiring new accounts or business relationships.

To succeed in the electronic commerce industry we must be able to offer a wide array of products and services, keep pace with evolving industry standards, business models and customer needs, and expand our merchant base through acquisitions. If we are not successful we will not be able to become profitable in this industry.

The electronic commerce industry is characterized by a number of factors including:

- very rapid technological advances
- rapidly evolving industry standards, business models and customer needs
- low barriers to entry and large numbers of new entrants
- acquisitions and consolidation by larger, well-financed e-commerce service providers

The increase in breadth of e-commerce services and product offerings and the trend in acquisitions and consolidations by larger, well-financed service providers has resulted in the availability of "one stop shopping" for small business owners. We must be able to adapt and enhance our existing technologies, develop or acquire new technologies and products, and integrate third party solutions with our products so that our e-commerce offerings include a wider array of online solutions and thus are attractive to small business merchants. We acquire new merchants primarily through acquisitions, and we face competition for acquisition targets from larger competitors. As new competitors enter the market product and service price reductions may occur. To retain customers we must offer an array of products and services, competitive pricing and high quality customer service.

Our success in the electronic commerce industry depends on the continued successful growth of this industry. If the Internet does not become a widely accepted vehicle for commerce, or if the Internet continues to experience rapid growth which cannot be supported, our business will suffer.

Our electronic commerce business depends on the continued growth of this industry and acceptance of the Internet by consumers and merchants as an effective means of conducting business. The rapid growth of electronic commerce is a recent development and there is no certainty that the Internet will continue to develop and attract sufficient numbers of consumers and merchants to become an alternative to traditional methods of commerce. If the Internet continues to grow and attract significant new users, existing infrastructure may not be capable of supporting the increased activity. Our business will suffer if the Internet does not become a widely accepted vehicle of commerce or if rapid growth is not supported by new technological advances.

System defects, failures or breaches of security could disrupt our electronic commerce business.

Our systems are vulnerable to interruptions of our hosting services resulting from factors including software or hardware defects, telecommunications failures, capacity limitations, fire and power losses, breaches of security and vandalism. The occurrence of any of these events could cause service interruptions and could result in damage to our reputation and loss of merchant accounts.

Our business will suffer if we fail to compete effectively with our competitors.

The audio industry and the electronic commerce industry are intensely competitive. We have competitors in both industries who have technologies and products that are similar to ours and compete directly with us. Some of these competitors are large, established companies with significantly greater resources than we have. More specifically:

- *audio industry*: Our major competitors in audio enhancement are Sensaura Ltd. which concentrates on the PC multimedia market, SRS Labs, Inc. and Spatializer Audio Laboratories, Inc. which compete with us primarily in the consumer electronics market, DFX which focuses on audio enhancement software plug-ins for Internet media players and Lake Technology Limited, which is our principal competitor in the headphone audio enhancement area. We also compete with Dolby and SRS in the multi-channel home theatre market.

- *electronic commerce industry*: We face many competitors in the electronic commerce industry and the number of companies providing products and services similar to ours is increasing at a rapid rate. Examples of competitors are Bigstep, Network Commerce Inc., Yahoo, Microsoft and Verisign. These companies sell products and services similar to those we offer, including building Internet-based electronic storefronts, hosting merchant sites and providing marketing services.

Our products and technologies are based on our intellectual property. If we fail to adequately protect our intellectual property our business will suffer, and if we are sued for infringement by a third party we will incur significant legal expenses.

Our success depends largely on our ability to protect our proprietary technologies and to keep infringers from using and marketing our technologies. We rely upon U.S. and international patent, copyright, trade secret and trademark laws to protect our intellectual property. We also rely on contractual obligations such as non-disclosure agreements. Despite our efforts, third parties may copy our technologies and we may be unable to prevent the sale of infringing products. Also, third parties may successfully develop products which compete with our products and which do not infringe our intellectual property rights. In addition, third parties may successfully assert that our technologies and products infringe their products and that our patents are invalid. Our business will suffer if we are not successful in defending our intellectual property, and we will incur significant legal expenses if we must defend third party infringement claims.

If we experience rapid growth and do not manage it effectively our business and financial results will suffer.

If our technologies and products achieve wide acceptance we may experience rapid growth. We may have to hire more employees including additional management, improve our financial and control systems, and expand and manage our technical, sales and support services operations. We would need increased revenues and/or additional funding to operate these increased activities. If we do not manage our growth effectively our business and financial results will suffer.

We depend on key employees and our business may suffer if we are not able to keep these employees or hire and train replacements.

Our success depends on the skills, experience and performance of our senior management and certain other key personnel. We do not carry key personnel insurance on these employees. Experienced management and highly skilled engineers and software programmers are critical to the success of our business. We could suffer adverse effects if we are unable to successfully retain our key personnel, or hire and train suitable replacements.

If in the future we do not demonstrate compliance with the minimum listing standards for continued quotation on the Nasdaq SmallCap Market our shares may become subject to delisting.

On a number of days during the month of June, 2002 the closing bid price for our common shares was below $1.00. Nasdaq requires that we maintain a minimum closing bid of $1.00. If we fail to achieve the minimum requirement for 30 consecutive business days, we will be given a 180 calendar day grace period to demonstrate compliance by achieving a $1.00 minimum closing bid for 10 consecutive business days. If compliance is not achieved within the grace period, issuers that demonstrate compliance with the core initial listing standards, that is net income of $750,000, stockholders equity of $5 million or market cap of $50 million, will be given a further grace period of 180 calendar days within which to achieve compliance. At the date of this annual report our shareholder equity is over $5 million.

We are incorporated in Alberta, Canada, some of our directors and officers live in Canada, and most of our assets are in Canada, and investors may have difficulty starting legal claims and enforcing judgments against us and our directors and officers.

We are incorporated in the Province of Alberta, Canada. Certain of our directors and officers live in Canada, and most of our assets, and the assets of those officers and directors, are located in Canada. As a result, it may be difficult for investors to effect service of legal process within the United States upon directors and officers who are not United States residents. Also, there is uncertainty as to the enforceability in Canada, in original actions or for enforcement of judgments of U.S. courts, of civil liabilities predicated upon U.S. federal or state securities laws.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

Our legal and commercial name is QSound Labs, Inc. and we were reincorporated on July 10, 1990 in the province of Alberta, Canada under the Business Corporations Act of Alberta, by way of continuance from the province of British Columbia where we were incorporated on December 6, 1968. We changed our name from Archer Communications Inc. to QSound Labs, Inc. on June 28, 1993. The address of our registered office is Suite 400 – 3115 12th Street NE, Calgary, Alberta, Canada T2E 7J2 and the telephone number is (403) 291-2492.

Recent Developments

On July 9, 2001 we consolidated our common shares on a one-for-four basis. Prior to the consolidation we were not in compliance with the minimum bid requirement for continued listing on the Nasdaq SmallCap Market. At the time of the consolidation, the number of our issued and outstanding shares decreased from 28,880,657 to 7,220,589 and the market price per share increased from $0.36 to $1.45.

Capital Expenditures

Our principal capital expenditures for each of fiscal year 2001, 2000, and 1999 are detailed in the table below:

	2001	**2000**	**1999**
Sound source and control equipment	$ 43	$ 9,919	$ 4,451
Furniture and fixtures	2,553	789	38,195
Computer equipment	34,546	31,780	169,999
Software and production tooling	134,418	683,750	372,202
Patents and trademarks	44,730	62,254	102,635
Total	$ 216,290	$ 788,492	$ 687,482

In fiscal 2001 our divestitures consisted of furniture and fixtures with a cost of $2,000. For financial statement purposes $16,614 was reclassified from computer equipment to furniture and fixtures as management felt this was a more appropriate classification for the asset. Software and production tooling of $383,750 that was allowed for in fiscal 2000 as part of the impairment of assets charge was removed from the capital asset cost base in 2001. In fiscal 2000 our divestitures consisted of furniture and fixtures with a cost of $27,895. There were no divestitures in fiscal 1999.

B. Business Overview

Our company is engaged in two business segments:

a) QSound Labs develops, markets and distributes multimedia software solutions based on its patented, proprietary audio technology portfolio. Revenues are generated by licensing to original equipment manufacturers ("OEM's"), chip manufacturers and game developers in the computer multimedia, consumer electronics and home video game industries and by selling downloadable software products directly to consumers over the Internet.

b) Our wholly owned Washington subsidiary QCommerce Inc. provides electronic commerce services that are dedicated to enabling small businesses to succeed in the emerging e-commerce marketplace (eSolutions™). QCommerce eSolutions provide Web merchants with all of the tools necessary to set up and operate an on-line store, and with marketing and advertising services to drive targeted traffic to the store.

Audio Business Segment

We are a world leader in the development, marketing and distribution of audio enhancement technologies. The QSOUND® portfolio of proprietary technologies includes a complete suite of virtual audio, reverberation, synthesis and enhancement algorithms as well as all of the components required to create custom software audio engines, namely, a sample rate converter, a sample player, a mixer and a music synthesiser.

We derive our audio business revenues principally from:

- licensing of QSOUND technologies to semiconductor companies, PC multimedia and consumer electronics OEM's, and video game developers, and our binaural localization technology license for hearing aids; and

- sales of downloadable software products over the Internet through third parties and on our web sites.

QSOUND Portfolio of Technologies

Since 1988, we have been engaged in the development and upgrading of a complete suite of proprietary technologies to cover all aspects of enhanced audio and audio synthesis requirements in the multimedia computer, consumer electronics and entertainment industries. Additionally, during this time, we developed binaural localization and hearing in noise algorithms for use in digital hearing aids. In the past year we have also developed a scalable software engine for products using Microsoft's Windows operating systems. The QSOUND portfolio consists of:

- Software Engines

QVE™: The QSound Virtual Engine("QVE") is a scalable software audio engine for PCs, PDAs and other digital devices. QVE provides synthesis and digital audio playback for entertainment and mobile audio applications, and is a platform for incorporating all of the proprietary algorithms described below.

QMixer™: QMixer is a high-performance audio mixer targeted at game developers. QMixer adds 3D speaker or headphone audio to regular stereo sound cards and also takes advantage of available DirectSound®3D and EAX™-compatible acceleration hardware. QMixer uses low CPU overhead and includes advanced resource management to dynamically distribute the rendering duties between hardware and software.

- 3D Audio Algorithms

Q3D™: Q3D 2.0 is our interactive sound positioning technology, which places multiple individual sounds in specific locations outside of the bounds of stereo speakers and headphones, and positions sound with equal effectiveness via multiple speaker systems. Q3D 2.0 also includes QSound Environmental Modeling™ (QEM™), a reverberation engine which is compatible with the Environmental Audio Extensions™ (EAX™) API from Creative Labs, Inc.

QSURROUND™: QSURROUND creates virtual surround sound for audio played back over two speaker and headphone entertainment systems. QSURROUND has been developed by QSound to take advantage of the DVD format, which enjoys enthusiastic support of the world's major electronics companies, and the digital broadcast format, both of which have become the new standards for music, video game and movie playback. Using QSURROUND, decoded Dolby Digital, Dolby ProLogic® and MPEG2 multi-channel audio streams can be played back over only two speakers, while maintaining the illusion of a multi-speaker system through creation of phantom or "virtual" speakers or headphones, eliminating the need for additional speakers. Dolby Digital and MPEG2 are the current audio standards for DVD based personal computers and home entertainment systems. QSURROUND has been certified by Dolby Laboratories for use with Dolby Digital and ProLogic.

QXPANDER™: QXPANDER processes existing pre-mixed stereo material to provide 3D enhancement for audio played back over traditional two speaker or headphone stereo.

QMDV™: QSOUND Matrix Surround Decoder/Virtualizer (QMDV), a superset of QXPANDER, decodes stereo audio material which has been encoded using matrix surround encoding such as Dolby

Surround, and virtualizes the decoded material to create a multiple speaker surround effect when the material is played back over stereo speakers. For three speaker systems, a centre channel output is available.

- Synthesis Algorithms

QSURROUND 5.1/QMSS™: QSURROUND 5.1 and QSOUND Multiple Speaker System (QMSS) process stereo audio material including regular stereo content and decoded surround content downmixed to two channels from sources such as Dolby Surround®, Dolby Digital (AC3), DTS® and MPEG2 and "steer" acoustic images to create a distinctly different output for each speaker in multiple-speaker systems.

QIMMERSION™: QIMMERSION is a superset of QMSS (four-channel) optimized for playback over a combination of stereo speakers and headphones.

QSIZZLE™: QSIZZLE is a virtual, adjustable treble feature that allows the listener to adjust the treble level.

QRUMBLE™*:* QRUMBLE is a virtual, fully adjustable bass boost that creates dynamic bass effects set to the listener's preference.

- Effects Algorithms

QVERB™: QVERB is a reverb feature that allows the listener to choose from a selection of adjustable listening environments, such as hall, theatre and stadium.

QBASS™: QBASS is a fully adjustable bass boost feature that allows the listener to optimize bass levels to the listener's preference.

- Other

Hearing Aid Technology: QSound Labs and its joint venture partner the House Ear Institute, a leading hearing research institute based in Los Angeles, (collectively "HEAR"), have developed technologies for use in digital hearing aids. Digital hearing aids are miniaturized computers, which convert sound to a digital signal which can be processed to meet individual needs and then converted back to sound. The ability to program the hearing aid greatly reduces feedback and background noise and enables automatic adjustment to changing levels of sound in the environment. HEAR's binaural localization technology for use in digital hearing aids enhances directional hearing capacity while compensating for hearing impairment. The hearing-in-noise test technology developed by HEAR is a DSP based hardware/software system which is used to test hearing impairment in environments where background noise is high and in hearing-critical job situations.

Licensing

We license QSOUND technologies to semiconductor companies, which manufacture and sell QSOUND enhanced chips to PC multimedia and consumer electronics OEM's. In certain instances we also have the right to purchase and resell these chips to OEM's. We also license these technologies directly to OEM's in the PC and consumer electronics industries, and for use in video game consoles and hearing aids.

QSOUND technologies are shipped in:

- PC's and PC peripherals including sound cards, speakers and monitors
- stereo systems
- MP3 players
- amplified and USB speakers

- home theatre systems, TV's and VCR's
- DVD players
- video games and game consoles
- digital hearing aids

Licenses with semiconductor companies and OEM's are negotiated on an individual basis. Certain semiconductor licensees pay royalties directly to us, and in other cases OEM's pay royalties to us when they purchase QSOUND-enhanced chips. Some of our license agreements provide for per-unit payments and others are on a fixed periodic payment or lump sum payment basis. Included as part of the license are provisions dictating the terms for use of QSound trademarks and logos with respect to packaging, the product and user manuals. The agreements do not have volume requirements and may be terminated by the licensees or QSound without a prescribed financial penalty.

The following is a partial list of OEM's whose products include QSOUND technologies:

Acer Computer International, Inc.
Addonics
AIWA
Ambit
Amoisonic
Atherton
Aztech Systems Ltd.
Best Union
Boston Acoustics
ChangHong Electronics
CHIC
Cyberlink
Daewoo Corporation
Esonic
Fujitsu
Gallant
HIS
Hoontech
IBM Corporation
InterVideo
Jaton
Labway
Matsushita
Midiland
Micron
Orient Power
Philips
Quickshot
Recoton
Samsung Electronics, Inc
Sanrupid Electronics
Sanyo
Sensory Science (Go-Video)
Shark
Sharp
Shuttle
Siemens Nixdorf
Thomson Multimedia
Toshiba
VideoLogic
Warpspeed
Zoltrix

Our DSP semiconductor licensees include:

AKM
Cirrus Logic
Fortemedia
Motorola
Philips Semiconductor
Samsung
TVIA
Zoran

In March, 2002 we entered into a three year joint development agreement with Royal Philips Electronics, one of the world's largest electronics companies, to produce digital audio solutions for the multi-channel sound card market and other consumer electronic products. Under this agreement Philips will be the exclusive manufacturer of soundcards that include our QVE soft audio engine. In addition Philips has the right of first refusal to develop, manufacture and distribute QMSS based products. Philips has agreed to pay an upfront fee, payable on the earlier of September 1, 2002 or first product release and creditable against future royalties, and ongoing royalties. We also granted to Philips 500,000 warrants exercisable at $1.04 per share which vest as to 250,000 warrants on each of September 25, 2002 and March 25, 2003, and a right of first refusal to acquire control of our company.

Our analog chip manufacturer licensees are Mitsumi Electric Co., Ltd., Mitsubishi Electric Corporation and Nippon Precision Circuits Inc. Mitsumi has the right to distribute QXPANDER chips in Japan, Europe and Asia and we distribute these chips in the rest of the world. We have the right to distribute Mitsumi-manufactured QMDV chips world-wide. Mitsubishi has the right to market and distribute QSOUND-enhanced chips world-wide except in China and Hong Kong, where we sell these chips. NPC distributes QSOUND-enhanced chips to Japanese companies and we sell these chips to Japanese and non-Japanese companies.

Professional sound studios use QSOUND software and our QSYSTEM hardware/software units in music recordings, television and radio programs, motion pictures and broadcast. West Productions of Los Angeles currently uses QSOUND in the production of various television programs, including: ”Millennium”, “Ally McBeal”, “The Practice” and “XFiles”, for which West Productions in 1996 received an Emmy award for outstanding sound quality. Video game developers use QMIXER, our first generation software audio engine in their video games. Game developers that have licensed QSOUND include:

Accolade
Activision
Bullfrog Productions
Capcom
Codemaster Software
Electronic Arts US
Electronic Arts UK
Fathom Pictures
Grolier
Imagitec
Intelligent Games
Interactive World Productions
Kuju Entertainment
Laurent Parent
Looking Glass Technologies
Microprose
Microsoft
Mindscape
Motion Factory
Overtime Sports
Philips Interactive
Remedy Entertainment
Simis Eidos
Singletrac
Softkey Multimedia
Sony
Psygnosis
Pumpkin Studios
Telstar
Electronics Studio
Velocity
Virgin Interactive
Virtual Adventures

In March 1993, QSound and the House Ear Institute entered into a development and license agreement with Starkey Laboratories, Inc., the world's largest manufacturer of custom in-the-ear hearing aids, for the development and licensing of DSP based binaural hearing aids which use HEAR’s binaural localization technology. Starkey agreed to pay lump sum royalties and per unit royalties to HEAR and subsequently introduced the Cetera digital hearing aid in August, 1999. Also, in 1999 Starkey, QSound and House Ear amended the agreement to add royalties for non-Cetera digital hearing aids sold by Starkey in North America (excluding Mexico) until the first quarter of 2003 and in the rest of the world until the third quarter of 2004. Currently, Starkey is shipping non-Cetera digital hearing aids.

Downloadable Software Products

QSound has several standalone software products as well as plug-in products for most media players and certain authoring tools. The majority of revenues to date have been derived from the plug-in products through distribution over the Internet.

We have an agreement for distribution of our iQfx® family of software products with RealNetworks Inc., a leader in media delivery on the Internet. The iQfx family enhances playback of content over all of RealNetworks' media players. In December, 2001 we released iQfx3, the latest addition to the family, for the new RealOne™ Player.

Due to changes in the sign up process for RealNetworks RealOne Player, RealNetworks is experimenting with how it promotes iQfx3 to new RealOne subscribers. This action has affected the amount of revenues received by QSound from RealNetworks in 2002. RealNetworks continues to sell iQfx3, and the change in strategy is not reflective of iQfx3's sales performance. In 2001, revenues received from RealNetworks accounted for 28% of QSound's total revenues.

QMAX™ is our universal plug-in for Internet streaming audio, and works with RealAudio®, MP3 files, WAV files, Shockwave, Emblaze™ and other players, as well as with system sounds. QMAX intercepts the audio output from any audio player and applies realtime processing to optimize speaker and headphone audio. We have also developed and distribute custom plug-ins for MusicMatch, Linux platforms, Microsoft Windows Media Player, WinAmp™ and UltraPlayer.

AudioPix™ is a standalone software product that enables Web users to combine images with music to create their own personalized multimedia presentations for personal or business use. A free version of AudioPix is included on Kodak Picture CD pursuant to a distribution agreement entered into in April, 2000 with the Eastman Kodak Company, and AudioPix Pro is certified "Kodak Picture Friendly" by Kodak. AudioPix and AudioPix Pro are available for purchase from our Web site www.audiopix.net. In May 2000, we acquired the AudioPix source code from Cinax Designs, Inc., which had formerly licensed the source code to QSound.

We distribute our downloadable consumer software from our Web sites www.qsound.com and www.audiopix.com.

We distribute a suite of plug-in software modules for popular audio editing platforms. Q3D sound positioning and QXPANDER audio enhancement modules are available for Digidesign's® Pro Tools III® (QSYS/TDM™ and QX/TDM™ and Sound Designer II® (QX/SDII™), for Sound Forge™ from Sonic Foundry® (QTools/SF™) and for DirectX® compatible PC digital audio editors (QTools/AX™). QCreator™ is a software application that allows users to add 3D audio effects to normal WAV or AIFF computer sound files.

In November, 2001 we acquired rights to the source code for Earjam.com Inc.'s IMP player, and a new product incorporating Internet media player, CD burning and 3D audio functionalities is in the development stage with commercial introduction anticipated for the third quarter of 2002.

E-commerce Business Segment

QCommerce provides electronic commerce services that are dedicated to enabling small businesses to succeed in the emerging e-commerce marketplace (eSolutions™). Our services include domain name registration, store set-up and hosting, merchant credit card account set-up, technical support services and marketing and advertising services to drive targeted traffic to the merchant's site. QCommerce eSolutions do not require any software installation or download and merchants need only Internet access and a web browser to use these services.

In December, 2001 we increased our merchant base through acquisition of eMerchantPro technology and business. In the third quarter of 2000, we downsized our operations in Seattle, WA. In the first quarter of 2001, we changed services suppliers and in the fourth quarter of 2001 we ceased using service suppliers and all customer support was brought in-house. These changes dramatically reduced our operating expenses.

QCommerce derives its revenues primarily from monthly service subscription fees paid by merchants for on-line storefront hosting and related services, in contrast to the earlier revenue model which was based on one-time lump sum product licensing fees.

We offer the following products for use by our online merchants:

QCommerce Internet Store™ is a full-featured Internet-based storefront, shopping cart and transaction system that allows a merchant's customers to browse products and purchase them using an optional on-line, real-time secure credit card authorization and verification system, or by manually downloading orders directly from Internet Store's administration area. Internet Store's robust database management system gives the merchant full control over administration processes including pricing data, accounting information and detailed customer order records. We have continued to upgrade and enhance Internet Store since the acquisition from Virtual Spin Inc. in 1999. (See "Virtual Spin Business Combination", below.)

QCommerce eXpress Store™ is a shopping cart that enables established Web sites to process sales and credit card transactions on-line without rebuilding or moving their site. eXpress Store, which is designed for merchants who already have (or prefer to build) their own unique Web site, has the ability to grow as the merchant adds products and increases sales volumes.

emerchantPro™ user-friendly software products help small businesses build e-commerce web sites, catalog and sell their products or services online, process and ship orders, report on their web businesses and initiate live chats with customers to maximize sales. Web sites can be up and running in minutes with professional and interactive results.

Choiceworld™.com shopping portal is an on-line shopping directory that drives targeted traffic to a merchant's on-line store and makes shopping more convenient for consumers through expanded category listings, detailed site descriptors, and a product oriented search engine. Choiceworld.com is listed in many of Looksmart's network of search engines, including msn.com, altavista.com, excite.com, and cnn.com. The Looksmart network reaches 77%, or nearly four out of five, US Internet users.

Since 1999 we have acquired four e-commerce properties:

- eMerchant Pro Acquisition

In December, 2001 QCommerce acquired the eMerchantPro technology, software products and web hosting business, formerly owned and operated by Big Picture Technologies Inc., for a purchase price of $34,418.

- I-netmall.com Acquisition

In November, 2000 QCommerce acquired the assets and business of i-netmall.com, an online shopping mall of Internet Store merchants from Cyberworks Institute Inc. The acquisition included a minimum $450,000 in contracted subscription fees, which was payable to QCommerce monthly and due in full no later than May 24, 2002. As consideration for the acquisition QSound Labs issued 500,000 pre-consolidation common shares to Cyberworks, 225,000 of which were held in escrow as a guarantee, on the basis of $1.00 per share, of payment of the contracted subscription fees. The escrow shares were cancelled in December, 2001 to offset the guarantee, and also to compensate QCommerce for providing web site building services which Cyberworks had previously agreed to perform. A marketing agreement entered into by QCommerce and Cyberworks in November, 2000 was terminated in December, 2001 and no options to purchase QSound shares were granted to Cyberworks as originally contemplated under the agreement.

- Choicemall.com Acquisition

In May 2000, QCommerce acquired choicemall.com, an online shopping mall whose merchants sell products and services in sixteen different categories ranging from arts and entertainment to professional services, real estate and travel, from Looksmart, a leading provider of Internet search services. Under the acquisition agreement Looksmart has agreed, for a period of seven years, to:

- list QCommerce merchants and their products and services in Looksmart directories
- list choicemall.com and up to five additional e-commerce destinations specified by QCommerce in Looksmart directories
- provide to QCommerce search and information services that are available on web sites controlled by Looksmart
- advertise choicemall.com on Guthy-Renker Corporation's television infomercials. Guthy-Renker is the leading marketer of consumer brands via infomercials, home shopping and direct response television sales.

Looksmart has also agreed to list QSound Labs' products and services in Looksmart directories at fees equal to or less than fees charged to its other customers.

QCommerce has agreed, for a period of seven years, to list Looksmart's "BuyItOnTheWeb" site on the choicemall.com web site.

As consideration for the acquisition of choicemall.com, we paid $1,300,000 over a period of eleven months and, in addition, issued and registered under the Securities Act of 1933 ("'33 Act") 1,000,000 pre-consolidation common shares to Looksmart. We repurchased 500,000 pre-consolidation shares from Looksmart at the price of $0.40 per share in May, 2001. QCommerce also assumed all liabilities arising from QCommerce's ownership of choicemall.com after the closing of the acquisition.

<u>Virtual Spin Business Combination</u>

In June, 1999 we acquired all of the assets and business of Virtual Spin Inc., a Washington corporation. As consideration we issued, after escrowed share adjustments, and registered under the '33 Act, 1,706,020 pre-consolidation shares to Virtual Spin. These shares were distributed to Virtual Spin shareholders and Virtual Spin was subsequently liquidated. QSound Labs and QCommerce also assumed all of Virtual Spin's liabilities.

At the date of this annual report, 88,178 post-consolidation options to purchase QSound Labs' shares, exercisable at $9.00 per share and expiring on August 3, 2002, of the 1,116,536 pre-consolidation options issued to Virtual Spin's employees in July, 1999 in replacement of their options to purchase Virtual Spin shares held prior to the business combination, are outstanding. QCommerce has employment agreements with 2 of the 21 former Virtual Spin employees.

Revenues by Business Segment

In fiscal 2001, our revenues were $2,454,800 from the audio business segment and $571,194 from the e-commerce business segment. In fiscal 2000, our revenues were $3,025,102 from the audio business segment and $1,443,900 from the e-commerce business segment. In fiscal 1999, our revenues from the audio business segment were $2,678,328 and from the e-commerce business segment were $947,295. Our e-commerce business segment was established in 1999.

Revenues by Geographic Market

Product sales revenue for the audio business segment comes primarily from the United States and license and royalty revenue is split between the United States and Asia.

Revenue for our e-commerce business segment comes primarily from the United States.

Seasonality

In 2001 we did not experience any seasonal changes in our e-commerce business segment. All revenue from e-commerce was subscription based, and this base remained relatively constant throughout the year. We generally experience increased royalty revenues in our audio business segment in the second and third quarters for consumer electronics, hearing aids, and PC sales, all related to the Christmas shopping season. These sales activities decrease during the fourth and first quarters. Overall, seasonality does not have a material effect on our business.

Marketing Channels

Our audio business segment sales and marketing activities are carried out by in-house employees and by representatives and agents in Asia that cover Japan, Hong Kong, China, Singapore, South Korea, Malaysia, Thailand, Philippines, India and Indonesia. In addition, certain of our semiconductor licensees market and promote their QSOUND-enhanced products to third parties worldwide. We distribute our downloadable software products through business partners, participants in our affiliate marketing program, and from our own web sites.

Our e-commerce business segment sales and marketing activities are carried on by our direct sales staff.

Intellectual Property

QSOUND technologies and products are covered by a variety of intellectual property protections which include patent, copyright, trade secret and trademark laws, and contractual obligations. However, there can be no assurance that competitors will not be able to produce non-infringing technologies, products or services, or that third parties will not assert infringement claims against us.

We hold sixteen patents in the United States, including four patents which cover the fundamental technology applicable to our Q3D positional audio, QSURROUND, and stereo enhancement technologies. In addition, three patents cover the binaural hearing aid technology developed by QSound Labs and the House Ear Institute. At the date of this annual report, an additional two patent applications for QSOUND complementary and improved technologies have been filed and more applications are in progress. Patent applications have been made in eighteen foreign countries and a number of foreign patents have been granted, including in Japan.

Our key trademarks, including QSOUND, QSURROUND and the stylized “Q” logo are registered in the United States and in various foreign countries. QSound Labs has filed trademark applications for many of its trademarks in the United States and internationally, and carries on a trademark protection program on an ongoing basis for new trademarks.

QCommerce’s e-commerce enabling technologies, including software developed for Internet Store, eXpressStore and our affiliateDirect marketing program, are covered by copyright and trade secret laws, and contractual obligations.

Competition

The audio industry and the electronic commerce industry are intensely competitive. We have competitors in both industries who have technologies and products that are similar to ours and compete directly with us. Some of these competitors are large, established companies with significantly greater resources than we have. More specifically:

- *audio industry*: Our major competitors in audio enhancement are Sensaura Ltd. which concentrates on the PC multimedia market, SRS Labs, Inc. and Spatializer Audio Laboratories, Inc. which compete with us primarily in the consumer electronics market, DFX which focuses on audio enhancement software plug-ins for Internet media players and Lake Technology Limited, which is our principal competitor in the headphone audio enhancement area. We also compete with Dolby and SRS in the multi-channel home theatre market. Certain major manufacturers of multimedia computers and peripherals, of consumer electronics products and of chips for use in these products have developed or are in the process of developing their own 3D audio solutions for incorporation in their products.

- *electronic commerce industry*: We face many competitors in the electronic commerce industry and the number of companies providing products and services similar to ours is increasing at a rapid rate. Examples of competitors are Bigstep, Network Commerce Inc., Yahoo, Microsoft and Verisign. These companies sell products and services similar to the ones we offer, including building Internet-based electronic storefronts, hosting merchant sites and providing marketing services. It is extremely likely that other companies will enter the market with new products and services similar to our e-commerce products and technologies, some of which are likely to be more competitively priced, have more attractive features or ease of use, and carry more recognized branding, than our products and services.

There are no governmental regulations that have a material effect on our business, other than regulations that affect the carrying on of business generally.

C. Organizational Structure

QSound Labs, Inc. is the parent of the parent of QSound Ltd., a California corporation and wholly owned subsidiary that owns certain assets including several patents, and QSound Electronics, Inc. Washington corporation that is non-operating. QSound Ltd. is the parent of wholly owned subsidiary QCommerce Inc., a Washington corporation, which operates our e-commerce business segment.

D. Property, Plants and Equipment

Our head office, including research facilities and a sound studio, is located at 400 – 3115 12th Street NE, Calgary, AB, Canada T2E 7J2 where we lease approximately 10,648 square feet of office space until October 31, 2003 at a rental rate of $8,429 Cdn. per month. We have the option to renew the lease for an additional two-year term at then prevailing market rates. Our audio business, and since the third quarter of 2000, our e-commerce business, are operated from our Calgary office.

We own computers, software, electronics equipment, studio and audio equipment, and electronics laboratory and testing equipment, all of which is used by us in the development of our technologies and products. All of this equipment is located at our head office in Calgary. We also own Web servers which are located mainly off-site. Inventory primarily consisting of QSOUND-enabled analog chips, UltraQ's and AudioPix CD's is also housed at our Calgary office, and warehoused off-site.

QCommerce's leases expired on August 31, 2001. Previously, after QCommerce downsized in the third quarter of 2000, QCommerce had sublet its leased premises in Bellevue, WA at current market rates.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of the financial condition and results of operations of QSound and subsidiaries for the year ended December 31, 2001 compared to the year ended December 31, 2000, and the year ended December, 2000 compared with the year ended December, 1999 should be read in conjunction with the Consolidated Financial Statements of QSound and related Notes included therein as well as the information and data provided in Item 3. "Key Information" of this annual report.

Critical Accounting Policies

On December 12, 2001, the Securities and Exchange Commission ("SEC") issued Financial Reporting Release ("FRR") No. 60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" which, among other things, encourages discussion concerning the most critical accounting policies used in the preparation of the Company's financial statements. Critical accounting policies are defined as those that are both very important to the portrayal of the Company's financial condition and results, and require management's most difficult, subjective or complex judgments. We are required to make certain estimates, judgments and assumptions that we believe are reasonable based upon available information, historical experience and/or forecasts. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported revenues and expenses during the reporting periods. Actual results could differ from these estimates. The accounting policies which management believes are the most critical to aid in fully understanding and evaluating our reported financial results include those relating to inventory, goodwill, research and development costs, and stock option plan.

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. We regularly review quantities of inventory on hand, and an allowance is made for obsolete items based upon current market demand and selling prices. Adverse changes in technology or new models could result in a decreased demand for our products which may require an additional allowance to be made for obsolete inventory.

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. We assess the recoverability of this intangible asset by determining whether the unamortized balance of the goodwill can be recovered through undiscounted future operating cash flows of the acquired operation over its remaining life. The amount of goodwill impairment, if any, is measured based on projected discounted future operating cash flows using a discount rate reflecting our average cost of funds. The assessment of the recoverability of goodwill will be impacted if estimated future operating cash flows are not achieved.

Effective January 1, 2002, we adopted the new Canadian Institute of Chartered Accountants standard No. 3062 - Goodwill and Other Intangibles ("CICA 3062"), which no longer permits the amortization of goodwill and other indefinite life intangibles. The new standard requires that a fair value impairment test be performed annually on goodwill and other indefinite life intangibles. On transition, goodwill and indefinite life intangibles are tested for impairment as of the beginning of the fiscal year in which CICA 3062 is first applied. As such, an impairment test will be performed to evaluate the carrying values as at January 1, 2002 on goodwill and indefinite life intangibles. As permitted under CICA 3062, this test will be completed by June 30, 2002. Barring unforeseen circumstances, it is not expected that any impairment charges will be recorded as a result of the adoption of CICA 3062 in 2002. The new standard is applied prospectively.

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. We interpret the assessment of whether development costs should be capitalized. In 2001, while $1,051,017 was spent on research and development, we capitalized only $100,000 of such costs. The remaining $951,017 was expensed as it could not be directly related to the development of new products, but instead was related to pure research and updates of existing products.

Stock option plan

No compensation expense is recognized when 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. Had we determined compensation cost in 2001 based on the fair value at the grant date for its stock options, $514,723 would have been recorded using the Black Scholes option pricing model with the weighted-average assumptions of a risk free interest rate of 4.5%, volatility of 113.3%, expected option life of 2 years, and zero dividend yield.

For the next financial year QSound will adopt the new CICA Handbook Section 3870 - Stock-Based Compensation and Other Stock-Based Payments. This section establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. It applies to transactions in which an enterprise grants shares of common stock, stock options, or other equity instruments, or incurs liabilities based on the price of the common stock or other equity instrument. We anticipate that we will adopt settlement date accounting to account for employee stock options, whereby their issuance is accounted for at intrinsic value. Options issued to non-employees will be accounted for at fair value.

A. Results of Operations

QSound's Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles in Canada. Except as disclosed in Note 13. to the Consolidated Financial Statements and as explained below, there are no material differences as pertains to these statements between accounting principles generally accepted in Canada and in the United States. We measure and report in United States currency.

Fiscal Year Ended December 31, 2001 compared to Fiscal Year ended December 31, 2000

Revenues:

Revenues for 2001 were $3,025,994 representing a decrease from revenues of $ 4,469,002 in 2000. Revenue in the audio segment decreased by $570,302 due to decreased royalty and license fees resulting from general stagnation in the world economy. In our e-commerce segment revenue decreased by $872,706. Our earlier e-commerce revenue model based on one-time lump sum product license fees became untenable following the dot.com decline and we adopted a more stable model based on monthly service subscription fees.

Operating Costs:

Operating costs decreased to $275,077 in 2001 from $375,000 in 2002 due to consolidation of our e-commerce operations into our Calgary office during the year.

Marketing Costs:

Marketing costs decreased to $1,074,139 in 2001 from $1,360,698 in 2000. In the audio segment costs decreased by $377,386 due to cost cutting measures taken to reflect overall weakness in the PC and consumer electronics industries and decrease in discretionary spending. In the e-commerce segment costs increased by $90,827 due to continuing marketing programs.

Product Research and Development:

Research and development costs decreased to $951,017 in 2001 from $1,610,436 in 2000. In the audio segment research and development costs decreased to $522,888 in 2001 from $787,800 in 2000 primarily due to less use of outside consultants. In the e-commerce segment costs decreased to $428,129 in 2001 from $822,636 in 2000 primarily due to the closing of the United States office and the reduction of United States engineering staff.

Administration Costs:

General and administrative expenses decreased to $597,685 in 2001 from $802,582 in 2002 due to consolidation of the administrative functions in the Calgary office, the closing of the United States office, and reduction in administrative staff.

Depreciation and Amortization:

Depreciation and amortization costs decreased to $831,193 in 2001 from $2,535,856 in 2000 due primarily to the decreased amortization of goodwill resulting from the impairment charged taken in 2000. No amortization of goodwill will be taken in 2002 as detailed in the discussion of major accounting policies above.

Impairment of Assets:

We did not incur any impairment of assets in 2001 except for the investment described in "Write-down of Investments and Gain on Sale of Investments" below.

Write-down of Investments and Gain on Sale of Investments:

During the 2001 year virtually all of one of the marketable securities held for sale were disposed of for total proceeds of $218,827, resulting in a gain over book value of $24,327. The remaining securities not sold were felt to have experienced a permanent decline in value, and a charge of $8,300 was recorded to write down the value of the investment.

Interest and Other Income:

Interest and other income decreased in 2001 to $73,568 from $154,788 due to interest rates declining in 2001.

Loss and Gain on Sale of Assets:

In 2001 we had a gain on sale of assets of $6,492 resulting from the disposal of sound source and control equipment and furniture and fixtures.

Fiscal Year Ended December 31, 2000 compared to Fiscal year Ended December 31, 1999

Revenues:

Revenues for 2000 were $ 4,469,002 representing an increase from revenues of $3,625,623 in 1999. Revenue in the audio segment increased by $346,774 due to increased royalty and license fees and internet sales of soft audio products. In our e-commerce segment revenue increased by $496,605 primarily from the continuing operations of Virtual Spin and the acquisition of the i-netmall.com and choicemall.com properties.

Marketing Costs:

Marketing costs increased to $1,360,698 in 2000 from $1,630,674 in 1999 due to continuing marketing efforts in the e-commerce segment of our business.

Administration Costs:

General and administrative expenses increased to $802,582 in 2000 from $557,402 in 1999 due to the cost of operating and acquiring new properties in the e-commerce segment of our business.

Product Research and Development:

Research and development costs increased to $1,610,436 in 2000 from $1,444,389 in 1999 due to a number of research and development projects. In the audio segment the development on AudioPix continued and iQfx 2.0 and QMax products were completed and launched. In the e-commerce segment the choiceworld.com product was developed and launched towards the end of the year.

Depreciation and Amortization:

Depreciation and amortization costs increased to $2,535,856 in 2000 from $632,387 in 1999 due to the acquisition of i-netmall.com and choicemall.com and the subsequent amortization of goodwill. (See "I-netmall.com Acquisition" and "Choicemall.com Acquisition" in Item 4. B. "Business Overview".)

Impairment of Assets:

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.com 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.com were calculated based on discounted expected future cash flows. A website property acquired in May, 2000 (webtailer.com) was found to have little value thus that operation was abandoned and the full purchase price of $445,654 was written off. In addition we wrote off $383,750 of previously capitalized deferred development costs which related to products no longer considered to have commercial value.

Write-down of Investments:

During the fiscal year 2000 we experience an other than temporary decline in the value of two marketable securities held available for sale. As a result we recorded a charge of $1,515,568 to write down the value of the investments.

Interest and Other Income:

Interest and other income increased in 2000 to $154,788 from $73,116 in 1999 due to more cash invested in 2000.

Loss and Gain on Sale of Assets:

In 2000 QSound had a loss on sale of assets of $34,634 resulting from the disposal of office equipment and the sale of part of the investments in publicly traded securities.

B. Liquidity and Capital Resources

In the first quarter of 2001, we successfully negotiated the reduction in debt to Looksmart from the original $3,000,000 to $1,300,000 and paid the remaining debt in full shortly after the end of the first quarter.

While QSound experienced a decrease in revenues, the cost cutting measures taken in 2001 resulted in cash of $789,281 being generated by operations. The e-commerce business segment became self financing and cash flow positive during the 2001 year, and the audio segment continues to be self financing and cash flow positive.

Our cash flow from audio business operations in 2002 is expected to come from royalties and licensing fees from current licensees and from new licensing arrangement for QSOUND technologies, from revenues related to sales of QSOUND-enabled chips which are manufactured by third parties and sold by those parties and by us, from revenue share and sales receipts related to sales of downloadable software products, and from royalties related to digital hearing aid chip sales.

Our cash flow from e-commerce business operations is expected to come from monthly subscription fees paid by merchants for set-up and hosting of on-line storefronts, sales of related services such as domain name registration and credit card processing capabilities, listings in choicemall.com and participation in third party affiliate programs.

Cash resources at the end of the first quarter of 2002 were $1,904,315 and liabilities for the same period were $222,670, which consisted of $187,710 in accounts payable and accrued liabilities and $34,960 in deferred revenue. We feel that with our current cash on hand and cash flows from operations we have sufficient capital to carry out our business plan for 2002.

During 2001, we received $218,827 from the sale of investments and $6,654 from the sale of excess capital assets. At December 31, 2001 we had $2,047,892 in cash and short-term deposits and compared to $2,264,639 in 2000. At year-end December 31, 2001 we had accounts receivable from various customers outstanding of $439,245 (of which $431,067 has been collected at June 11, 2002) and finished goods inventory with a cost of $28,587 consisting of QSOUND-enabled analog chips, AudioPix CDs and UltraQ's.

During 2000, we received $857,573 from the exercise of options and warrants. We also completed a series of private placements for gross proceeds of $2,030,000 in 2000. At December 31, 2000 we had $2,264,639 in cash and short-term deposits and compared to $1,524,363 in 1999. At year-end December 31, 2000 we had accounts receivable from various customers outstanding of $1,166,941 (of which $895,674 has been collected at June 13, 2000) and finished good inventory with a cost of $48,431 consisting of QSOUND-enabled analog chips and UltraQ's.

Cash Flows

Cash generated by operations in fiscal 2001 was $789,281 as compared to cash used in operations of $482,950 in 2000. The increase was due primarily to non-cash working capital decreasing to $240,189 in 2001 from $962,006 in 2000 and reduction in operating expenses.
Cash used in operations in fiscal 2000 was $482,950 as compared to cash generated by operations of $1,065,973 in 1999. The decrease was due primarily $928,118 in deferred revenues from 1999 being recognised as revenue in 2000 and payment of accounts payable. Historically our primary source of capital has been cash provided by financing activities.

Cash used in financing in fiscal 2001 was $980,800 as compared to cash generated by financing in fiscal 2000 of $1,854,244. The cash was used to retire the debt to Looksmart and to repurchase 241,615 common shares, resulting in an increase of $1,108,668 in contributed surplus.

Cash provided by financing in fiscal 2000 increased to $1,854,244 from $612,745 in fiscal 1999 due to an increase in common share issuances and a reduction in repayments of debt.

Cash used in investments decreased to $25,228 in 2001 form $631,018 in 2000. Capital assets were purchased for $216,291 and the eMerchant Pro hosting property was purchased for $34,418. Investments were sold for total proceeds of $218,827 and capital assets were sold for proceeds of $6,654.

Cash used in investments decreased significantly in 2000 to $631,018 from $2,279,968 in 1999. The acquisition of the I-netmall.com and Choicemall.com properties was financed through non-cash means in 2000.

C. Research and Development

As a result of sustained research and development activities in our audio business we have been able to maintain our position as a world leader in audio enhancement with cutting edge products and technologies. In addition to developing our own audio products we work jointly with our licensees and business partners to adapt and optimize our technologies for their products. In 2001 we worked with, among others, Philips, Motorola, Zoran, Fortemedia, RealNetworks and MusicMatch. We continue to carry out research and development of new products, and have signed a joint development agreement with Philips Electronics to develop new products for the personal computer and consumer electronics markets. (See Item 4.B. "Business Overview".)

In our e-commerce business segment, we carry out continual upgrading and enhancement of our eSolutions products, and in 2001 moved to convert our merchant customers whose sites are enabled with technologies of our 1999 and 2000 acquisition targets, to the upgraded Internet Store technology platform. This work was completed in 2002.

D. Trends

Audio Segment

With the general stagnation in the world economy affecting our customers we saw our royalty revenue decrease in 2001. While we do not expect any further significant decreases in royalty revenue, we do not expect royalties to increase in 2002 but to remain flat at the current level. Sales of integrated circuits are increasing and we expect the volume of sales to not only continue but to increase throughout the remainder of the year. Royalties from our hearing aid license remains strong and we expect these royalties to stay strong through the 2002 year until the North American portion of the license expires in February, 2003. In February, 2002 RealNetworks caused iQfx3 revenues to decrease by reducing the exposure of the product to consumers on their site. While our revenue from product sales has decreased management expects financial results for the remainder of the year to be similar to the results from the first quarter of fiscal 2002. Revenues for the first quarter of 2002 for the audio segment were $594,364 as compared to $705,665 for the same period in 2001. Operating profit for the audio segment for the quarter was $167,256 as compared to $236,163 for the same period 2001.

E-commerce Segment

Our e-commerce segment derives substantially all of it’s revenue from a recurring service subscription base. We expect this revenue to remain relatively constant throughout the year. We have consolidated operations in Calgary, Canada, and as we realise the cost savings we expect the segment to not only remain operationally profitable, but for profitability to improve.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. Directors and Senior Management

The following table sets forth certain information with respect to our executive officers and directors as of June 25, 2002. All positions indicated are with QSound Labs, Inc. only.

Name	Period of Service Since	Position
David Gallagher	May 1989	President, Chief Executive Officer and a Director
Francis Munoz	April 1999	Executive Vice President
Joanna Varvos	June 1991	Corporate Secretary
Doug Drury	December 1999	Controller
James Bonfiglio	October 1992	Director
Brian Harrington	June 2001	Director

David Gallagher has served as President and Chief Executive Officer since June 1992 and as a director since June, 1991. Mr. Gallagher joined our company 1989 and has acted as Vice-President, Finance and as Chief Financial Officer. Mr. Gallagher has over nineteen years experience in technology development and commercialization.

Francis Munoz joined our company as Executive Vice President in April, 1999. Mr. Munoz has thirty years of experience in the information technology industry. From January, 1997 to January, 1999 he was General Manager, Metronet Solutions, for Metronet Communications Group Inc., a Calgary based, local exchange carrier with national operations which was purchased in March, 1999 by AT&T Canada. Previously, since 1991 Mr. Munoz was employed by Minerva Technologies Inc., a software development consulting company, most recently as Vice President, Business Development, where he created and developed the IT services outsourcing business unit which was subsequently acquired by Metronet.

Joanna Varvos is Corporate Secretary of QSound. Ms. Varvos is a barrister and solicitor, admitted to the Law Society of Alberta in 1979. Ms. Varvos has provided legal services to QSound Labs since 1989 and was previously in private practice with a emphasis on corporate and securities law.

Doug Drury, a Certified Management Accountant, is our Controller since December, 1999. Mr. Drury has eighteen years of financial and accounting experience. Prior to joining our company Mr. Drury was Controller of Meyers Sheet Metal Ltd., Master Plastics Inc. and Jenkins Control Systems Ltd. He also taught accounting at the University of Calgary and the Southern Alberta Institute of Technology and operated his own public accounting firm from 1986 to December, 1997.

James Bonfiglio has been a director since 1992. Mr. Bonfiglio, a business consultant since April, 1995, has business experience including as President and CEO of Kroy Inc., a multi-national corporation specializing in manufacture and distribution of presentation products, labelling, lettering and bar-code equipment and other speciality industrial products, and of Home America, Phoenix, Arizona, the largest independent appliance and electronic retail operation in the Southwestern United States.

Brian Harrington was appointed to the board of directors concurrent with the resignation of Ian Tweedie as a director following our annual meeting of shareholders held on June 28, 2001. Mr. Harrington has extensive experience in the computer software industry. Since 1995 Mr. Harrington has worked with, and is currently a partner in, Western New Ventures Capital Corporation, an Alberta venture capital firm. Previously Mr. Harrington co-founded and operated two successful software companies, PSI Energy Software, an oil and gas software company and The 10 PLANNER Corporation, a large scale financial modelling business. Mr Harrington is a director of Diversity Corporation and Battrix Investments Ltd. which trade on the Canadian Venture Exchange.

There are no family relationships between any directors or officers of QSound. There are no arrangements or understandings between any director or officer of QSound and any other person pursuant to which the director or officer was selected, except for employment agreements between QSound and Messrs. Gallagher, Munoz and Drury.

B. Compensation

Remuneration paid or payable to our directors and executive officers during fiscal year 2001 was $279,100 Cdn. for compensation paid to Messrs. Munoz and Drury and Ms. Varvos, and $148,200 U.S. paid to Mr. Gallagher. Our directors are not paid cash compensation for their services in their capacity as directors; however, directors are reimbursed for reasonable travel and lodging expenses incurred in the provision of such services and receive stock options.

We have no pension, retirement or similar plans and none are proposed at present. Accordingly no amounts have been set aside or reserved for such plans.

The following table gives information concerning the compensation earned by our executive officers in 2001:

Name & Principal Position	Salary	Bonus
David J. Gallagher[1] President, CEO and Director	148,200 U.S.	nil
Francis Munoz Executive Vice President	100,000 Cdn.	nil
Joanna Varvos Corporate Secretary	107,100 Cdn.	nil
Doug Drury Controller	72,000 Cdn.	nil

[1] Mr. Gallagher's salary payable in 2001 was $200,000 U.S. If terminated without cause, if Mr. Gallagher's employment contract is not renewed for at least one year following expiration, or if there is a change in control of the Company and Mr. Gallagher elects not to continue his employment, Mr. Gallagher is entitled to payment of the difference between the salary payable and the salary paid. See item 6.C. "Board Practices" below.

The following table gives information concerning stock options granted to our executive officers and directors during 2001. Options granted at the exercise price of $1.04 U.S. are subject to the approval of shareholders of the Company, which is scheduled to take place on June 27, 2002. All numbers have been adjusted to reflect the consolidation of our shares on a one-for-four basis in July, 2001.

Name	Securities Under Options Granted	Exercise or Base Price	Market Value of Securities Underlying Options on Date of Grant	Expiration Date
David J. Gallagher President & CEO	253,190 207,810	$1.04 U.S. $0.47 U.S.	$1.04 U.S. $0.47 U.S.	July 22, 2006 December 2, 2006

Francis Munoz Executive Vice President	66,435[1]	$1.04 U.S.	$1.04 U.S.	July 22, 2006
Joanna Varvos Corporate Secretary	25,467 71,533	$1.04 U.S. $0.47 U.S.	$1.04 U.S. $0.47 U.S.	July 22, 2006 December 2, 2006
Doug Drury Controller	5,536[2] 16,464[2]	$1.04 U.S. $0.47 U.S.	$1.04 U.S. $0.47 U.S.	July 22, 2006 December 2, 2006
James R. Bonfiglio	114,760 155,240	$1.04 U.S. $0.47 U.S.	$1.04 U.S. $0.47 U.S.	July 22, 2006 December 2, 2006
Brian G. Harrington	6,250 28,750	$1.04 U.S. $0.47 U.S.	$1.04 U.S. $0.47 U.S.	July 22, 2006 December 2, 2006

[1] These options are subject to vesting in accordance with performance criteria to be agreed upon by Mr. Munoz and QSound.
[2] These options are subject to vesting in accordance with performance criteria to be agreed upon by Mr. Drury and QSound.

C. Board Practices

During fiscal 2001, the members of our board of directors were Messrs. David Gallagher, James Bonfiglio, Ian Tweedie and Brian Harrington. Mr. Tweedie resigned as a director on June 28, 2001 and Mr. Harrington was concurrently appointed to the board. Directors are elected annually by shareholders at our annual meeting of shareholders, and serve until their successors are elected or appointed.

Our board of directors has two standing committees: a compensation committee and an audit committee, whose members at the date of this annual report are Messrs. Bonfiglio and Harrington. The compensation committee recommends and establishes salaries, incentives and other forms of compensation for our executive officers. The audit committee meets with our independent auditors and reviews our financial statements, and provides an open avenue of communication among the independent accountants, our financial and executive officers and the board of directors.

We do not have any service contracts with directors, other than the employment contract with Mr. David Gallagher. Under that contract, if terminated without cause, if Mr. Gallagher's employment contract is not renewed for at least one year following expiration, or if there is a change in control of QSound and Mr. Gallagher elects not to continue his employment, Mr. Gallagher is entitled to remuneration in an amount equal to the greater of salary for the unexpired term of the employment agreement or one year, a lump sum payment in the amount of $203,000 U.S. and a lump sum payment equal to the difference between the salary payable and the salary paid to Mr. Gallagher from January 1, 2000 to the date of termination. Mr. Gallagher's employment contract is subject to renewal on September 30, 2002. If there is a change in control of QSound and Mr. Gallagher elects not to continue his employment, Mr. Gallagher is entitled to vesting of any unvested options.

D. Employees

At December 31, 2001 we had 36 employees and persons engaged by contract on a fulltime basis, of whom 12 were in research, product development and engineering support, 10 were in marketing and sales, 7 were in customer support and 7 were in administrative positions. Four of these employees were located in the United States and the remainder were located in Canada. At December 31, 2000 we had 33 employees and persons engaged by contract on a fulltime basis, of whom 14 were in research, product development and engineering support, 13 were in marketing and sales, and 6 were in administrative positions. At December 31, 1999 we had 56 employees and consultants engaged by contract on a full-time basis, of whom 19 were located in the United States and 37 were located in Canada.

We are not subject to any collective bargaining agreements and believe our relationship with our employees is satisfactory.

E. Share Ownership

The following tables show information as to share ownership by directors and executive officers as of June 25, 2002. All numbers have been adjusted to reflect the consolidation of our shares on a one-for-four basis in July, 2001.

Shares

Name and Position	**Common Shares Owned or Controlled**	**Percent of Class**
David Gallagher President and CEO and Director	23,250	*
Fran Munoz Executive Vice President	2,500	*
Joanna Varvos Corporate Secretary	0	
Doug Drury Controller	1,000	*
James Bonfiglio Director	25,000	*
Brian Harrington Director	750	*

* represents less than 1%

Options

Name and Position	**Options**	**Exercise Price**	**Expiry Date**
David Gallagher President and CEO and Director	253,190[1] 207,810	$1.04 $0.47	July 22, 2006 December 2, 2006
Fran Munoz Executive Vice President	75,000 66,435[1, 3]	$9.00 $1.04	Oct 18/02 to Apr 18/05[2] July 22, 2006
Joanna Varvos Corporate Secretary	25,467[1] 71,533	$1.04 $0.47	July 22, 2006 December 2, 2006
Doug Drury Controller	5,536[1, 4] 16,464[4]	$1.04 $0.47	July 22, 2006 December 2, 2006
James Bonfiglio Director	114,760[1] 155,240	$1.04 $0.47	July 22, 2006 December 2, 2006
Brian Harrington Director	28,750	$0.47	December 2, 2006

[1] These options are subject to shareholder approval.

[2] 12,500 options expire on each of Oct 19, 2002, April 19, 2003, Oct 19, 2003, April 19, 2004, October 19, 2004 and April 19, 2005.

[3] These options are subject to vesting in accordance with performance criteria to be agreed upon by Mr. Munoz and QSound.

[4] These options are subject to vesting in accordance with performance criteria to be agreed upon by Mr. Drury and QSound.

We may grant stock options to officers, directors, key employees and persons or companies providing ongoing services for QSound or its subsidiaries pursuant to our 1998 Stock Option Plan (“1998 Plan”). The Board of Directors or a Committee appointed by the Board may in its discretion from time to time grant stock options under the 1998 Plan at exercise prices determined by the Board or the Committee. The Board or the Committee may also delegate to an executive officer the authority to grant options to employees who are not insiders. The purchase price of shares covered by each option granted by an executive officer may not be less their market value on the date of grant. The term of each stock option must be determined by the Board or Committee when the option is granted, and may not exceed ten years from the date of grant. Options may be exercised for a period of 30 days after termination of the optionee’s employment, or the expiration of the term, whichever period is shorter. If an optionee should die while a service provider of QSound or its subsidiaries, his or her options may be exercised by the optionee’s legal representative until the earlier of one year after the date of death or the expiration of the term. The foregoing 30 day and one year time periods may be increased by the Board of Directors. The 1998 Plan may be amended by the Board provided that any such amendment may not adversely affect any outstanding option without the consent of the optionee. Options granted under the 1998 Plan may also be amended upon agreement with the optionee.

In the event there should be any subdivision or consolidation of our common shares the price of shares then subject to each option is to be adjusted equitably so that the optionee's proportionate interest is maintained without change in the aggregate option price. If we are reorganized or merged with another corporation, provisions shall be made to continue any options then outstanding and to prevent their dilution or enlargement.

We may also grant options outside of the 1998 Plan, and we may grant options to employees who are not officers or directors under QSound's Employee Stock Option Plan. Any such options are generally granted on the same terms as options granted under the 1998 Plan. Shareholder approval of grants of over 25,000 options made to directors and officers outside of the 1998 Plan is required by Nasdaq rules.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. Major Shareholders

We do not have any shareholders that are beneficial owners of 5% or more of our common shares.

At June 15, 2002 we had 7,085,574 common shares issued and outstanding. At such date, there were 1,359 shareholders of record in the United States who collectively held approximately 84% of our outstanding common shares.

We are not directly or indirectly owned or controlled by any other corporation, foreign government or legal person. We know of no arrangements which may result in a change of control of our company at a future date.

B. Related Party Transactions

We did not have any material transactions with any of our related parties during fiscal year 2000 except for compensation of executive officers as employees or consultants. (See Item 6. B "Compensation").

Except for immaterial advances in the ordinary course of business that may have been outstanding on a short-term basis, no related party was indebted to us during fiscal year 2001.

C. Interests of Experts and Counsel

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. Consolidated Statements and Other Financial Information

See Item 17.

Legal Proceedings

From time to time we may be involved in various disputes and litigation arising in the normal course of business. As of the date of this annual report we are not involved in any legal proceedings that are expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Export Sales

We derive over 98% of our revenues from export sales made to customers outside Canada. 86% of our export sales are made to the United States of America, and a further 13% are made to Asian companies located in Japan, Hong Kong and Taiwan.

Dividend Distribution

We have never made a distribution of dividends.

B. Significant Changes

There have been no significant changes since the date of the financial statements included in this annual report.

ITEM 9. THE OFFER AND LISTING

A. Offer and Listing Details

Price History

Our shares traded during the periods and at the prices set out below on The NASDAQ SmallCap Market. On July 9, 2001 we consolidated our common shares on a one-for-four basis. Prior to the consolidation we were not in compliance with the minimum bid requirement for continued listing on the Nasdaq SmallCap Market. At the time of the consolidation the number of our issued and outstanding shares decreased from 28,880,657 to 7,220,589 and the price per share increased from $0.36 to $1.45. All numbers have been adjusted to reflect the consolidation of our shares on a one-for-four basis in July, 2001.

The high and low market prices for the last five fiscal years:

Fiscal Year	High	Low
2001	4.875	0.420
2000	21.500	1.376
1999	16.500	7.500
1998	12.000	5.000
1997	14.712	5.248

The high and low market prices for the first full quarter of 2002, and for each of the four quarters of 2001 and 2000:

Quarter Ending		High	Low
March	2002	2.000	0.700
December	2001	0.750	0.420
September	2001	1.720	0.560
June	2001	2.875	1.400
March	2001	4.875	2.000
December	2000	7.876	1.376
September	2000	9.252	4.124
June	2000	14.252	5.124
March	2000	21.500	7.752

The high and low market prices for each of the last six months:

Month		High	Low
May	2002	1.120	1.000
April	2002	1.300	1.010
March	2002	1.370	1.010
February	2002	1.560	1.100
January	2002	2.000	0.700
December	2001	0.750	0.440

B. Plan of Distribution

Not Applicable

C. Markets

Our shares trade (since January, 1989) on The NASDAQ SmallCap Market under the symbol QSND (formerly QSNDF). On a number of days during the month of June, 2002 the closing bid price for our common shares was below $1.00. Nasdaq requires that we maintain a minimum closing bid of $1.00. If we fail to achieve the minimum requirement for 30 consecutive business days, we will be given a 180 calendar day grace period to demonstrate compliance by achieving a $1.00 minimum closing bid for 10 consecutive business days. If compliance is not achieved within the grace period, issuers that demonstrate compliance with the core initial listing standards, that is net income of $750,000, stockholders equity of $5 million or market cap of $50 million, will be given a further grace period of 180 calendar days within which to achieve compliance. At the date of this annual report our shareholder equity is over $5 million. See Item 3. D. "Risk Factors" and Item 4. A. "History and Development of the Company" of this annual report.

D. Selling Shareholders

Not Applicable

E. Expenses of the Issue

Not Applicable

ITEM 10. ADDITIONAL INFORMATION

A. Share Capital

Not Applicable

B. Memorandum and Articles of Association

Objects and Purposes

Our objects and purposes, which are found in section 6. of our Articles of Continuance, allow us generally to engage in any act or activity that is not prohibited under the laws of the province of Alberta.

Directors

Our by-laws and the laws of the province of Alberta provide that a director must disclose the nature and extent of his or her interest, or the interest of a party in which the director has a material interest, in a material contract with our company. The interest must be disclosed at the time the contract is considered or after the interest arises, whichever occurs first. A director may not approve a contract in which the director or the related party has a material interest unless the contract is an arrangement by way of security for money lent to or obligations undertaken by the director, or relates to his remuneration, or is for indemnity insurance or with an affiliate. A material contract in which a director has an interest is not void or voidable by reason only of the interest, or because the director is counted to determine the presence of a quorum at the meeting where the contract is considered. A director or former director to whom a profit accrues as a result of the material contract is not liable to us for the profit only by reason of the interest if the interest of the director was disclosed, the contract was approved by the directors or shareholders and the contract was reasonable and fair to us when approved.

Our by-laws and the laws of the province of Alberta provide that our directors may fix the remuneration of our directors, officers and employees. Under our by-laws the directors may also by resolution award special remuneration to any director that provides services to us other than routine work ordinarily required of a director. Directors, officers and employees are entitled to be paid their work-related travelling and other expenses.

Under Alberta law and our by-laws, our directors, or a delegated director, managing director or committee of directors, may borrow money, issue debt obligations, give a guarantee or mortgage or otherwise create a security interest in the property of our company.

We do not have an age limit requirement for retirement of directors, and our directors are not required to hold our shares in order to be members of the board of directors.

Dividends

Our directors may declare dividends on issued shares. Dividends may consist of shares, money or property. No dividends may be declared if we have reasonable grounds to believe that we are, or would be after payment of the dividend, unable to pay our debts as they become due, or if the realizable value of our assets would be less than our aggregate liabilities and stated capital. Our directors may attach preferential dividend rights to first or second preferred shares. Dividends are paid to preferred shareholders, if their preferred shares carry the right to a preferential dividned, before they are paid to common shareholders.

Shares

We are authorized to issue an unlimited number of common shares, an unlimited number of first preferred shares, and an unlimited number of second preferred shares. At the date of this annual report there are 7,085,574 common shares, and no preferred shares, outstanding.

Voting

Holders of common shares are entitled to one vote for each share they own on any matter that is submitted to a shareholder vote, unless only a different class of shareholders, for example holders of preferred shares, is entitled to vote on that matter. Our board of directors may attach various voting rights and restrictions to preferred shares. Shareholders elect our directors to hold office until the next annual meeting of shareholders, or until their successors are elected or appointed. Our Articles of Continuance do not provide for cumulative voting for the election of directors.

Other Rights of Shareholders

If we are dissolved or liquidated, we must use our assets to pay liabilities and any remaining assets would be distributed first to preferred shareholders if their preferred shares carry the right to distribution of assets in priority to distribution of assets to common shareholders, and second to the holders of common shares, in proportion to the number of shares they own. Our common shares do not have any redemption or sinking fund provisions. There is no liability on the part of any shareholder to further capital calls and there are no provisions discriminating against any existing or prospective shareholder as a result of owning a substantial number of shares.

Shareholders may by special resolution change the rights of holders of our shares. A special resolution means a resolution passed by a majority of not less than two-thirds of the votes cast by shareholders entitled to vote on the resolution.

We are required by Alberta law and our by-laws to hold an annual meeting of shareholders in each year not later than fifteen months following the last annual meeting. All business other than the consideration of financial statements and the auditor's report, election of directors and reappointment of the incumbent auditor, is special business. A notice in writing stating the time and place of the meeting, the nature of any special business to be transacted and the text of any proposed special resolution must be given to shareholders of record not less than 21 days and not more than 50 days prior to the meeting. In addition, Canadian securities regulatory policy requires us to deliver these shareholder meeting materials to brokers and intermediaries who hold shares on behalf of beneficial shareholders who do not hold their shares of record. The brokers and intermediaries must seek voting instructions from the beneficial shareholders. At meetings of shareholders two persons present and each holding or representing by proxy at least one common share constitute a quorum for purposes of selecting a chairman for the meeting or adjourning the meeting. For transacting any business at a shareholders meeting, two persons present and each holding or representing by proxy at least five percent of the shares entitled to vote at the meeting must be present. Holders of five percent or more of issued voting shares may requisition the directors to call a meeting for the purpose stated in the requisition. If the directors do not call a meeting within twenty-one days of the requisition, any shareholder who signed the requisition may call the meeting. Shareholders may vote at meetings in person or by proxy.

There are no limitations on rights to hold our shares or to exercise voting rights imposed by Alberta law or by our articles or by-laws. There are no provisions in our articles or by-laws that would have the effect of delaying, deferring or preventing a change in control of our company and that would operate only with respect to a merger, acquisition or corporate restructuring of our company or subsidiaries. Our by-laws do not contain any provision governing the threshold above which share ownership must be disclosed.

C. Material Contracts

We have not entered into any contracts other than agreements entered into in the ordinary course of business.

D. Exchange Controls

There are no government laws, decrees or regulations in Canada which restrict the export or import of capital or which affect the remittance of dividends, interest or other payments to non-resident holders of our common shares. However, any such remittance to a resident of the United States is generally subject to Canadian withholding tax pursuant to the Income Tax Act (Canada) (the "Act"). (For further information concerning such non-resident withholding tax, see Item 10 E. "Taxation" of this annual report.)

E. Taxation

The following is a general summary only and is not intended to be, nor should it be considered to be, legal or income tax advice to any particular QSound shareholder or relied upon for tax planning purposes. Accordingly each shareholder should consult their own independent tax advisors for advice with respect to the income tax consequences to them having regard to their own particular circumstances.

U.S. Federal Income Tax Consequences

The following is a general discussion of certain possible U.S. federal income tax consequences, under current law, generally applicable to a U.S. Holder (as hereinafter defined) of common shares of QSound. This discussion is of a general nature only and does not take into account the particular facts and circumstances, with respect to U.S. federal income tax issues, of any particular U.S. Holder. In addition, this discussion does not cover any state, local or foreign tax consequences. (See "Taxation--Canadian Federal Income Tax Consequences" above).

The following discussion is based upon the sections of the Internal Revenue Code of 1986, as amended (the "Code"), Treasury Regulations, published Internal Revenue Service ("IRS") rulings, published administrative positions of the IRS and court decisions that are currently applicable, any or all of which could be materially and adversely changed, possibly on a retroactive basis, at any time and which are subject to differing interpretations. This discussion does not consider the potential effects, both adverse and beneficial, of any proposed legislation which, if enacted, could be applied, possibly on a retroactive basis, at any time.

This discussion is for general information only and it is not intended to be, nor should it be construed to be, legal or tax advice to any U.S. Holder or prospective U.S. Holder of common shares of QSound, and no opinion or representation with respect to the U.S. federal income tax consequences to any such U.S. Holder or prospective U.S. Holder is made. Accordingly, U.S. Holders and prospective U.S. Holders of common shares of QSound should consult their own financial advisor, legal counsel or accountant regarding the U.S. federal, state, local and foreign tax consequences of purchasing, owning and disposing of common shares of QSound.

U.S. Holders

As used herein, a "U.S. Holder" means a holder of common shares of QSound who is (i) a citizen or individual resident of the U.S., (ii) a corporation or partnership created or organized in or under the laws of the U.S. or of any political subdivision thereof, (iii) an estate whose income is taxable in the U.S. irrespective of source or (iv) a trust subject to the primary supervision of a court within the U.S. and control of a U.S. fiduciary as described Section 7701(a)(30) of the Code.

Persons Not Covered

This summary does not address the U.S. federal income tax consequences to persons (including persons who are U.S. Holders) subject to special provisions of U.S. federal income tax law, including (i) tax-exempt organizations, (ii) qualified retirement plans, (iii) individual retirement accounts and other tax-deferred accounts, (iv) financial institutions, (v) insurance companies, (vi) real estate investment trusts, (vii) regulated investment companies, (viii) broker-dealers, (ix) persons or entities that have a "functional currency" other than the U.S. dollar, (x) persons subject to the alternative minimum tax, (xi) persons who own their common shares of QSound as part of a straddle, hedging, conversion transaction, constructive sale or other arrangement involving more than one position, (xii) persons who acquired their common shares of QSound through the exercise of employee stock options or otherwise as compensation for services, (xiii) persons that own an interest in an entity that owns common shares of QSound, (xiv) persons who own, exercise or dispose of any options, warrants or other rights to acquire common shares of QSound, or (xv) persons who own their common shares of QSound other than as a capital asset within the meaning of Section 1221 of the Code.

Distribution on Common Shares of QSound

U.S. Holders receiving distributions (including constructive distributions) with respect to common shares of QSound are required to include in gross income for U.S. federal income tax purposes the gross amount of such distributions, equal to the U.S. dollar value of such distributions on the date of receipt (based on the exchange rate on such date), to the extent that QSound has current or accumulated earnings and profits, without reduction for any Canadian income tax withheld from such distributions. Such Canadian tax withheld may be credited, subject to certain limitations, against the U.S. Holder's U.S. federal income tax liability or, alternatively, may be deducted in computing the U.S. Holder's U.S. federal taxable income by those who itemize deductions. (See more detailed discussion at "Foreign Tax Credit" below). To the extent that distributions from QSound exceed current or accumulated earnings and profits of QSound, such distributions will be treated first as a return of capital, to the extent of the U.S. Holder's adjusted basis in the common shares, and thereafter as gain from the sale or exchange of the common shares of QSound. (See more detailed discussion at "Disposition of Common Shares of QSound" below)

In the case of foreign currency received as a distribution that is not converted by the recipient into U.S. dollars on the date of receipt, a U.S. Holder will have a tax basis in the foreign currency equal to its U.S. dollar value on the date of receipt. Generally any gain or loss recognized upon a subsequent sale or other disposition of the foreign currency, including the exchange for U.S. dollars, will be ordinary income or loss. However, an individual whose realized gain does not exceed $200 will not recognize that gain, to the extent that there are no expenses associated with the transaction that meet the requirements for deductibility as a trade or business expense (other than travel expenses in connection with a business trip) or as an expense for the production of income.

Dividends paid on the common shares of QSound generally will not be eligible for the "dividends received deduction" allowed to corporate shareholders receiving dividends from certain U.S. corporations. Under certain circumstances, a U.S. Holder that is a corporation and that owns shares representing at least 10%of the total voting power and the total value of QSound's outstanding shares may be entitled to a 70% deduction of the "U.S. source" portion of dividends received from QSound (unless QSound qualifies as a "Foreign Personal Holding Company" or a "Passive Foreign Investment Company" as defined below). The availability of the dividends received deduction is subject to several complex limitations which are beyond the scope of this discussion, and U.S. Holders of common shares of QSound should consult their own financial advisor, legal counsel or accountant regarding the dividends received deduction.

Certain information reporting and backup withholding rules may apply with respect to certain payments related to QSound's common shares. In particular, a payor or middleman within the U.S., or in certain cases outside the U.S., will be required to withhold 30% (which rate is scheduled for periodic adjustment) of any payments to a U.S. Holder of QSound's common shares of dividends on, or proceeds from the sale of, such common shares within the U.S., if a U.S. Holder fails to furnish its correct taxpayer identification number or otherwise fails to comply with, or establish an exemption from, the backup withholding tax requirements. Any amounts withheld under the U.S. backup withholding tax rules will be allowed as a refund or a credit against the U.S. Holder's U.S. federal income tax liability, provided the required information is furnished to the IRS. **U.S. Holders should consult their own financial advisor, legal counsel or accountant regarding the information reporting and backup withholding rules applicable to QSound's common shares.**

Foreign Tax Credit

A U.S. Holder who pays (or has withheld from distributions) Canadian or other foreign income tax with respect to the ownership of common shares of QSound may be entitled, at the option of the U.S. Holder, to either receive a deduction or a tax credit for U.S. federal income tax purposes with respect to such foreign tax paid or withheld. Generally, it will be more advantageous to claim a credit because a credit reduces U.S. federal income taxes on a dollar-for-dollar basis, while a deduction merely reduces the taxpayer's income subject to U.S. federal income tax. This election is made on a year-by-year basis and applies to all foreign taxes paid by (or withheld from distributions to) the U.S. Holder during that year.

There are significant and complex limitations that apply to the foreign tax credit, among which is the general limitation that the credit cannot exceed the proportionate share of the U.S. Holder's U.S. income tax liability that the U.S. Holder's "foreign source" income bears to his or its worldwide taxable income. In applying this limitation, the various items of income and deduction must be classified as either "foreign source" or "U.S.

source." Complex rules govern this classification process. In addition, this limitation is calculated separately with respect to specific classes of income such as "passive income," "high withholding tax interest," "financial services income," "shipping income," and certain other classifications of income. Dividends distributed by QSound will generally constitute "foreign source" income, and will be classified as "passive income" or, in the case of certain U.S. Holders, "financial services income" for these purposes.

In addition, U.S. Holders that are corporations and that own 10% or more of the voting stock of QSound may be entitled to an "indirect" foreign tax credit under Section 902 of the Code with respect to the payment of dividends by QSound under certain circumstances and subject to complex rules and limitations. **The availability of the foreign tax credit and the application of the limitations with respect to the foreign tax credit are fact specific, and each U.S. Holder of common shares of QSound should consult their own financial advisor, legal counsel or accountant regarding the foreign tax credit rules.**

Disposition of Common Shares of QSound

A U.S. Holder will recognize gain or loss upon the sale or other taxable disposition of common shares of QSound equal to the difference, if any, between (i) the amount of cash plus the fair market value of any property received, and (ii) the shareholder's tax basis in the common shares of QSound. This gain or loss will be capital gain or loss if the common shares are a capital asset in the hands of the U.S. Holder, which will be long-term capital gain or loss if the common shares of QSound are held for more than one year.

Preferential tax rates apply to long-term capital gains of U.S. Holders that are individuals, estates or trusts. There are currently no preferential tax rates for long-term capital gains for a U.S. Holder that is a corporation (other than a corporation subject to Subchapter S of the Code). Deductions for net capital losses are subject to significant limitations. For U.S. Holders that are not corporations, any unused portion of such net capital loss may be carried over to be used in later tax years until such net capital loss is thereby exhausted. For U.S. Holders that are corporations (other than corporations subject to Subchapter S of the Code), an unused net capital loss may be carried back three years and carried forward five years from the loss year to be offset against capital gains until such net capital loss is thereby exhausted.

Other Considerations for U.S. Holders

In the following circumstances, the above sections of this discussion may not describe the U.S. federal income tax consequences to U.S. Holders resulting from the ownership and disposition of common shares of QSound:

Foreign Personal Holding Company

If at any time during a taxable year (i) more than 50% of the total voting power or the total value of QSound's outstanding shares is owned, directly or indirectly, by five or fewer individuals who are citizens or residents of the U.S. and (ii) 60% (or 50% in certain cases) or more of QSound's gross income for such year is "foreign personal holding company income" as defined in Section 553 of the Code (e.g., dividends, interest, royalties, certain gains from the sale of stock and securities, and certain gains from commodities transactions), QSound may be treated as a "Foreign Personal Holding Company" ("FPHC") In that event, U.S. Holders of common shares of QSound would be required to include in gross income for such year their allocable portions of such "foreign personal holding company income" to the extent QSound does not actually distribute such income.

QSound does not believe that it currently qualifies as a FPHC. However, there can be no assurance that QSound will not be considered a FPHC for the current or any future taxable year.

Foreign Investment Company

If (i) 50% or more of the total voting power or the total value of QSound's outstanding shares is owned, directly or indirectly, by citizens or residents of the U.S., U.S. partnerships or corporations, or U.S. estates or trusts (as defined by the Code Section 7701(a)(30)), and (ii) QSound is found to be engaged primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest therein, QSound may be treated as a "Foreign Investment Company" (“FIC”) as defined in Section 1246 of the Code, causing all or part of any gain realized by a U.S. Holder selling or exchanging common shares of QSound to be treated as ordinary income rather than capital gain.

QSound does not believe that it currently qualifies as a FIC. However, there can be no assurance that QSound will not be considered a FIC for the current or any future taxable year.

Controlled Foreign Corporation

If more than 50% of the total voting power or the total value of QSound’s outstanding shares is owned, directly or indirectly, by citizens or residents of the U.S., U.S. partnerships or corporations, or U.S. estates or trusts (as defined by the Code Section 7701(a)(30)), each of which own, directly or indirectly, 10% or more of the total voting power of QSound’s outstanding shares (each a “10% Shareholder”), QSound could be treated as a “Controlled Foreign Corporation” (“CFC”) under Section 957 of the Code.

The classification of QSound as a CFC would effect many complex results, including that 10% Shareholders of QSound would generally (i) be treated as having received a current distribution of QSound’s “Subpart F income” and (ii) would also be subject to current U.S. federal income tax on their pro rata shares of QSound’s earnings invested in “U.S. property.” The foreign tax credit may reduce the U.S. federal income tax on these amounts for such 10% Shareholders (See more detailed discussion at “Foreign Tax Credit” above). In addition, under Section 1248 of the Code, gain from the sale or other taxable disposition of common shares of QSound by a U.S. Holder that is or was a 10% Shareholder at any time during the five-year period ending with the sale is treated as ordinary income to the extent of earnings and profits of QSound attributable to the common shares sold or exchanged.

If QSound is classified as both a Passive Foreign Investment Company as described below and a CFC, QSound generally will not be treated as a Passive Foreign Investment Company with respect to 10% Shareholders. This rule generally will be effective for taxable years of 10% Shareholders beginning after 1997 and for taxable years of QSound ending with or within such taxable years of 10% Shareholders.

QSound does not believe that it currently qualifies as a CFC. However, there can be no assurance that QSound will not be considered a CFC for the current or any future taxable year. **The CFC rules are very complicated, and U.S. Holders should consult their own financial advisor, legal counsel or accountant regarding the CFC rules and how these rules may impact their U.S. federal income tax situation.**

Passive Foreign Investment Company

Certain U.S. income tax legislation contains rules governing “Passive Foreign Investment Companies” (“PFIC”) which can have significant tax effects on U.S. Holders of foreign corporations. Section 1297 of the Code defines a PFIC as a corporation that is not formed in the U.S. and, for any taxable year, either (i) 75% or more of its gross income is “passive income” or (ii) the average percentage, by fair market value (or, if the corporation is not publicly traded and either is a controlled foreign corporation or makes an election, by adjusted tax basis), of its assets that produce or are held for the production of “passive income” is 50% or more. “Passive income” includes, for example, dividends, interest, certain rents and royalties, certain gains from the sale of stock and securities, and certain gains from commodities transactions. However, gains resulting from commodities transactions are generally excluded from the definition of passive income if “substantially all” of a merchant’s, producer’s or handler’s business is as an active merchant, producer or handler of such commodities.

For purposes of the PFIC income test and the assets test, if a foreign corporation owns (directly or indirectly) at least 25% by value of the stock of another corporation, such foreign corporation shall be treated as if it (a) held a proportionate share of the assets of such other corporation, and (b) received directly its proportionate share of the income of such other corporation. Also, for purposes of such PFIC tests, passive income does not include any interest, dividends, rents or royalties that are received or accrued from a “related” person to the extent such amount is properly allocable to the income of such related person which is not passive income. For these purposes, a person is related with respect to a foreign corporation if such person “controls” the foreign corporation or is controlled by the foreign corporation or by the same persons that control the foreign corporation. For these purposes, “control” means ownership, directly or indirectly, of stock possessing more than 50% of the total voting power of all classes of stock entitled to vote or of the total value of stock of a corporation.

U.S. Holders owning common shares of a PFIC are subject to the highest rate of tax on ordinary income in effect for the applicable taxable year and to an interest charge based on the value of deferral of tax for the period during which the common shares of the PFIC are owned with respect to certain “excess distributions” on and dispositions of PFIC stock under Section 1291 of the Code. However, if the U.S. Holder makes a timely election to treat a PFIC as a qualified electing fund ("QEF") with respect to such shareholder's interest therein, the above-described rules generally will not apply. Instead, the electing U.S. Holder would include annually in his gross income his pro rata share of the PFIC's ordinary earnings and net capital gain regardless of whether such income or gain was actually distributed. A U.S. Holder of a QEF can, however, elect to defer the payment of U.S. federal income tax on such income inclusions. In addition, subject to certain limitations, U.S. Holders owning, actually or constructively, marketable (as specifically defined) stock in a PFIC will be permitted to elect to mark that stock to market annually, rather than be subject to the tax regime of Section 1291 of Code as described above. Amounts included in or deducted from income under this alternative (and actual gains and losses realized upon disposition, subject to certain limitations) will be treated as ordinary gains or losses.

QSound believes that it was not a PFIC for its fiscal year ended December 31, 2001 and does not believe that it will be a PFIC for the fiscal year ending December 31, 2002. There can be no assurance that QSound's determination concerning its PFIC status will not be challenged by the IRS, or that it will be able to satisfy record keeping requirements that will be imposed on QEFs in the event that it qualifies as a PFIC.

The PFIC rules are very complicated, and U.S. Holders should consult their own financial advisor, legal counsel or accountant regarding the PFIC rules and how these rules may impact their U.S. federal income tax situation.

Canadian Federal Income Tax Consequences

The following is a general summary of certain Canadian federal income tax considerations generally applicable to a holder of QSound common shares who is not a resident of Canada for the purposes of the *Income Tax Act* (Canada) (the “Act”) and who holds such common shares as capital property. The discussion does not address all the potentially relevant Canadian federal income tax matters and it does not address consequences peculiar to persons subject to special provisions of federal income tax law including a “financial institution” as defined in the Act subject to the mark to market rules or a shareholder an interest in which would be a “tax shelter” as defined in the Act.

This summary is based upon the current provisions of the Act and the Regulations thereunder and our understanding of the current administrative practices published by the Canada Customs and Revenue Agency. This summary takes into account proposals to amend the Act and Regulations announced prior to the date hereof (although no assurances can be given that such changes will be enacted in the form presented or at all), but does not otherwise take into account or anticipate any other changes in law, whether by judicial, governmental or legislative action or decision nor does it take into account any provincial, territorial, local or foreign tax considerations which may vary significantly from those discussed herein. Accordingly, holders and prospective holders of our shares should consult their own tax advisors about the federal, provincial, territorial, local and foreign tax consequences to them of purchasing, owning and disposing of such shares having regard to their particular circumstances.

The Act provides that dividends and other distributions which are deemed to be dividends and which are paid or credited, or are deemed to be paid or credited by a corporation resident in Canada, to a person who is not resident of Canada for purposes of the Act shall be subject to withholding tax equal to 25 percent of the gross amount of the dividend. This rate of withholding tax is subject to reduction if the provisions of a tax treaty between Canada and the country in which the recipient is resident provide for a lesser rate of withholding tax.

Shareholders who are residents of the United States for purposes of the Canada-United States Income Tax Convention (1980) (the "1980 Convention") will generally be entitled to the benefits of the 1980 Convention.

Article X of the 1980 Convention generally provides that the rate of Canadian withholding tax on dividends paid or deemed to be paid by a corporation resident in Canada to a corporation resident in the U.S. that beneficially owns at least 10 percent of the voting stock of the corporation paying the dividend shall not exceed 5 percent. Otherwise, and except as described below, the rate of non-resident withholding shall not exceed 15 percent of the dividend. Where the dividends are received by a resident of the United States carrying on business in Canada through a permanent establishment in Canada or by a person who performs independent personal services in Canada from a fixed base situated in Canada, and holding of the shares in respect of which the dividends are paid is effectively connected with that permanent establishment, the dividends are generally subject to Canadian tax as business profits or income from rendering such services and the 1980 Convention does not limit the Canadian tax payable on such income under the Act.

Generally a non-resident person is not subject to income tax in Canada on any capital gain arising on the disposition of shares of a corporation which are listed on a prescribed stock exchange unless such shares constitute "taxable Canadian property" to such holder. Generally, the shares will be taxable Canadian property to a non-resident person only if, at any time during the five year period immediately preceding the disposition, the non-resident person, either alone or together with persons with whom such non-resident did not deal at arm’s length, owned or had the right to acquire 25 percent or more of the issued shares of any class or series of the capital stock of the corporation, or the non-resident's shares were acquired in a tax deferred exchange in consideration for property that was itself taxable Canadian property.

Article XIII of the 1980 Convention generally provides that gains realized on the disposition of shares of a corporation that is a resident of Canada by a resident of the United States for purposes of the 1980 Convention, may not be taxed in Canada unless the value of those shares is derived principally from real property situated in Canada or the shares form part of the business property of a permanent establishment which the resident of the United States has or had in Canada within the 12 month period preceding the date of disposition or if the shares pertain to a fixed base in Canada which is or was available within the 12 month period preceding the date of disposition for the purpose of performing independent personal services. However, Article XIII permits Canada to tax gains on shares of other corporations (including substituted shares), if the United States resident was a resident of Canada for 120 months during any prior 20-consecutive-year period and at any time during the preceding 10 years and owned our common shares at the time the person emigrated from Canada

In situations where our common shares constitute taxable Canadian property, and the treaty benefits discussed above are not applicable, one-half of any capital gain (a "taxable capital gain") realized by a shareholder in a taxation year must be included in the shareholder's income for the year for Canadian tax purposes, and one-half of any capital loss (an "allowable capital loss") realized by a shareholder in a taxation year may be deducted from taxable capital gains realized by the shareholder in that year. Allowable capital losses for a taxation year in excess of taxable capital gains for that year generally may be carried back and deducted in any of the three preceding taxation years or carried forward and deducted in any subsequent taxation year against net capital gains realized in such years, to the extent and under the circumstances described in the Act.

F. Dividends and Paying Agents

Not applicable.

G. Statements by Experts

Not Applicable

H. Documents on display

We are subject to the informational requirements of the Securities Exchange Act of 1934 and we file reports, registration statements and other information with the SEC. Our reports, registration statements other information can be inspected and copied at the public reference facilities maintained by the SEC:

Judiciary Plaza Room 1024 Washington D.C. 20549	500 West Madison Street Suite 1400 Chicago, IL 60661

Copies of these materials can also be obtained by mail at prescribed rates from the Public Reference Section of the SEC, 450 Fifth Street, N.W., Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330.

I. Subsidiary Information

Not Applicable

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Investments

Our investments consist of share holdings in one company. The company, with a carrying value of nil, is not yet publicly traded. 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.

Foreign Currency

We use the U.S. dollar as our currency of measurement and display. We are exposed to foreign currency fluctuation on our Canadian dollar denominated cash, receivables, and payables. Canadian dollar denominated accounts receivables are nominal. Canadian dollar denominated payables are all trade payables arising out of the normal course of business. Foreign currency risk arising from a decline or increase in the relative value of the Canadian dollar is managed to the extent that the amount of Canadian dollar denominated cash and receivables is kept equal to the amount of Canadian dollar denominated payables. The majority of our overseas transactions are conducted in U.S. dollars.

Interest Rates

QSound's exposure to market risk for changes in interest rates, relates to our invested balances of cash and cash equivalents. QSound's investment policy specifies excess funds are to be invested in a manner that preserves capital, provides liquidity and generates the highest available after-tax return. To limit exposure to market risk, QSound places its cash in banks and cash not required for immediate operations are placed in bank term deposits and high quality, short-term commercial paper. QSound does not invest in any derivative instruments. The fair value of QSound's cash and cash equivalents or related income would not be significantly impacted by either a 100 basis point increase or decrease in interest rates as most investments are at fixed rates and are relatively short term. All cash and cash equivalents are carried at fair value, which approximates cost.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not Applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

We are not in material default on any of our obligations relating to indebtedness. We have not declared any dividends and are not delinquent with respect to the payment of dividends.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS

During our last fiscal year, we have not materially modified any of the rights or instruments defining the rights of our security holders. We do not have any registered securities which are secured by our assets. We do not have trustees or paying agents for our securities.

ITEM 15. [RESERVED]

Not Applicable.

ITEM 16. [RESERVED]

Not Applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

Consolidated Financial Statements of QSound Labs, Inc. and subsidiaries:

Auditor’s Report to the Shareholders.

Consolidated Balance Sheets – December 31, 2001 and 2000.

Consolidated Statements of Operations and Deficit – Years ended December 31, 2001, 2000 and 1999.

Consolidated Cash Flows– Years ended December 31, 2001, 2000 and 1999.

Notes to Consolidated Financial Statements – Years ended December 31, 2001, 2000 and 1999.

ITEM 18. FINANCIAL STATEMENTS

Not Applicable.

ITEM 19. EXHIBITS

1.1 Articles of Continuance of QSound Labs, Inc. (formerly called Archer Communications Inc.). (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.2 By-law No. 1 dated May 14, 1991. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.3 By-law No. 2 dated May 14, 1991. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.4 Articles of Amendment dated September 3, 1991. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.5 Articles of Amendment dated July 8, 1992. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.6 Articles of Amendment dated June 25, 1993. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.7 Articles of Amendment dated November 26, 1996. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

1.8 Articles of Amendment dated January 8, 1997. (Incorporated by reference to our Annual Report on Form 20-F filed June 29, 2001.)

2.1 Not Applicable

3.1 Not Applicable

4.1 Not Applicable

5.1 Not applicable.

6.1 Not applicable.

7.1 Not applicable.

8.1 See Item 4. C. "Information on the Company - Organizational Structure".

9.1 Not applicable.

10.1 Not applicable.

The registrant hereby certifies that it certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

QSound Labs, Inc.

/S/ David Gallagher
David Gallagher
President and Chief Executive Officer

June 25, 2002

Consolidated Financial Statements

Consolidated Financial Statements of

QSOUND LABS, INC.

Years ended December 31, 2001, 2000 and 1999
(Expressed in United States dollars)

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 2001 and 2000 and the consolidated statements of operations and deficit and cash flows for each of the years in the three year period ended December 31, 2001. 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, 2001 and 2000 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2001, 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, 2001 and total assets and shareholders' equity as at December 31, 2001 and 2000 to the extent summarized in note 14 to the consolidated financial statements.

Chartered Accountants

Calgary, Canada
February 27, 2002

QSOUND LABS, INC.

Consolidated Balance Sheets

December 31, 2001 and 2000
(Expressed in United States dollars)

	2001	2000
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,047,892	$ 2,264,639
Accounts receivable	439,245	1,166,941
Inventory	28,587	48,431
Deposits and prepaid expenses	85,365	108,752
	2,601,089	3,588,763
Investments (note 2)	–	194,500
Capital assets (note 3)	1,145,911	1,301,464
Intangible assets (note 4)	2,219,007	2,644,100
	$ 5,966,007	$ 7,728,827
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 304,726	$ 352,865
Consideration payable on acquisition	–	550,000
Deferred revenue	8,282	9,253
	313,008	912,118
Shareholders' equity		
Share capital (note 5)	43,737,626	45,277,094
Contributed surplus (note 5)	1,114,316	5,648
Deficit	(39,198,943)	(38,466,033)
	5,652,999	6,816,709
Commitments and contingencies (note 12)		
	$ 5,966,007	$ 7,728,827

See accompanying notes to consolidated financial statements.

Approved by the Board:

"David Gallagher" Director

"James R. Bonfiglio" Director

QSOUND LABS, INC.

Consolidated Statements of Operations and Deficit

Years ended December 31, 2001, 2000 and 1999
(Expressed in United States dollars)

	2001	2000	1999
REVENUE			
Royalties, license fees and product sales	$ 3,025,994	$ 4,469,002	$ 3,625,623
Cost of product sales	91,438	208,298	359,613
	2,934,556	4,260,704	3,266,010
EXPENSES			
Marketing	1,074,139	1,360,698	1,630,674
Operations	275,077	375,000	–
Product research and development	951,017	1,610,436	1,444,389
Administration	597,685	802,582	557,402
	2,897,918	4,148,716	3,632,465
Operating profit (loss)	36,638	111,988	(366,455)
Depreciation and amortization	(831,193)	(2,535,856)	(632,387)
Impairment of assets	–	(5,163,504)	–
Write-down of investments	(8,300)	(1,515,568)	–
Interest and other income	73,568	154,788	73,116
Gain (loss) on sale of capital assets	6,492	(34,634)	23,714
Gain on sale of investments	24,327	–	–
Other	(34,442)	(225,048)	–
	(769,548)	(9,319,822)	(535,557)
Net loss for the year	(732,910)	(9,207,834)	(902,012)
Deficit, beginning of year	(38,466,033)	(29,258,199)	(28,356,187)
Deficit, end of year	$(39,198,943)	$(38,466,033)	$ (29,258,199)
Loss per common share	$ (0.10)	$ (1.30)	$ (0.14)

See accompanying notes to consolidated financial statements.

QSOUND LABS, INC.
Consolidated Statements of Cash Flows

Years ended December 31, 2001, 2000 and 1999
(Expressed in United States dollars)

	2001	2000	1999
Cash provided by (used in):			
Operations:			
Net loss for the year	$ (732,910)	$(9,207,834)	$ (902,012)
Items not requiring (providing) cash:			
Depreciation and amortization	831,193	2,535,856	632,387
Impairment of assets	–	5,163,504	–
Loss (gain) on sale of capital assets	(6,492)	34,634	(23,714)
Loss (gain) on sale of investments	(24,327)	–	–
Write-down of investments	8,300	1,515,568	–
Changes in non-cash working capital balances (note 7)	713,517	(524,678)	1,359,312
	789,281	(482,950)	1,065,973
Financing:			
Issuance of common shares	–	2,757,233	2,069,184
Repurchase of common shares, net	(430,800)	(152,989)	–
Repayments of debt	(550,000)	(750,000)	(1,456,439)
	(980,800)	1,854,244	612,745
Investments:			
Investments, net	218,827	23,638	(1,745,700)
Purchase of capital assets	(216,291)	(529,863)	(550,482)
Purchase of intangible asset	(34,418)	–	–
Goodwill	–	(130,168)	(7,500)
Proceeds from sale of capital assets	6,654	5,375	23,714
	(25,228)	(631,018)	(2,279,968)
Increase (decrease) in cash and cash equivalents	(216,747)	740,276	(601,250)
Cash and cash equivalents, beginning of year	2,264,639	1,524,363	2,125,613
Cash and cash equivalents, end of year	$ 2,047,892	$ 2,264,639	$ 1,524,363

See accompanying notes to consolidated financial statements.

QSOUND LABS, INC.
Notes to Consolidated Financial Statements

Years ended December 31, 2001, 2000 and 1999
(Expressed in United States dollars)

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.

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 recoverable amounts are less than their unamortized balance. When an impairment is identified, the amount of impairment is charged to period earnings and is included in depreciation and amortization.

Significant accounting policies (continued):

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 unamortized balance of the goodwill can be recovered through undiscounted future operating cash flows of the acquired operation over its remaining life. 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.

Purchased customer list:

The purchased customer list is recorded at cost and amortized over the estimated useful life of 5 years. The Company assesses the recoverability of this intangible asset by determining whether the unamortized balance of the purchased customer list can be recovered through future operating cash flows of the acquired operation over its remaining life. The amount of purchased customer list 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 purchased customer list 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 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 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 interprets the assessment of whether development costs should be capitalized.

Significant accounting policies (continued):

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 stock-based compensation plans, which is described in note 6. No compensation expense is recognized when 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.

Change in Accounting Policy:

In 2000, The Canadian Institute of Chartered Accountants issued a new accounting standard with respect to earnings per share. The new standard requires the use of the treasury stock method for calculating diluted earnings per share. Under this method all options whose average price is less than or equal to the average share price for the period to date are considered outstanding and all convertible securities are considered to be converted at the average share price for the period. The Company has adopted this section retroactively with the restatement of all previous periods, effective December 31, 2000. There was no impact on loss per share for the year ended December 31, 2001, nor for the year ended December 31, 2000.

1. Business acquisitions:

On December 6, 2001 the Company acquired the eMerchant Pro hosting property for consideration of $34,418. The acquisition has been accounted for by the purchase method, and accordingly the results of the operations of the eMerchant Pro hosting property has been included in these financial statements from December 6, 2001. The entire purchase price has been allocated to purchased customer list.

On May 10, 2000 the Company acquired the Choicemall website property for consideration of $3,393,800, consisting of 1,000,000 pre-consolidation 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.

1. **Business acquisition (continued):**

On May 17, 2000 the Company acquired the Webtailer website property for consideration of $415,486, consisting of 222,222 pre-consolidation 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 pre-consolidation common shares valued at $1.00 per share which approximated the fair value at that date and $100,000 cash. The 500,000 pre-consolidation 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 pre-consolidation common shares remained in escrow. Due to the contingent nature of the contract, no consideration was recorded with respect to the 225,000 escrowed pre-consolidation shares. During 2001 the performance milestones specified in the acquisition agreement were not achieved resulting in the shares held in escrow being cancelled. 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 pre-consolidation 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. 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 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 one company as consideration for license fees of prior years. The security with a carrying value of nil, is not yet publicly traded.

In 2000 investments consisted of equity securities acquired in two companies as consideration for license fees and are recorded at cost. The investment in one company with a carrying value of $194,500 was liquidated during 2001.

3. Capital assets:

2001	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 538,812	$ 506,839	$ 31,973
Real time systems	905,534	888,126	17,408
Furniture and fixtures	353,827	297,021	56,806
Computer equipment	756,215	547,392	208,823
Software and production tooling	1,214,729	596,962	617,767
Patents and trademarks	728,065	514,931	213,134
	$ 4,497,182	$ 3,351,271	$ 1,145,911

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.

4. Intangible assets:

2001	Cost	Accumulated amortization	Net book value
Goodwill	$ 9,894,777	$ 7,710,188	$ 2,184,589
Purchased customer list	34,418	–	34,418
	$ 9,929,195	$ 7,710,188	$ 2,219,007

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

5. Share capital:

On June 28, 2001, the shareholders of the Company authorized the board of directors to approve a share consolidation on the common shares of the company. On July 3, 2001 the directors of the Company approved a share consolidation on the basis of one new common share for four old common shares. This consolidation was implemented effective July 9, 2001. All references to income and loss per common share, and common shares repurchased and outstanding, have been restated to reflect the impact of the July 9, 2001 reverse stock split, on a retroactive basis.

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, 1998	6,004,497	$ 32,939,632
Issued for cash:		
On exercise of warrants and options	34,375	292,818
On exercise of options granted to directors and employees	44,325	329,966
Private placement	167,793	1,296,060
Business acquisition (note 1)	415,935	4,497,516
Additional paid-in-capital stock options	–	129,131
Share subscription paid	–	150,340
Balance, December 31, 1999	6,666,925	39,635,463
Issued for cash:		
On exercise of warrants and options	15,750	137,970
On exercise of options granted to directors and employees	82,625	739,603
Private placement	180,909	2,030,000
Business acquisitions (note 1)	374,305	2,784,286
Acquisition of assets	28,750	258,750
Repurchase of common shares	(22,500)	(158,638)
Share subscription paid	–	(150,340)
Shares held in escrow (note 1)	56,250	–
Balance at December 31, 2000	7,383,014	$ 45,277,094
Additional shares issued due to conditions of reverse stock split	425	–
Repurchase of common shares	(241,615)	(1,539,468)
Cancellation of shares held in escrow (note 1)	(56,250)	–
Balance December 31, 2001	7,085,574	$ 43,737,626

During the 2001 year, the company repurchased 241,615 common shares for $430,800. The excess of the average cost of the shares over the purchase price amounting to $1,188,668 has been assigned to contributed surplus.

6. Stock option plan:

The Company has Stock Option Plans 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, 2001, stock options to purchase 1,820,600 common shares were outstanding. The stock options are exercisable at prices ranging from $0.47 to $12.24 per share and expire on various dates between 2002 and 2006.

During the years ended December 31, 2001, 2000 and 1999 the Company granted fixed and variable options to employees, directors and officers. During 2001, 898,875 fixed plan options (2000 – 99,000, 1999 - 3,075,536) and 238,435 variable plan options (2000 – 491,444, 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 3,487 shares of authorized but unissued common stock in connection with services performed by third parties. These options are exercisable at $12.24 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 during the years ended December 31, 2001, 2000 and 1999 were as follows:

	Number of Shares	**Exercise price per share**	**Weighted average exercise price**
Balance at December 31, 1998	663,125	$ 6.12 – 12.60	$ 7.48
Granted	845,746	7.76 – 14.00	10.20
Exercised	(78,700)	5.00 – 12.44	8.12
Cancelled or expired	(193,387)	8.00 – 12.00	9.56
Balance at December 31, 1999	1,236,784	6.12 – 14.00	9.08
Granted	147,611	6.00 – 9.00	8.44
Exercised	(98,375)	6.12 – 12.24	8.76
Cancelled or expired	(416,621)	6.00 – 12.24	9.56
Repriced			
Previous	(131,625)	10.00 – 14.00	12.04
New	131,625	9.00 – 9.00	9.00
Balance at December 31, 2000	869,399	6.00 – 12.24	8.32
Granted	1,137,310	0.47 – 2.12	0.76
Cancelled or expired	(186,109)	6.00 – 9.00	8.43
Balance at December 31, 2001	1,820,600	$ 0.47 – 12.24	$ 3.59

6. Stock option plan (continued):

The following table summarizes the information about stock options outstanding at December 31, 2001:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding at December 31, 2001**	**Weighted Average Remaining Term (years)**	**Weighted Average Exercise Price**	**Number Exercisable at December 31, 2001**	**Weighted Average Exercise Price**
$ 0.47	629,797	4.7	$ 0.47	473,333	$ 0.47
1.04	471,638	4.6	1.04	445,802	1.04
2.12 to 7.07	86,375	1.8	4.67	86,375	4.67
8.00 to 12.24	632,790	1.8	8.55	560,623	8.55
	1,820,600			1,566,133	

7. Changes in non-cash working capital balances:

	2001	2000	1999
Accounts receivable	$ 727,696	$ 148,108	$ (288,230)
Accrued revenue	–	–	655,243
Inventory	19,844	167,040	10,235
Deposits and prepaid expenses	15,087	226,823	(260,295)
Accounts payable and accrued liabilities	(48,139)	(147,784)	395,693
Deferred revenue	(971)	(918,865)	846,666
	$ 713,517	$ (524,678)	$ 1,359,312

Excluded from the 1999 statement of cash flows are net current liabilities of $18,652 which were assumed on the acquisition of Virtual Spin.

8. Transactions with related parties:

In 2001 and 2000 there were no charges for management services provided by directors and officers pursuant to consulting arrangements. In 1999 the Company was charged $64,847 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:

	2001	2000	1999
Loss for the year	$ (732,910)	$(9,207,834)	$ (902,013)
Combined Canadian Federal and Provincial statutory rate	42.12%	44.62%	44.62%
Computed recovery	(308,702)	(4,108,536)	(402,478)
Increase resulting from:			
Unrealized benefit of future tax assets	193,127	2,749,000	367,460
Income taxes computed at different rates in the United States	115,575	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	2001	2000	1999
Future income tax assets:					
Capital assets	$ 402,000	$ –	$ 402,000	$ 372,000	$ 246,000
Share issue costs	6,000	–	6,000	6,000	3,000
Loss and SRED carryforwards	3,437,000	4,222,000	7,659,000	8,285,000	8,085,000
Intangible assets	120,000	1,725,000	1,845,000	1,898,000	735,000
Investments	–	153,000	153,000	567,000	–
	3,965,000	6,100,000	10,065,000	11,128,000	9,069,000
Less: Valuation allowance	(3,965,000)	(6,100,000)	(10,065,000)	(11,128,000)	(9,069,000)
Net future tax assets	$ –	$ –	$ –	$ –	$ –

The Company has Canadian non-capital loss carry-forwards in the amount of $5,966,000 which expire at various dates between 2002 and 2008 and Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of $3,489,000 which have no expiry. The Company also has United States net operating loss carry-forwards in the amount of $12,416,000 which expire at various dates between 2004 and 2021

10. Segmented information:

Management has determined that for 2001 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 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.

For Audio products, during 2001, 65% of total audio revenue arose from two customers, each of which individually resulted in greater than 10% of total revenues. For 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 E-Commerce products, during 2001, 64% of total e-commerce revenue arose from two customers, each of which individually resulted in greater than 10% total revenues.

2001	**Audio**	**E-Commerce**	**Total**
REVENUE			
Royalties, license fees and product sales	$ 2,454,800	$ 571,194	$ 3,025,994
Cost of product sales	91,438	–	91,438
	2,363,362	571,194	2,934,556
EXPENSES			
Marketing	734,429	339,710	1,074,139
Operations	–	275,077	275,077
Product research and development	522,888	428,129	951,017
Administration	453,490	144,195	597,685
	1,710,807	1,187,111	2,897,918
Operating profit (loss)	652,555	(615,917)	36,638
Depreciation and amortization	(306,885)	(524,308)	(831,193)
Write-down of investments	(8,300)	–	(8,300)
Interest and other income	73,144	424	73,568
Gain on sale of capital assets	6,515	(23)	6,492
Gain on sale of investments	–	24,327	24,327
Other	(32,600)	(1,842)	(34,442)
	(268,126)	(501,422)	(769,548)
Net income (loss) for the year	$ 384,429	$(1,117,339)	$ (732,910)
Segment assets	$ 3,463,729	$ 2,502,278	$ 5,966,007

10. Segmented information (continued):

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	248,883	1,360,698
Operations	–	375,000	375,000
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

11. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 2001.

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 has not, at December 31, 2001, 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, 2001 there were outstanding accounts receivable balances from two entities which comprised 45% and 22% of the total balance. 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. These amounts have been collected subsequent to the year end.

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.

The company has in place an employment contract that expires September 30, 2002. The contract calls for remuneration of $506,418 to be paid should the employment contact not be renewed for at least one year following expiration, there is a change in control of the company and the employee elects not to continue his employment.

Under the terms of its lease agreements for office space and equipment, the Company is obligated at December 31, 2001 to make the following minimum lease payments over the next two years:

2002	$ 123,930
2003	84,297
	$ 208,227

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 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.

13. United States accounting principles (continued):

(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 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, 2001 of the differences between Canadian and United States accounting principles is summarized as follows:

	Years ended December 31,		
	2001	2000	1999
Loss for the year as reported in accordance with Canadian GAAP	$ (732,910)	$(9,207,834)	$ (902,012)
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	$ (732,910)	$(7,807,032)	$(2,312,442)
Loss per share under US GAAP	$ (0.10)	$ (1.10)	$ (0.37)

13. United States accounting principles (continued):

The components of comprehensive income are as follows:

	Years ended December 31, 2001	2000	1999
Loss under US GAAP	$ (732,910)	$(7,807,032)	$(2,312,442)
Other comprehensive income (loss):			
Recovery of other comprehensive income (loss) through sale of investments	151,943	–	–
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)	$ (580,967)	$(7,588,075)	$(2,683,342)
Accumulated other comprehensive income (loss) beginning of year	$ (151,943)	$ (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, 2001, 2000 and 1999 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, 2001	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 2,601,089	$ –	$ 2,601,089
Capital assets	1,145,911	(213,135)	932,776
Intangible assets	2,219,007	213,135	2,432,142
	$ 5,966,007	$ –	$ 5,966,007
Current liabilities	$ 313,008	$ –	$ 313,008
Shareholder’s equity:			
Common shares	43,737,626	202,058	43,939,684
Contributed Surplus	1,114,316		1,114,316
Deficit	(39,198,943)	(202,058)	(39,401,001)
Balance at December 31, 2001	$ 5,966,007	$ –	$ 5,966,007

13. United States accounting principles (continued):

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
Shareholder's 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

Included in the current liabilities above are accrued liabilities of $149,368 in 2001 and $64,624 in 2000.

During the years ended December 31, 2001, 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 2001, 898,875 fixed plan options (2000 – 99,000, 1999 - 3,075,536) and 238,435 variable plan options (2000 – 491,444, 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, in 2000 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.

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:

	2001	2000	1999
Risk free interest rate	4.5%	5.0%	5.5%
Volatility	113.3%	120.0%	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 shares would have been reduced to the pro forma amounts indicated below:

	2001	2000	1999
Net loss under US GAAP:			
As reported	$ (732,910)	$ (7,807,032)	$(2,312,442)
Pro forma	(1,247,633)	(7,966,758)	(2,993,820)
Basic loss per common share:			
As reported	$ (0.10)	$ (1.10)	$ (0.37)
Pro forma	(0.17)	(1.12)	(0.48)

During 2001 and 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 3,487 shares of authorized but unissued common stock in connection with services performed by third parties. These options are exercisable at $12.24 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.