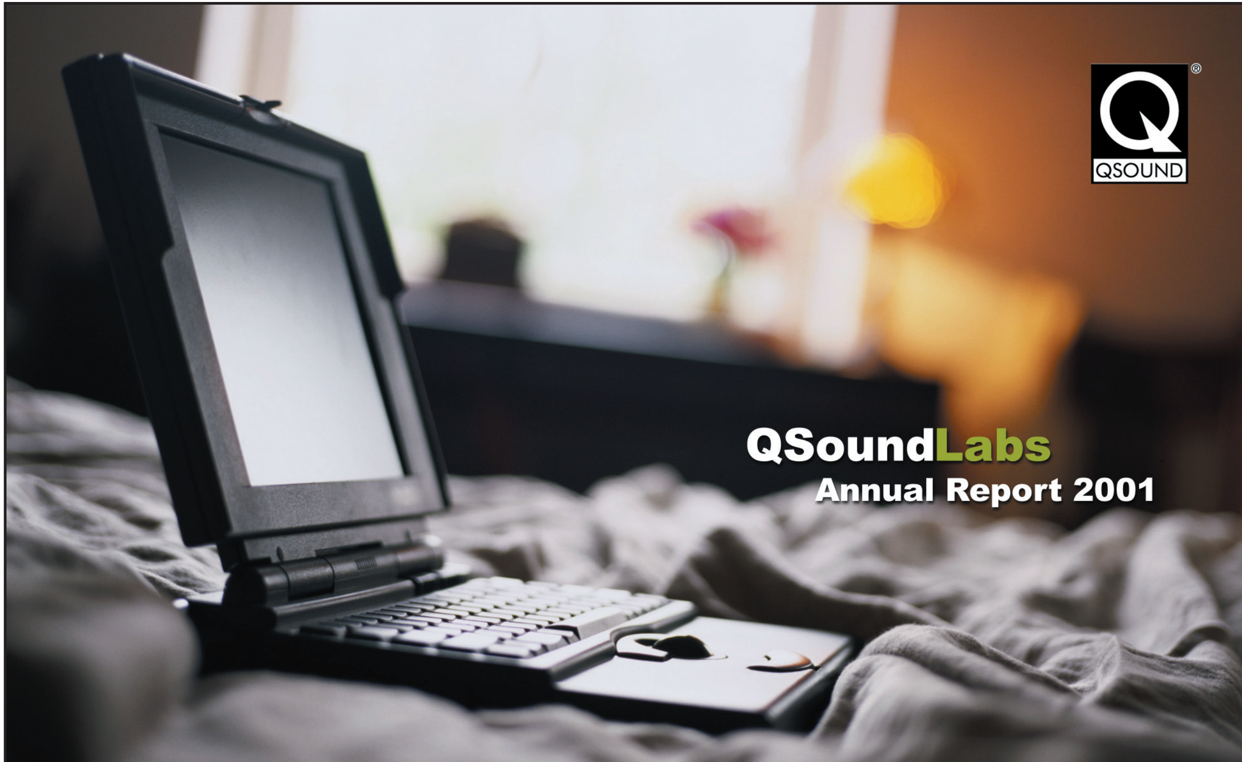
QSOUND
QSoundLabs
Annual Report 2001

Table of Contents

President's Message 2

Auditor's Report To The Shareholders 5

Consolidated Balance Sheets 7

Statements of Operations and Deficit 8

Statements of Cash Flows 9

Notes to Financial Statements 10

Corporate Information...............................30

President's Message

In 2001, external factors were more influential on the Company's circumstances than at any time in our previous thirteen-year history. The general stagnation in the world economy affected our customers to the point that none were immune to the adoption of an entrenchment mentality. This manifested itself through downsizing measures, deferment of R&D initiatives, delays in new product introductions and a tendency to manage the status quo. The challenge for QSound was simple to state, not so simple to execute: how to maintain our innovative edge in a period of growth stagnation and with limited resources at management's disposal and thus position the Company for growth as and when the economy recovers. In order to achieve this, our goals for FY2001 were to:

- Maintain our positive cash flow from operations through disciplined financial management;

- Continue product development within our audio business; and

- Refocus our e-commerce business on building a recurring revenue base and consolidating operations in Calgary thereby taking advantage of the inherent cost advantage of a weaker Canadian dollar.

In FY2001 we achieved these goals and now believe we are positioned for long-term success.

Financial

Revenues for the year ended December 31, 2001 were $3,026,000 compared to $4,469,000 for the same period in 2000. The operating profit for the year was $37,000 or $0.00 per share as compared to $112,000 or $0.01 for FY2000. Operating costs were 30% lower in FY2001 as compared to FY2000. Net loss for the year was $(733,000) or $(0.10) per share in 2001 and $9,208,000 or $(1.30) per share in 2000. Net loss is calculated after the inclusion of non-cash items, primarily depreciation and amortization charges.

The Company reported a working capital surplus of $2.3 million and continues to generate positive cash flow from operations. During the year, the Company generated $789,000 of cash flow from operations as opposed to utilizing $483,000 of cash in FY2000 operations. The Company retired all of its debt during the year, repurchased 241,615 of its common stock and cancelled 56,250 common shares previously held in escrow.

In order to maintain its NASDAQ listing, the Company sought shareholder approval to consolidate its common shares on a one for four basis. In July, after the approval was received, this consolidation took effect and the Company continues to maintain its listing.

Outlook

At the beginning of FY2002, several QSound-enhanced products from our audio business partners were introduced and as confidence in the general economy returns, management expects this trend to continue. Additionally, the investment made by the Company in FY2001 in broadening its technology portfolio ensures several new audio products in FY2002.

The e-commerce business will continue to seek opportunities for customer acquisition and assimilation into the existing infrastructure. The steps taken in FY2001 provide a solid platform for this to occur in a positive manner.

In closing, I would like to thank QSound's dedicated employees – they have been the driving force behind our achievements, and their excitement and determination will shape the company's future in the months and years to come. I also wish to thank our shareholders, business partners and customers for their continued support. We look forward to making 2002 a better year for all of you.

David Gallagher

David Gallagher
President and
Chief Executive Officer

Auditor's Report

to the Shareholders

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 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 13 to the consolidated financial statements.

KPMG LLP

Chartered Accountants

Calgary, Canada
February 27, 2002

FINANCIALS

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 Bongfiglio
Director

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.

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.

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 13. 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.

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.

Significant accounting policies (continued):

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.

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.

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,

1. Business acquisitions (continued):

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			
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			
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.

5. Share capital (continued):

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 at 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 at 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

6. Stock option plan (continued):

	Number of Shares	Exercise price per share	Weighted average exercise price
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

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 Dec. 31, 2001	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at Dec. 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:

9. Income taxes (continued):

	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 deductable 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 2000, 64% of total e-commerce revenue arose from two customers, each of which individually resulted in greater than 10% total revenues.

10. Segmented Information (continued):

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

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.

11. Financial instruments and risk management (continued):

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, or 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.

(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:

13. U.S. accounting principles (continued):

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)

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
Shareholders' 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. U.S. 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
Shareholders' equity:			
Common shares	45,277,094	202,058	45,479,152
Contributed surplus	5,648	—	5,648
Deficit	(38,466,033)	(202,058)	(38,668,091)
Accumulated other comprehensive income	—	(151,943)	(151,943)
Balance at December 31, 2000	$ 7,728,827	$ (151,943)	$ 7,576,884

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%

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

	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.

Corporate Information

DIRECTORS

David Gallagher
James Bonfiglio
Brian Harrington

STOCK EXCHANGE/ STOCK SYMBOLS

NASDAQ SmallCap Market:
QSND

PATENT COUNSEL

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

BANKERS

The Royal Bank of Canada
335 - 8th Avenue SW
Calgary, Alberta T2P 1C9

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

AUDITORS

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

TRANSFER AGENT

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

QSOUND LABS, INC. HEAD OFFICE AND TECHNICAL RESEARCH FACILITY

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

QSOUND®

Notice of Meeting

The Annual Meeting of Shareholders will be held at QSound Labs' head office in Calgary, Alberta on June 27, 2002 at 10:00 a.m.

www.qsound.com

QSOUND LABS, INC.

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

www.qsound.com

Printed in Canada