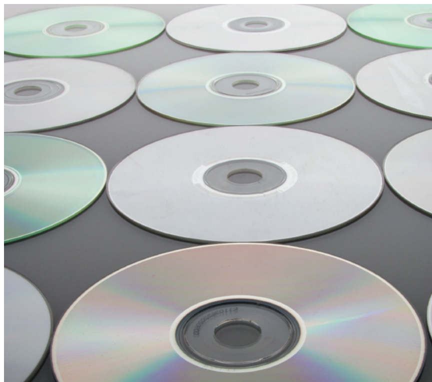

QSOUND

QSoundLabs
Annual Report 2002

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In 1988, QSound began as a research and development company, exploring and perfecting psycho-acoustics - the art of 3D audio processing.

Since then, we've grown to include many new and exciting markets. Of course, QSound is still providing superior audio quality in some of your favorite CDs. But we're also delivering incredible Internet audio enhancement, solid e-commerce solutions, cell phone ringtones, IP telephony, and unbelievable sound in numerous home electronics.

QSound enhances your world.

Notice of Meeting

The Annual Meeting of Shareholders will be held at QSound Labs' head office in Calgary, Alberta on June 19, 2003 at 10:00 a.m.

President's Message

We improved our financial performance dramatically in FY2002. The increase in revenues was derived primarily from our audio algorithm licensing business. This coupled with a successful cost containment program resulted in a profitable year. QCommerce, while not providing growth, remained cash flow positive throughout the year.

As previously reported, the Company focused most of its development efforts in FY2002 on software solutions for audio and voice applications. During FY2003, the Company will be offering these solutions to the cellular, handheld device, and IP telephony markets. FY2003 will see QSound transition to an audio solutions provider in addition to remaining a provider of audio algorithms. Revenue from existing algorithm licenses will diminish and management is focused on replacing such revenue streams from its new product lines.

Our customers continue to be cautious with their forecasts. This, coupled with our own efforts in new markets, hampers long range visibility so management will continue to provide guidance on a short term basis, as we did last year. At this time, management expects the net income for the first quarter in FY2003 to improve over the comparable period in FY2002, in which the net income was $88,000 or $0.01.

Financial

Revenues for the year ended December 31, 2002 were $4,224,000 compared to $3,026,000 in FY2001. The operating profit was $1,672,000 or $0.24 per share in FY2002 and $37,000 or $0.01 per share in FY2001. Net income for FY2002 was $1,129,000 or $0.16 per share as compared to a loss of $(733,000) or $(0.10) per share in FY2001.

The Company reported a working capital surplus of $3,284,000 at December 31, 2002 of which cash comprised $2,621,000. Cash flow from operations totaled $1,193,000 for the year. After investing $614,000 in new technology and assets, cash increased $573,000 for the year.

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, 2002 and 2001 and the consolidated statements of operations and deficit and cash flows for each of the years in the three year period ended December 31, 2002. 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, 2002 and 2001 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2002, 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, 2002 and total assets and shareholders' equity as at December 31, 2002 and 2001 to the extent summarized in note 15 to the consolidated financial statements.

KPMG LLP

Chartered Accountants

Calgary, Canada
March 21, 2003

Consolidated

Balance Sheets

December 31, 2002 and 2001
(Expressed in United States dollars)

	2002	2001
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,621,205	$ 2,047,892
Accounts receivable	929,519	439,245
Inventory	16,455	28,587
Deposits and prepaid expenses	58,674	85,365
	3,625,853	2,601,089
Note receivable (note 2)	500,000	—
Capital assets (note 3)	747,553	932,777
Goodwill (note 4)	2,184,589	2,184,589
Other intangible assets (note 5)	213,771	247,552
	$ 7,271,766	$ 5,966,007
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	$ 220,894	$ 304,726
Deferred revenue	120,511	8,282
	341,405	313,008
Shareholders' equity		
Share capital (note 6)	43,886,036	43,737,626
Contributed surplus (note 6)	1,114,316	1,114,316
Deficit	(38,069,991)	(39,198,943)
Commitments and contingencies (note 14)	6,930,361	5,652,999
	$ 7,271,766	$ 5,966,007

See accompanying notes to consolidated financial statements.

Approved by the Board:

David Gallagher
Director

James Bonfiglio
Director

Consolidated

Statements of Operations and Deficit

Years ended December 31, 2002, 2001 and 2000
(Expressed in United States dollars)

	2002	2001	2000
REVENUE			
Royalties	$ 2,663,550	$ 1,384,431	$ 1,286,990
License fees	147,167	40,683	772,081
Product sales	1,413,594	1,600,880	2,409,931
	4,224,311	3,025,994	4,469,002
Cost of product sales	271,530	91,438	208,298
	3,952,781	2,934,556	4,260,704
EXPENSES			
Marketing	895,820	1,074,139	1,360,698
Operations	235,201	275,077	375,000
Product research and development	643,524	951,017	1,610,436
Administration	506,028	597,685	802,582
	2,280,573	2,897,918	4,148,716
Operating profit	1,672,208	36,638	111,988
Depreciation and amortization	(382,662)	(831,193)	(2,535,856)
Impairment of assets	(100,000)	—	(5,163,504)
Funding of past service pension costs	(55,189)	—	—
Write-down of investments	—	(8,300)	(1,515,568)
Interest and other income	29,833	73,568	154,788
Gain (loss) on sale of capital assets	740	6,492	(34,634)
Gain on sale of investments	—	24,327	—
Other	(35,978)	(34,442)	(225,048)
	(543,256)	(769,548)	(9,319,822)
Net income (loss) for the year	1,128,952	(732,910)	(9,207,834)
Deficit, beginning of year	(39,198,943)	(38,466,033)	(29,258,199)
Deficit, end of year	$ (38,069,991)	$ (39,198,943)	$ (38,466,033)
Income (loss) per common share, basic	$ 0.16	$ (0.10)	$ (1.30)
Income (loss) per common share, diluted	$ 0.15	$ (0.10)	$ (1.30)

See accompanying notes to consolidated financial statements.

Consolidated

Statements of Cash Flows

Years ended December 31, 2002, 2001 and 2000
(Expressed in United States dollars)

	2002	2001	2000
Cash provided by (used in):			
Operations:			
Net income (loss) for the year	$ 1,128,952	$ (732,910)	$ (9,207,834)
Items not requiring (providing) cash:			
Depreciation and amortization	382,662	831,193	2,535,856
Impairment of assets	100,000	—	5,163,504
Compensation cost of options issued to non-employees	4,870	—	—
Loss (gain) on sale of capital assets	(740)	(6,492)	34,634
Gain on sale of investments	—	(24,327)	—
Write-down of investments	—	8,300	1,515,568
Changes in non-cash working capital balances (note 10)	(423,054)	713,517	(524,678)
	1,192,690	789,281	(482,950)
Financing:			
Issuance of common shares	34,815	—	2,757,233
Repurchase of common shares, net	—	(430,800)	(152,989)
Repayments of debt	—	(550,000)	(750,000)
	34,815	(980,800)	1,854,244
Investments:			
Investments, net	—	218,827	23,638
Purchase of capital assets	(113,880)	(216,291)	(529,863)
Purchase of intangible assets	(41,052)	(34,418)	—
Note receivable (note 2)	(500,000)	—	—
Goodwill	—	—	(130,168)
Proceeds from sale of capital assets	740	6,654	5,375
	(654,192)	(25,228)	(631,018)
Increase (decrease) in cash and cash equivalents	573,313	(216,747)	740,276
Cash and cash equivalents, beginning of year	2,047,892	2,264,639	1,524,363
Cash and cash equivalents, end of year	$ 2,621,205	$2,047,892	$ 2,264,639

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 15. All amounts are expressed in United States dollars.

Use of estimates:

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. During 2002 QKidz Inc. was wound up.

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%

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:

Effective January 1, 2002, the Corporation 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. As required by CICA 3062, goodwill and indefinite life intangibles were tested for impairment as of January 1, 2002. This transitional impairment test was completed, and it was determined that the fair values of the Corporation's goodwill and indefinite life intangibles exceeded their carrying values. Consequently, no impairment loss was recorded. Further impairment tests will be conducted on December 31 each year. The new standard is applied prospectively. There has been no change in the carrying value of goodwill ($2,184,589) since December 31, 2001.

Intangible assets:

Intangible assets are recorded at cost and amortized over their estimated useful lives. The Company assesses the recoverability of intangible assets by determining whether the unamortized balance can be recovered through future operating cash flows. The amount of intangible asset 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 intangible assets 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 net income or loss for the year.

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.

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.

Per Share Amounts:

Per share amounts are calculated using the weighted average number of common shares outstanding during the year. The basic weighted average shares outstanding for the year ended December 31, 2002 was 7,095,552 (December 31, 2001 – 7,252,764, December 31, 2000 – 7,100,815). The diluted weighted average shares outstanding for the year ended December 31, 2002 was 7,455,833. For the years ended December 31, 2001 and 2000 the diluted weighted average shares outstanding were in all material respects the same as the basic weighted average shares outstanding. Diluted per share amounts are calculated using the treasury stock method.

Stock-based compensation:

Effective January 1, 2002, the Company adopted the new Canadian accounting standard relating to stock-based compensation. Under this standard, the Company follows the settlement date method of accounting for stock options granted to employees and the fair value method for stock options granted to non-employees. The Company discloses the pro-forma effect on income of accounting for stock options awarded to employees under the fair value method (see note 7).

Comparative figures:

Certain comparative information has been restated to conform with the current year's presentation.

Change in accounting policy:

In 2000, the Company adopted the new Canadian accounting standard relating 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 adopted this section retroactively with restatement of all previous periods, effective December 31, 2000. There was no impact on loss per share for the years ended December 31, 2001 and 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 which is being amortized on a straight-line basis over five years.

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 and up to December 31, 2001 was being amortized on a straight-line basis over seven years.

1. Business acquisitions (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 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 and up to December 31, 2001 was being amortized on a straight-line basis over seven years.

2. Note receivable:

The Company has advanced $500,000 to a private company. The advance was secured by all of the assets of the private company. Subsequent to the end of the year the Company enforced its security and collected on the note by acquiring title to furniture and equipment, software, inventory and in process research and development.

3. Capital assets:

2002	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 544,872	$ 514,948	$ 29,924
Real time systems	905,534	893,349	12,185
Furniture and fixtures	353,827	307,763	46,064
Computer equipment	808,650	608,628	200,022
Software and production tooling	1,348,395	889,037	459,358
	$ 3,961,278	$ 3,213,725	$ 747,553

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
	$ 3,769,117	$ 2,836,340	$ 932,777

Included in the accumulated depreciation above for software and production tooling is a current year asset impairment charge of $100,000 (2001 - nil, 2000 - $383,750). The impairment charge was measured based on projected future operating cash flows of purchased software.

4. Goodwill:

2002 and 2001	Cost	Accumulated amortization	Net book value
Goodwill	$ 9,894,777	$ 7,710,188	$ 2,184,589

5. Other intangible assets:

2002	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 780,503	$ 594,266	$ 186,237
Purchased customer list	34,418	6,884	27,534
	$ 814,921	$ 601,150	$ 213,771

2001	Cost	Accumulated amortization	Net book value
Patents and trademarks	$ 728,065	$ 514,931	$ 213,134
Purchased customer list	34,418	—	34,418
	$ 762,483	$ 514,931	$ 247,552

6. 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 every four outstanding 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, 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 acquisition (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

	Number of Shares	Consideration
Issued for cash on exercise of options	70,500	$ 34,815
Additional paid-in-capital stock options (note 7)	—	4,870
Additional paid-in capital warrants (note 8)	—	108,725
Balance at December 31, 2002	7,156,074	$ 43,886,036

In 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 $1,108,668 has been assigned to contributed surplus.

7. 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, 2002, stock options to purchase 1,595,922 common shares were outstanding and 349,696 shares are reserved for issuance under the option plans. The stock options are exercisable at prices ranging from $0.47 to $12.24 per share and expire on various dates between 2002 and 2012.

During the year ended December 31, 2002, the Company granted 411,000 options to employees, directors and officers (2001 – 1,137,310, 2000 - 147,611) with exercise prices at or greater than the market price of the Company's stock on the date of grant. Of the 411,000 options granted during the year ended December 31, 2002, 36,000 options vested at the time of granting. The remaining 405,000 options vest at various times depending upon individual specified performance criteria being met. No compensation cost is recorded in the Company's statement of operations and deficit. Had compensation cost for stock options granted to employees been determined based on the fair value method, the company's pro-forma net income would have been decreased by $8,478 to $1,120,474 and net income per common share would be unchanged at $0.16 per share.

During 2002 the Company granted 35,000 stock options in connection with services performed by third parties. These options are exercisable at $1.75 and expire March 31, 2006. Of these options, 5,000 had vested as of December 31, 2002, and the remaining 30,000 vest during 2003. The fair value of the vested options granted is estimated on the day of grant using the Black Scholes option pricing model with the following assumptions; risk free interest rate – 4.5%, volatility – 80%, expected option life (in years) - 3, dividend yield – 0%. $4,870 has been charged to income for these options in 2002. During 2001 and 2000 the Company did not issue any stock options in connection with services performed by third parties.

6. Stock option plan (continued):

Changes in options granted during the years ended December 31, 2002, 2001 and 2000 were as follows:

	Number of Shares	Exercise price per share	Weighted average exercise price
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
Granted	446,000	0.57 - 1.75	0.96
Exercised	(70,500)	0.47 - 0.75	0.49
Cancelled or expired	(600,178)	2.12 - 12.00	8.18
Balance at December 31, 2002	1,595,922	$ 0.47 - 12.24	$ 1.26

The following table summarizes the information about stock options outstanding at December 31, 2002:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at Dec. 31, 2002	Weighted-Average Remaining Term (Years)	Weighted-Average Exercise Price	Number Exercisable at Dec. 31, 2002	Weighted-Average Exercise Price
$ 0.47	565,297	3.7	$ 0.47	510,297	$ 0.47
0.57 to 0.62	275,000	8.2	0.61	—	—
1.04	501,638	3.5	1.04	420,203	1.04
1.65 to 2.12	168,000	3.8	1.76	38,000	2.07
6.00 to 12.24	85,987	2.1	8.93	85,987	8.93
	1,595,922			1,054,487	

8. Warrants:

During 2002, the Company issued 250,000 common share purchase warrants as consideration for services received. Each warrant entitles the holder to acquire one common share of the Company for $1.04 per share and expire March 25, 2007. The company has entered into an agreement to issue an additional 250,000 common share purchase warrants under the same conditions and terms provided certain performance criteria are met.

The fair value of the warrants was determined to be $ 108,725, was capitalized to software and production tooling, and was calculated using the Black Scholes pricing model with the following weighted average assumptions:

Risk free interest rate	4.5%
Volatility	80%
Life of warrant	4.5 years
Dividend yield	0%

9. Adjusted net income and earnings per share:

	2001	2000
Reported net loss	$ (732,910)	$ (9,207,834)
Add back amortization of goodwill	459,511	1,731,684
Adjusted net loss	$ (273,399)	$ (7,476,150)
Adjusted net loss per share	$ (0.04)	$ (1.05)

10. Changes in non-cash working capital balances:

	2002	2001	2000
Accounts receivable	$ (490,274)	$ 727,696	$ 148,108
Inventory	12,132	19,844	167,040
Deposits and prepaid expenses	26,691	15,087	226,823
Accounts payable and accrued liabilities	(83,832)	(48,139)	(147,784)
Deferred revenue	112,229	(971)	(918,865)
	$ (423,054)	$ 713,517	$ (524,678)

11. 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 income (loss) for the year. The reasons for the differences are as follows:

	2002	2001	2000
Income (loss) for the year	$ 1,128,952	$ (732,910)	$ (9,207,834)
Combined Canadian Federal and Provincial statutory rate	39.24%	42.12%	44.62%
Computed tax (recovery)	443,001	(308,702)	(4,108,536)
Increase (decrease) resulting from:			
Unrealized (realized) benefit of future tax assets	(450,988)	193,127	2,749,000
Income taxes computed at different rates in the United States	7,987	115,575	1,424,498
Reduction of unrealized future tax assets for enacted changes in income tax rates	—	—	(690,000)
Non deductable amortization	—	—	625,038
Actual expense (recovery)	$ —	$ —	$ —

11. Income taxes (continued):

The tax effects of temporary differences that give rise to significant portions of future income tax assets are as follows:

	Canada	United States	2002	2001	2000
Future income tax assets:					
Capital assets	$ 564,000	$ —	$ 564,000	$ 402,000	$ 372,000
Share issue costs	6,000	—	6,000	6,000	6,000
Loss and SRED carryforwards	2,664,000	4,411,000	7,075,000	7,659,000	8,285,000
Intangible assets	133,000	1,581,000	1,714,000	1,845,000	1,898,000
Investments	—	158,000	158,000	153,000	567,000
	3,367,000	6,150,000	9,517,000	10,065,000	11,128,000
Less: Valuation allowance	(3,367,000)	(6,150,000)	(9,517,000)	(10,065,000)	(11,128,000)
Net future tax assets	$ —	$ —	$ —	$ —	$ —

The Company has Canadian non-capital loss carry-forwards in the amount of $3,894,000 which expire at various dates between 2003 and 2008 and Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of $3,523,000 which have no expiry. The Company also has United States net operating loss carry-forwards in the amount of $12,604,000 which expire at various dates between 2004 and 2022.

12. Segmented Information:

The Company operates in two operating segments consisting of Audio Projects (Audio) and E-Commerce Products ("E-Commerce"). Audio involves the developing and marketing of sound localization technology for use in various industries. E-Commerce involves the developing and marketing of internet business services.

For Audio products, during 2002 76% of total audio revenue arose from two customers, each of which individually provided greater than 10% of total revenues. For 2001, 65% of total revenue arose from two customers, each of which individually provided greater than 10% of total revenues. For 2000, 63% of total revenue arose from three customers, each of which individually provided greater than 10% of total revenues.

For E-Commerce products, during 2002 and 2001 no one customer contributed to more than 10% of total E-Commerce revenue. For 2000, 64% of total E-Commerce revenue arose from two customers, each of which individually resulted in greater than 10% total revenues.

2002	Audio	E-Commerce	Total
Revenues	$ 3,649,238	$ 575,073	$ 4,224,311
Interest revenue	25,867	1,402	27,269
Amortization of capital assets	410,633	57,230	467,863
Segment profit	1,027,351	101,601	1,128,952
Segment assets	4,844,886	2,426,880	7,271,766
Goodwill	—	2,184,589	2,184,589
Expenditures for segment capital assets	263,554	103	263,657

2001			
Revenues	$ 2,454,800	$ 571,194	$ 3,025,994
Interest revenue	73,094	425	73,519
Amortization of capital assets	306,885	64,756	371,641
Segment profit (loss)	384,429	(1,117,339)	(732,910)
Segment assets	3,463,729	2,502,278	5,966,007
Goodwill	—	2,184,589	2,184,589
Expenditures for segment capital assets	132,021	39,539	171,560

2000			
Revenues	$ 3,025,102	$ 1,443,900	$ 4,469,002
Interest revenue	145,770	4,959	150,729
Amortization of capital assets	206,209	88,600	294,809
Segment (loss)	(522,875)	(8,684,959)	(9,207,834)
Segment assets	4,284,459	3,444,368	7,728,827
Goodwill	—	2,644,100	2,644,100
Expenditures for segment capital assets	332,078	10,530	342,608

12. Segmented Information (continued):

Geographic Information	2002 Revenue	2001 Revenue	2000 Revenue
Canada	$ 3,443	$ 5,669	$ 2,179
United States	3,636,657	2,607,868	3,736,159
Asia	584,211	412,457	730,664
	$ 4,224,311	$ 3,025,994	$ 4,469,002

As at December 31, 2002 substantially all of the Company's product assets and employees were located in Canada. As at December 31, 2001 substantially all of the Company's Audio product assets and employees were located in Canada and substantially all of the Company's E-Commerce product assets were located in the United States.

13. Financial instruments and risk management:

The fair values of financial assets and liabilities approximate their carrying values at December 31, 2002.

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, 2002, 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, 2002 there were outstanding accounts receivable balances from one entity which comprised 74% of the total balance. As at December 31, 2001 there were outstanding accounts receivable balances from two entities which comprised 45% and 22% of the total balance. The entities are primarily located in the United States. These amounts have been collected subsequent to the year end.

14. 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.

During the year the Company resolved an outstanding contingency relating to an employment contract that expired September 30, 2002 by putting in place an individual pension plan for the individual. Subsequent to the year end, $ 55,189 was contributed to the plan as a past service cost.

Under the terms of its lease agreements for office space and equipment, the Company is obligated at December 31, 2002 to make the following minimum lease payments over the next four years:

2002	$	67,683
2003		12,221
2004		12,221
2005		4,074
	$	96,199

15. 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.

15. 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. in 1999 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, 2002 of the differences between Canadian and United States accounting principles is summarized as follows:

Years ended December 31,	2002	2001	2000
Income (loss) for the year as reported in accordance with Canadian GAAP	$ 1,128,952	$ (732,910)	$ (9,207,834)
Amortization of acquired in-process research and development	—	—	1,400,802
Income (loss) under US GAAP	$ 1,128,952	$ (732,910)	$ (7,807,032)
Income (loss) per share under US GAAP	$ 0.16	$ (.10)	$ (1.10)

The components of comprehensive income are as follows:

Years ended December 31,	2002	2001	2000
Income (loss) under US GAAP	$ 1,128,952	$ (732,910)	$ (7,807,032)
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)
Write down of investment through net loss	—	—	370,900
Comprehensive income (loss)	$ 1,128,952	$ (580,967)	$ (7,588,075)
Accumulated other comprehensive income (loss) beginning of year	$ —	$ (151,943)	$ (370,900)
Accumulated other comprehensive income (loss) end of year	$ —	$ —	$ (151,943)

15. United States accounting principles (continued):

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, 2002, 2001 and 2000 under Canadian and United States accounting principles.

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

December 31, 2002	As reported in accordance with Canadian GAAP	Differences	Under US GAAP
Current assets	$ 3,625,853	$ —	$ 3,625,853
Note receivable	500,000	—	500,000
Capital assets	933,790	—	933,790
Intangible assets	2,212,123	—	2,212,123
	$ 7,271,766	$ —	$ 7,271,766
Current liabilities	$ 341,405	$ —	$ 341,405
Shareholders' equity:			
Common shares	43,886,036	202,058	44,088,094
Contributed surplus	1,114,316	—	1,114,316
Deficit	(38,069,991)	(202,058)	(38,272,049)
	$ 7,271,766	$ —	$ 7,271,766

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	—	1,145,911
Intangible assets	2,219,007	—	2,219,007
	$ 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)
	$ 5,966,007	$ —	$ 5,966,007

Included in the current liabilities above are accrued liabilities of $109,178 in 2002 and $149,368 in 2001.

During the years ended December 31, 2002, 2001 and 2000 the Company granted options to employees, directors and officers. During 2002, 411,000 options (2001 – 1,137,310, 2000 - 147,611) 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, 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.

15. United States accounting principles (continued):

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

	2002	2001	2000
Risk free interest rate	4.5%	4.5%	5.0%
Volatility	80.0%	113.3%	120.0%
Expected option life (in years)	7.5	2.0	2.0
Dividend yield	0%	0%	0%

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

	2002	2001	2000
Net income (loss) under US GAAP:			
As reported	$ 1,128,952	$ (732,910)	$ (7,807,032)
Pro forma	1,120,474	(1,247,633)	(7,966,758)
Basic income (loss) per common share:			
As reported	$ 0.16	$ (0.10)	$ (1.10)
Pro forma	0.16	(0.17)	(1.12)

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

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QSOUND LABS, INC.

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

www.qsound.com

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