

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, 2004.**

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 – 12<sup>th</sup> 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, 2004: 8,404,085**

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  No

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

Item 17  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”, “the 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., QCommerce Inc. and QTelNet Inc., as a combined entity, except where the context requires otherwise.

## **CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS**

This annual report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, reflecting management's current expectations. 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 involve inherent risks and uncertainties that may cause actual results to differ materially from those anticipated in the 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.

## **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, 2004, are derived from the consolidated financial statements of QSound and subsidiaries, which financial statements have been audited by the external auditors for the company. The consolidated financial statements as of December 31, 2004 and 2003, and for each of the years in the three-year period ended

December 31, 2004, 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 12 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, and in 2004 in accordance with the standards of the Public Company Accounting Oversight Board (United States).

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, 2004, 2003, 2002, 2001, and 2000					
(Under United States GAAP in United States Dollars)					
	2004	2003	2002	2001	2000
Revenue:					
Royalties, license fees and product sales	\$ 2,213,178	\$ 2,043,088	\$ 4,224,311	\$ 3,025,994	\$ 4,469,002
Cost of product sales	(419,290)	(419,837)	(271,530)	(91,438)	(208,298)
	1,793,888	1,623,251	3,952,781	2,934,556	4,260,704
Expenses:					
Marketing	1,251,695	1,301,890	895,820	1,074,139	1,360,698
Operations	240,691	174,558	235,201	275,077	375,000
Product research and development	962,340	834,333	643,524	951,017	1,610,436
Administration	800,611	578,805	502,861	597,685	802,582
Foreign exchange	41,955	4,958	3,167		
Depreciation and amortization	457,572	308,717	382,662	831,193	1,135,054
Impairment of assets	–	108,154	100,000	–	–
Impairment of goodwill	–	2,184,589	–	–	5,163,504
Funding past service pension costs	–	–	55,189	–	–
Write-down of investments	–	–	–	8,300	1,515,568
	3,754,864	5,496,004	2,818,424	3,737,411	11,962,842
Operating (loss) profit	(1,960,976)	(3,872,753)	1,134,357	(802,855)	(7,702,138)
Interest and other income	78,727	41,164	29,833	73,568	154,788
Gain (loss) on sale of capital assets	(15,616)	2,204	740	6,492	(34,634)
Gain on sale of investments	–	–	–	24,327	–
Other	(28,081)	123,754	(35,978)	(34,442)	(225,048)
	35,030	167,122	(5,405)	69,945	(104,894)
Net (loss) income for the year	(1,925,946)	(3,705,631)	1,128,952	(732,910)	(7,807,032)
Deficit,	(41,977,680)	(38,272,049)	(39,401,001)	(38,668,091)	(30,861,059)

beginning of year

Deficit, end of year	<u>\$(43,903,626)</u>	<u>\$(41,977,680)</u>	<u>\$(38,272,049)</u>	<u>\$(39,401,001)</u>	<u>\$(38,668,091)</u>
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Comprehensive income (loss)	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$(580,976)</u>	<u>\$(7,588,075)</u>
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Income (loss) per common share, basic	\$ (0.25)	\$ (0.52)	\$ 0.16	\$ (0.10)	\$ (1.06)
Income (loss) per common share, diluted	\$ (0.25)	\$ (0.52)	\$ 0.15	\$ (0.10)	\$ (1.06)
Total assets	\$ 5,227,834	\$ 3,776,579	\$ 7,271,766	\$ 5,966,007	\$ 7,576,884
Net assets	\$ 4,922,425	\$ 3,446,834	\$ 6,930,361	\$ 5,652,999	\$ 6,664,766
Share capital – common shares	\$ 45,994,584	\$ 44,003,303	\$ 43,974,499	\$ 43,939,684	\$ 45,479,152
Warrants	\$ 1,502,331	\$ 217,450	\$ 108,725		
Contributed surplus	\$ 1,329,136	\$ 1,203,761	\$ 1,119,186	\$ 1,114,316	\$ 5,648
Share capital – common shares issued and outstanding	8,404,085	7,199,244	7,156,074	7,085,574	7,383,014

At March 2, 2005 the exchange rate was U.S. \$0.7448 per CDN. \$1.00.

The high and low exchange rates for each month during the previous six months ended February 28, 2005, and the average rates (average of the exchange rates on the last day of each month during the year) for Canadian dollars for each of the years in the five year period ended December 31, 2004 based on the closing rates of the Bank of Canada and expressed in U.S. dollars were as follows:

	Month High	Low
February 2005	0.8164	0.7962
January 2005	0.8331	0.8057
December 2004	0.8448	0.8055
November 2004	0.8504	0.8168
October 2004	0.8210	0.7857
September 2004	0.7926	0.7652

	Average
2004 Year	0.7698
2003 Year	0.7135
2002 Year	0.6368
2001 Year	0.6458
2000 Year	0.6736

### **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. 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.

**We were not profitable in 2004 or in 2003 in any of our business segments. The IP telephony and e-commerce business units have never been profitable. Except for 2002, we have been only marginally profitable in previous years, and we have had to rely on the sale of our common shares, and in the past on debt financing, to fund our business operations.**

With the exception of 2002, we have a history of losses and we have had to fund our operations through a combination of equity and debt financings. In 2004 we had revenues of \$2,213,178 and operating expenses of \$4,174,154, including cost of products sold of \$419,290. The net loss for the year was \$(1,925,946). In 2003 we had revenues of \$2,043,088 and operating expenses of \$3,623,098 including cost of products sold of \$419,837. After impairment of assets of \$108,154 and impairment of goodwill of \$2,184,589, there was a resultant loss of \$(3,705,631) for the year. Our loss per share for 2003 was \$(0.52). If we are not successful in enhancing revenues through increased sales of our products and technologies or the development and marketing of additional products, or if there is a material increase in our expenses, we may be unable to achieve profitability in the future. As a result, we may have to rely on the sale of shares and on debt financings in the future. If we are unable to raise financing when and in the amount required, we may be required to cease operations.

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

The sources of our audio industry revenues are limited in number and a reduction in the performance, or expiration or termination, of any of these accounts, would have a material effect on our revenues and consequently, the Company's financial condition. For example, our hearing aid license with Starkey Laboratories, which accounted for 30% of our 2003 revenues, expired in the third quarter of 2004 and we have not replaced this revenue stream yet. In the event that we lose one or more of these accounts, our results of operation would suffer materially.

**Our audio revenues depend primarily on license fees generated upon the sale of devices that incorporate our technology. As a result, we are highly dependent upon the sales efforts of the manufacturers of these products and market acceptance of their product offering.**

Our primary business in the audio business revolves around entering into license agreements with semiconductor and handset manufacturers who wish to incorporate our microQ and QVE audio engine technology into their products. Under these agreements, we generate revenue based on the number of units incorporating our microQ audio engine produced by each manufacturer. To date, significant distribution of microQ enabled devices has not yet begun. The target for product delivery to the marketplace for many of these products is in the latter part of 2005. Factors that contribute to performance of these products include, among others:

- end-user demand;
- timeliness, quality and pricing;
- success or failure of distribution and commercialization efforts;
- competition from similar or substitute products;
- manufacturing uncertainties; and
- general or regional economic conditions.

If the these products do not meet the currently anticipated timeline or if these products are not widely accepted by consumers, our revenue stream may be delayed or may not materialize at all. As a consequence of the effect that these



and similar factors may have on our licensees, customers and partners, we may from time to time experience significant fluctuations in our revenues, even on a quarterly basis and as a result, we believe that period-to-period comparisons for our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance.

**Three distributors accounted for 37% of our IP telephony revenue in 2004 and the loss of one or more of these distributors could cause our revenues to decline.**

For the year ended December 31, 2004, three distributors accounted 37% of our revenues from our IP telephony business. We anticipate that a limited number of distributors will continue to account for a significant portion of our IP telephony revenues for the foreseeable future. Key factors in maintaining our relationships with these distributors include the reliability of our products, the pricing of our products relative to competitors, and the relationships of our sales employees with their personnel. To the extent that our performance does not meet their expectations, or the reputation of our product quality or relationships with one or more major distributor are impaired such that they reduce or eliminate use of our services, our revenues could decline significantly and our operating results could be adversely affected.

**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.**

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; and
- development of audio enhancement technologies in-house by potential customers.

It is important for us to be able to identify emerging trends in the mobile devices, PC multimedia, consumer electronics 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.

**Due to the rapid technological development in our field and changing regulatory and industry standards, our IP telephony technologies may become obsolete quickly.**

The IP telephony industry is characterized by rapid technological advances, evolving industry standards and frequent new product introductions. Unless we continue development and improvement of our products and technologies to respond to advances in technology and changes in the regulatory landscape, our products may not be accepted by consumers or industry regulators. To keep pace with industry changes, we must continue to incur research and development costs which may not be offset by new and existing revenue streams.

**Our products incorporate technologies licensed from a number of third parties. If we are unable to maintain these licenses on favorable terms or we are unable to effectively integrate these technologies, our revenues will suffer.**

Our products incorporate a number of technologies licensed from third parties. If we are unable to maintain our relationships with these third parties on favorable terms or if we are unable to successfully integrate these technologies into our product line, we may need to revise our products, including by limiting product features or locating substitute technologies. Any modifications of our products would be costly and divert research and development efforts. As a result, our business and results of operation would suffer.

**We have limited experience with manufacture and distribution of hardware products and intend to outsource the majority of production. Our success will depend on our ability to manage this process.**

We have not previously engaged to any material extent in the manufacture and distribution of hardware products and intend to outsource the manufacture of the majority of the components of our products. As a result, we will be heavily dependent on these manufacturers to meet product delivery schedules and maintain quality. Our success will depend upon our ability to:

- source competitively priced component parts;
- partner with low-cost manufacturers;
- maintain product quality standards;
- contain operating expenses;
- finance product inventory; and
- co-ordinate inventory stock quantities with product distribution requirements.

If we are unable to effectively manage our relationships with our manufacturers, the quality or supply of our products may suffer.

**If we fail to obtain product standard certification in particular countries we will be unable to sell our IP telephony products in such countries. Any such limitations would adversely impact our revenues and business prospects.**

Our IP telephony products must meet certain safety and radio-frequency emission standards. Products that connect to the telephone network must also meet certain standards aimed at protecting the network. Virtually all countries have developed their own sets of standards, which are not uniform. If we do not obtain certifications attesting that our products comply with the standards of the country where our equipment will be used, we will be unable to export our products to that country. Any such failure would adversely impact our revenues and business prospects.

**Telecommunications failures, computer viruses, breaches of security or terrorist attacks could disrupt our IP telephony and e-commerce businesses by reducing consumer confidence in the Internet as a means of communication and commerce.**

Internet communications are susceptible to interruptions resulting from factors including telecommunications failures, computer viruses, capacity limitations, breaches of security, terrorist attacks and vandalism. If one or a combination of these events causes consumers to lose confidence in the Internet as a means for communication or commerce, the growth of use of the Internet and reliance upon the Internet as an alternative to the telephone network would be negatively impacted. Any shift of consumers away from the Internet would adversely impact sales of our IP telephony and e-commerce products.

**Our e-commerce revenues have declined in the past few years and we do not expect growth in this business.**

Our e-commerce revenues have declined in the past few years. Consolidation has become the principal method for acquiring new merchants, and we do not expect organic growth in our merchant base nor do we anticipate adding merchants through acquisition of competitors. Larger service providers may offer their products and services at reduced prices and we may have to adjust our prices accordingly. As new technologies are developed and introduced our e-commerce products may become less attractive to small business merchants.

**Many of our competitors have greater resources available to them. If we fail to compete effectively with our competitors, our results of operation and viability will be negatively impacted.**

The audio, IP telephony and electronic commerce industries are intensely competitive. We have competitors in these industries who have technologies and products that are similar to ours and compete directly with us. Many of these competitors are large, established companies with significantly greater resources than we have. If we are unable to

develop and commercialize products that consumers view as superior to those of our competitors in terms of leading edge technology, performance, features, functions or price, among other elements, our results of operation will suffer.

**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 and may be required to pay substantial fees and/or cease using any such intellectual property.**

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. 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. In addition, we may be ordered to pay substantial penalties and/or cease using certain intellectual property if we are found to have infringed on the intellectual property rights of a third party.

**We may be subject to financial penalties in the event that the registration statement we filed on January 6, 2005 is not declared effective by the 90th day following the filing date.**

In connection with the private placement completed in December 2004, we agreed to file a resale registration statement, and to bring such registration statement effective within ninety days of the filing. In the event that the registration statement is not declared effective by the 90th day following its filing, we are subject to a monthly penalty of approximately \$20,000 in the first month and approximately \$40,000 in each succeeding month until such date as the registration statement shall be declared effective by the SEC. The SEC is conducting a review of the registration statement and we filed an amended registration statement on February 24, 2005.

**New equity financing would dilute current shareholders.**

If we raise funds through future equity financing, it will have a dilutive effect on existing holders of our shares by reducing their percentage ownership. The shares may be sold at a time when the market price is low because we need the funds. This will dilute existing holders more than if our stock price were higher. In addition, private equity financings normally involve shares sold at a discount to the current public market price. Our articles of incorporation allow us to issue an unlimited number of common and preferred stock. Therefore, there is no theoretical cap on the amount of dilution our investors may suffer in subsequent financings.

**The telecommunications market fluctuates and is impacted by many factors, including decisions by service providers regarding their deployment of technology and their timing of purchases, as well as demand and spending for communications services by businesses and consumers.**

Beginning in fiscal 2001 and continuing through fiscal 2003, the global telecommunications market deteriorated significantly, reflecting a significant decrease in the competitive local exchange carrier market, failures of many other start-up telecommunications service providers and a significant reduction in capital spending by established service providers. In 2004, the market stabilized but is still subject to fluctuations.

If adoption of IP telephony advances at a slower pace than we anticipate, our revenues and profitability may be adversely affected. The level of demand by service providers and their customers can change quickly and can vary over short periods of time, including from month to month. As a result of the uncertainty and variations in our markets, accurately forecasting revenues, results and cash flow remains difficult.

**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 February 28, 2005 our stock price has ranged from a high of \$8.47 to a low of \$1.63. The market price may be affected by announcements of, among other things:

- new products by our competitors;

- fluctuations in our operating results; and
- assertions of intellectual property infringement made by us against third parties or by third parties against us and changes in our financial position.

In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. A securities class action lawsuit against us, regardless of its merit, could result in substantial costs and divert the attention of our management from other business concerns, which in turn could have a materially adverse impact on our financial results.

**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 and are in high demand. We would suffer adverse effects if we are unable to successfully retain our key personnel, or hire and train suitable replacements.

**Some of our directors and officers may in the future have potential conflicts of interest between their positions with QSound and their positions as executives or directors of companies that are in the same industries in which we engage.**

Some of our officers and directors may in the future have conflicts of interest due to involvement as shareholders, officers, directors or partners of businesses that are engaged in the audio technology, IP telephony or e-commerce industries. These conflicts could include time and effort devoted to QSound, competition for customers and suppliers and interest in material contracts. Although our by-laws and our corporate legislation require disclosure of conflicts of interest, and our code of ethics prohibits such conflicts, should a conflict arise our business could be adversely affected.

**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 initiating 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**

QSound Labs, Inc. was 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 QSound 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 12<sup>th</sup> Street NE, Calgary, Alberta, Canada T2E 7J2 and the telephone number is (403) 291-2492.

Since 1988 QSound's main focus is development, licensing and distribution of audio enhancement algorithms and software to the personal computer and consumer electronics, and more recently, the mobile devices, industries. In 2004 we added to our number of licensees for microQ™, our audio software engine for portable applications, in the growing

mobile and handheld devices market which we had entered in 2003. We completed sixteen OEM and semiconductor license agreements and three partner agreements for our audio software solutions. With respect to the PC market, we refocused our efforts and signed new license agreements with VIA Technologies, Ego Systems and Sony VAIO. Also in 2004 we continued sales of existing and development of new Internet telephony technology products through our subsidiary QTelNet Inc. Since 1999 our subsidiary QCommerce Inc. provides e-commerce enabling services to small business merchants.

## **Capital Expenditures**

Our principal capital expenditures for each of fiscal year 2004, 2003, and 2002 are detailed in the table below:

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Sound source and control equipment	\$ 1,320	\$ 12,818	\$ 6,060
Furniture and fixtures	5,092	6,747	-
Computer equipment	103,468	94,454	52,435
Software and production tooling	483,029	592,731	164,164
Patents and trademarks	46,233	51,392	41,052
Total	\$ 639,142	\$ 758,142	\$ 263,657

In fiscal 2004 our divestitures consisted of sound source and control equipment, furniture and fixtures, and computer equipment with a combined net book value of \$20,045. In fiscal 2003 our divestitures consisted of furniture and fixtures, computer equipment, and sound source and control equipment with a combined net book value of \$3,857. In fiscal 2002 our divestitures consisted of computer equipment with a net book value of nil.

## **B. Business Overview**

QSound was engaged in three business segments in 2004:

a) Audio Business Segment Since its inception in 1988 QSound has established itself as one of the world's leading audio technology companies, and we derive most of our revenues from this business segment. QSound develops, markets and distributes multimedia software solutions and licenses algorithms based on our patented, proprietary audio technology portfolio. Our strategy is to focus on new products and technologies targeted for high-growth markets where the technical barriers to entry are high, and where we can lever our audio technology expertise to penetrate the market. We generate revenues by licensing to original equipment manufacturers and chip manufacturers in the mobile and handheld devices, computer multimedia and consumer electronics markets, through sales of QSound-enabled analog chips to consumer electronics manufacturers, and by selling downloadable software products for Internet streaming audio, primarily through third parties and also directly, to consumers over the Internet.

b) Internet Telephony Business Segment Our wholly owned Alberta subsidiary QTelNet Inc. develops and sells Internet telephony products under the brand-name FreeRide™. We target the small to medium sized business and enterprise branch office market, offering Freeride™ products that enable these businesses to eliminate long distance charges between offices and to expand existing switchboards to encompass remote teleworkers or offices. QTelNet continues to develop new VoIP products offering increased functionalities, ease of customization and cost savings to the customer.

c) E-commerce Business Segment Our wholly owned Washington subsidiary QCommerce Inc. provides electronic commerce services that enable electronic commerce for small businesses. QCommerce provides our existing client base of 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

QSound is a world leader in the development, marketing and distribution of audio enhancement and audio synthesis technologies, and audio engines. 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 music synthesiser, a digital audio playback engine, a sample rate converter and a mixer.

QSOUND technologies are currently shipped in:

- PC's and PC peripherals including sound cards, speakers and monitors
- mobile phones & PDAs
- stereo systems
- MP3 players
- home theatre systems, TV's and VCR's
- DVD players
- amplified and USB speakers
- video games

#### QSOUND Portfolio of Technologies

Our technological efforts concentrate on the development and upgrading of a complete suite of proprietary technologies to cover all aspects of enhanced audio and audio synthesis requirements in the mobile devices, multimedia computer and consumer electronics industries. The QSOUND portfolio consists of:

- Software Engines

microQ™: microQ is a modular and scalable software digital audio engine providing functions such as polyphonic ringtones, game sound, music playback, digital effects and recording for portable and embedded applications in the growing hand-held and mobile devices markets. microQ offers a highly flexible modular architecture, a small memory footprint and support for industry standard (linear and compressed) content formats. microQ's core components consist of a digital audio playback engine, a wavetable synthesis engine with a scalable sample set, a multi-channel stereo mixer and a sample rate convertor.

QVE™: The QSound Virtual Engine ("QVE") is a scalable software audio engine for PCs, soundboards and other digital devices. QVE provides synthesis and digital audio playback for entertainment 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 EAX (Environmental Audio Extensions™) 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 and the digital broadcast format, both of which have become 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.

## **Licensing**

Our primary business model consists of licensing QSOUND technologies to:

- original equipment manufacturers (“OEM’s”) for specific products;
- semiconductor/component companies which manufacture and sell QSOUND enhanced chips to OEMs; and
- semiconductor/component companies that include QSOUND as an option for the OEM, who can then, at their choosing, license the technology directly from the Company (“facilitator license agreements”).

Licenses are negotiated on an individual basis. Some of our license agreements provide for per-unit payments and others are on a fixed periodic payment or lump sum payment basis, and in some cases licensees pay engineering fees. The agreements do not have volume requirements and generally may be terminated by the licensee or by QSound without a prescribed financial penalty.

At the early stages of market adoption, licenses with OEM’s are feasible and desirable since they provide early endorsement of new technology. As markets mature and OEM product margins decrease, there is less opportunity for direct OEM licensing, since the OEM’s are now dependant upon the semiconductor companies to provide them with a cost effective fully featured solution. Semiconductor licenses typically have smaller royalties per unit but can provide potentially much bigger volumes. The mobile and handheld device market is still at an early stage with respect to audio technologies, whereas the PC and DVD markets are at a mature stage.

In 2004 we negotiated and completed license agreements with eight OEM’s and eight semiconductor/component companies. Additionally, we entered into three facilitator license agreements under which our technologies are available for license by customers of these licensees.

The majority of these licenses were for the mobile and handheld device market. Among others, we added to our roster of microQ licensees semiconductor manufacturers Broadcom Corporation and Qualcomm Incorporated, mobile phone manufacturers Wistron Corporation and Eten Information Systems Co., Ltd. and multimedia component software supplier Packetvideo Corporation. These licensees have agreed to pay license fees and/or periodic royalties for use of QSOUND technologies. The facilitator license agreements were with Vodafone Group Services Limited, LSI Logic Corporation and Samsung semiconductors division of Samsung Electronics Co., Ltd. Vodafone, the world’s largest mobile telecommunications company, licensed microQ Q3D in its VFX reference implementation for development of mobile devices offered by Vodafone. microQ Q3D will be available for license by developers of applications targeted for Vodafone products. Samsung introduced, in early 2004, a reference design for the world’s first 3G smartphone based on a Linux operating system. This design included components of our microQ technology.

In the PC multimedia market, we licensed our audio enhancement technologies in 2004 to Via Technologies, Inc., a leading developer of silicon chip technologies and PC platform solutions, for use in Via’s Vinyl Audio line of audio controllers and audio codecs. For Sony Vaio, we developed a new multimedia platform to be used in all of their Vaio PC product lines.

In 2003 we licensed microQ to MiTAC International Corporation which manufactures Pocket PC’s and smartphones, to Ceva, Inc., a leading designer of DSP cores for the cellular and digital multi-media markets and to DSP Group, a fabless

semiconductor company. microQ is available for license by Ceva's customers. In 2003 we also entered into license agreements with semiconductor manufacturers Mediatek, NEC and Apogee, all of whom provide our audio enhancement technologies as an option to their customers.

Under our 2002 three year joint development agreement with Royal Philips Electronics, one of the world's largest electronics companies, Philips & QSound jointly developed a soft audio engine based on QSound's QVE technology. Philips have branded the audio engine as the Philips SoundAgent2. To date Philips has bundled the Philips SoundAgent2 with soundcards such as Ultimate Edge, Rythmic Edge, Acoustic Edge, Seismic Edge, Sonic Edge, Dynamic Edge and Aurilium, with USB speakers namely, the DGX220 and with mini-component stereo systems, such as the MCM530. Philips paid an upfront fee creditable against future royalties, and has agreed to pay ongoing royalties. We also granted to Philips 500,000 warrants currently exercisable at \$1.04 per share and a right of first refusal to acquire control of our company.

### **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 our software product revenues are derived from distribution of our iQfx family by RealNetworks, Inc., a leader in media delivery on the Internet. The iQfx family enhances playback of content over all of RealNetworks' media players. Our third generation iQfx3 plug-in is made exclusively for RealNetworks' RealOne Player®. Since the 2002 introduction of the RealOne Player and the concurrent change in RealNetworks' business model, revenues from sales of iQfx3 have decreased from past years' levels. RealNetworks continues to sell iQfx3, and the changes in strategy are not reflective of iQfx3's sales performance.

QMAX® II is our universal plug-in for Internet streaming audio, and works with any sound source, including Windows Media Player and RealPlayer. QMAX II intercepts the audio player output and applies realtime processing to optimize speaker and headphone audio. We have also developed and distribute custom plug-ins iQms2 plug-in for Windows Media Player 9 Series for Windows XP and QDVD for Intervideo's popular DVD player, WinDVD

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.

We distribute our downloadable consumer software from our Web sites [www.3dsoundstore.com](http://www.3dsoundstore.com), [www.qsound.com](http://www.qsound.com) and [www.audiopix.com](http://www.audiopix.com).

### **Other**

We also purchase and resell QSOUND enhanced analog chips to OEM's. This is a small part of our business. Our analog chip manufacturer licensees are Mitsumi Electric Co., Ltd., Renesas Technology Corp. (formerly 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. Renesas 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.

### IP Telephony Business Segment

Our wholly-owned subsidiary QTelNet Inc. develops and sells Internet telephony systems under the brand-name FreeRide™. The current product offerings include:

- FreeRide FXS Gateways - products that allow conventional analog phones and switchboards to connect to a computer network
- FreeRide FXO Gateways - products that allow IP Phones to connect to conventional telephone networks.
- FreeRide IP Telephones - telephones that connect to a computer network.

FXS and FXO gateways can be combined in a number of different ways to connect remote office locations using VoIP technology. The growing adoption of broadband access is making it easier for smaller sized businesses to utilize VoIP



products. Businesses can easily and seamlessly connect office phone systems, and extend their office phone capability to remote offices or home offices that have a broadband connection.

Typical applications for FreeRide products are implementations that eliminate long distance charges between offices, extend existing switchboard functionality to encompass remote teleworkers or offices and provide VoIP over broadband wireless.

More specific examples of cost saving VoIP applications for small businesses using FreeRide gateways and IP telephones include:

- As a point-to-point application, eliminating high long distance charges for direct phone calls between two locations that may be a great distance apart and have high voice traffic.
- As a telecommuter application, eliminating long distance charges from remote offices by connecting them to the office switchboard so that they may work remotely as if they were at the office location.
- As a low cost alternative for adding local telephones and extensions to an existing switchboard that has reached its capacity, rather than upgrading or replacing the switchboard.
- As a low cost alternative for connecting phone extensions in different offices, allowing workers to use their existing desk phones to call through their switchboard to workers on a phone system at a different location, essentially extending the telephone system functionality in each office to include both offices.
- As a toll-free trunk line between office switchboards in different locations, linking voice traffic between switchboards via the Internet and bypassing long distance toll charges for the voice traffic between switchboards in the different offices.

In Q4 of 2004, QTelNet entered into a distribution agreement with Talley Communications, a leading distributor of broadband wireless communications products. This relationship broadens the scope of QTelNet's traditional telephony reseller channels to include fixed wireless resellers.

Fixed wireless creates available bandwidth beyond where DSL or cable broadband can reach, extending the "last mile" and introduces new VoIP applications and opportunities for FreeRide products. Some examples of broadband wireless applications being sold by Talley's channels include energy companies who have deployed QTelNet VoIP over wireless to remote gas wells and oil derricks in the ocean. Fixed wireless is also widely used to provide bandwidth and VoIP phone service to temporary facilities, such as trailers used for a variety of construction and government applications.

In April, 2003 QTelNet acquired all of the assets of e-tel Corporation, consisting primarily of Internet telephony-enabling software, hardware inventory and trademark rights, for the purchase price of approximately \$525,000 which was paid by way of cash and an offset of \$500,000 against a secured claim in the principal amount of \$500,000 owed by e-tel to QSound.

Since the acquisition QTelNet has focused on development of this business segment through product improvement, manufacturing efficiencies and marketing efforts. We upgraded and added functionalities to our software, re-designed the internal layout and external features of our gateways, and secured a cost-effective, overseas manufacturing partner. On the marketing side we worked to establish a worldwide dealer network, resulting in dealers in the United States, Canada, Mexico, Europe, Asia and Africa, we entered into an OEM agreement with Telrad Connegy, and we retained sales and marketing managers with extensive industry experience. We continue to explore opportunities to expand our product line.

#### E-commerce Business Segment

QCommerce provides electronic commerce enabling services to small businesses. We provide Web merchants with all of the tools necessary to set up and operate an on-line store, including custom design and programming, domain name registration, hosting, merchant credit card account set-up, technical support services and marketing and advertising services to drive targeted traffic to the store.

QCommerce derives its revenues from monthly service subscription fees paid by merchants for on-line storefront hosting and related services.

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

QCart™ is a full-featured Internet-based catalog 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 our administration area. QCart's robust database management system gives the merchant full control over administration processes including pricing data, accounting information and detailed customer order records.

merchantPro™ 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 services such as Lycos, InfoSpace, RoadRunner, CNET and LookSmart.com.

### **Revenues by Business Segment**

In fiscal 2004, our revenues were \$1,820,028 from the audio business segment, \$245,238 from the e-commerce business segment and \$147,912 from the Internet telephony segment. In fiscal 2003, our revenues were \$1,511,312 from the audio business segment, \$346,456 from the e-commerce business segment and \$185,320 from the Internet telephony segment. In fiscal 2002, our revenues were \$3,649,238 from the audio business segment and \$575,073 from the e-commerce business segment.

### **Revenues by Geographic Market**

Audio Business: In 2004 product sales revenue was split between the United States and Asia. Royalties and license fee revenue came primarily from the United States (62%) and Asia (28%). In 2003 product sales revenue was split between the United States and Asia and royalty revenue came primarily from the United States. In 2002 product sales, royalty and licensing revenue came primarily from the United States.

Internet Telephony Business: In 2004 79% of our revenue came from the United States with an additional 16% coming from Canada. In 2003 62% came from the United States and 33% was from Canada. The remaining revenue in both years was split among Asia, Europe, Africa and Mexico.

E-commerce Business: Revenue for our e-commerce business segment has come primarily from the United States in 2004, 2003 and 2002.

### **Seasonality**

We generally experience increased royalty revenues in our audio business segment in the second and third quarters for consumer electronics and PC sales, all related to the Christmas shopping season. These sales activities decrease during the fourth and first quarters. In 2004 we did not experience any seasonal changes in our e-commerce business segment. All revenue from e-commerce was subscription based. This revenue decreased a constant amount throughout the year. Our IP telephony business is not mature enough to track any seasonality trends. Overall, seasonality does not have a material effect on our business.

### **Marketing Channels**

Audio Business: 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, Taiwan, 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. Our downloadable software products are marketed primarily through RealNetworks, and also by participants in our affiliate marketing program, and from our own web sites.

Internet Telephony Business: Sales and marketing activities of our IP telephony products are directed and carried out by QTelNet's sales and marketing personnel, who focus on setting up sales channels through established distributors, OEM's and resellers of communications products.

E-commerce Business: We are managing our existing client base and we do not actively carry on sales and marketing in this business segment.

### **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 fourteen 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 binaural hearing aid technology previously co-developed by QSound Labs and the House Ear Institute of Los Angeles, California. At the date of this report, an additional four patent applications for QSOUND complementary and improved technologies have been filed and more applications are in progress. Patent applications have been made in fourteen foreign countries and a number of foreign patents have been granted, including in Japan.

Our key trademarks, including QSOUND, QSURROUND, QXPANDER 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 other 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 QCart, are covered by copyright and trade secret laws, and contractual obligations.

QTelNet’s VoIP software and technologies are covered by copyright and trade secret laws, and contractual obligations. QTelNet’s products also include technologies that are licensed from third parties.

### **Competition**

Each of the industries in which we engage is intensely competitive. In these industries we have competitors 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. These large companies have advantages including greater financial strength, marketing resources and distribution capabilities, and greater ability to hire skilled personnel. In addition, we face competition from new market entrants.

- audio industry: Our competitors in the audio industry have products and technologies that compete with us in the mobile devices market; PC multimedia market; the consumer electronics market; audio enhancement software plug-ins for Internet media players; the headphone audio enhancement area; and the multi-channel home theatre market.
- IP telephony industry: We face significant competition in the IP telephony business. We expect competition to remain intense as existing communications companies enter into and new entrants emerge in this 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. These companies sell products and services similar to those we offer, including building Internet-based electronic storefronts, hosting merchant sites and providing marketing services.

There are no governmental regulations in the audio or e-commerce industries that have a material effect on our business, other than regulations that affect the carrying on of business generally. In the IP telephony industry our products are subject to testing and certification in the United States, Canada and other countries to satisfy a variety of regulatory requirements and protocols, such as for example to avoid interference with radio frequencies and to comply with emission standards.

### **C. Organizational Structure**

QSound Labs, Inc. is the parent of QSound Ltd., a California corporation and wholly owned subsidiary that owns certain assets including several patents, and of QTelNet Inc., an Alberta corporation and wholly owned subsidiary that operates our Internet telephony activities. 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 12<sup>th</sup> Street NE, Calgary, AB, Canada T2E 7J2 where we lease approximately 10,648 square feet of office space until October 31, 2008 at a rental rate of \$7,986.00 Cdn. per month. We have the option to renew the lease for an additional two-year term at then prevailing market rates. Our audio and e-commerce businesses and, since April, 2003 our Internet telephony 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.

#### **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following discussion and analysis of the financial condition and results of operations of QSound and subsidiaries should be read in conjunction with the consolidated financial statements of QSound and related notes contained elsewhere in this Annual Report on Form 20-F. These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada. Except as disclosed in Note 12 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.

The preparation of these financial statements requires us to make 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

#### **Overview**

QSound Labs is a developer and provider of software solutions for audio, voice and e-commerce applications. We operate our business through three different operating units; QSound Labs, the parent company; its wholly-owned subsidiary QTelNet Inc; and its wholly-owned subsidiary QCommerce Inc.

##### *Audio Business Unit*

Our Audio business unit develops and licenses audio solutions to the world's leading manufacturers of consumer products as well as semiconductor solution providers for these products. Specifically, these are products for the home theatre, video gaming, portable audio, mobile phone and computer markets. Revenues from this business unit comprised 82%, 74% and 86% of total consolidated revenues in fiscal 2004, 2003 and 2002 and are derived primarily through per unit royalty agreements.

##### *Telephony Business Unit*

Our Telephony business unit develops and distributes IP Telephony products which are targeted for the small business environment. Revenues from this business unit comprised 7%, 9% and 0% of total consolidated revenues in fiscal 2004, 2003 and 2002 and are derived from product sales to distributors.

##### *E-Commerce Business Unit*

Our E-Commerce business unit provides electronic commerce services, such as on-line storefront hosting and shopping carts, to small businesses. Revenues from this business unit comprised 11%, 17% and 14% of total consolidated revenues in fiscal 2004, 2003 and 2002 and are comprised primarily of monthly subscription fees.

The following represents a summary of our critical accounting policies, defined as those policies 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. Our most critical accounting estimates include valuation of inventory, which impacts gross margin; valuation of goodwill and capitalization of software development costs, which both impact operating expenses when we impair assets or accelerate their depreciation.

#### Inventory

Inventory is comprised of work in progress and 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

Effective January 1, 2002, we adopted the new Canadian Institute of Chartered Accountants standard 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 by management on goodwill and other indefinite life intangibles. Our judgments in performing this test are based on operational performance of acquired businesses and market conditions. In 2003 an analysis of the recorded goodwill was completed and an assessed goodwill impairment of the remaining balance was recognized at December 31, 2003.

#### Capitalization of Software Development

Research and development costs are expensed as incurred except if development costs are determined to be recoverable from and directly related to development of new products, processes or systems. In 2004, while \$1,433,941 was spent on research and development, we capitalized only \$498,336 of such costs. The remaining \$962,340 was expensed as the costs could not be directly related to the development of new products, but instead were related to pure research and updates of existing products. In 2003, \$943,058 was spent on research and development of which \$108,725 was capitalized and \$834,333 was expensed. Capitalized development costs are amortized against the related expected revenue as that revenue is recognized.

### **A. Operating Results**

Overall, our results have been effected by three main factors during the three year period ended December 31, 2004. These are:

#### 1) Fluctuations in audio licensing revenues

The majority of the decrease in licensing revenues from \$2,811,000 in fiscal 2002 to \$779,000 in fiscal 2003 was caused by the expiration of one license agreement in February 2003. This event accounted for a decrease in licensing revenue of \$1,707,000 between these periods. The increase from \$779,000 to \$1,162,000 in 2004 is a direct result of the introduction of new product solutions, microQ, targeted for the growing mobile and handheld device market. We have added several new licensees since the introduction of microQ in March 2003. Most of these licensees have plans to ship products incorporating microQ in fiscal 2005. Therefore we have not yet established a re-occurring royalty revenue base but we have received upfront license fees as compensation for customization and engineering requirements per these license contracts. This revenue is the basis for the increase.

#### 2) A change in accounting policy re: stock based compensation

For fiscal 2004, 2003 & 2002, we recorded stock based compensation expenses of \$320,000, \$90,000 and \$5,000 respectively. The expense is based on a methodology for determining the cost of issuing stock options and warrants, called Black-Scholes. Prior to fiscal 2003, the Company calculated this expense for non-employee stock options only, hence the lesser amount. For fiscal 2003 onwards, we have included director and employee stock options in this calculation as recommended by the accounting authorities. The expense does not affect cash flow and is not reversible should the options or warrants expire without being exercised.

#### 3) The fiscal 2003 goodwill impairment charge of \$2,185,000

We completed an analysis of the recorded goodwill asset in the e-commerce business segment in fiscal 2003. As a result of this, we determined that an impairment charge of \$2,185,000 was necessary.

A further factor that has affected the financial results in a more general sense during this period is the increase in value of the Canadian Dollar as measured against the United States Dollar. During the two year period ended December 31, 2004, the Canadian Dollar increased in value by approximately 23% over the United States Dollar. This has no effect on our reported revenues, since the majority of revenues are invoiced and collected in United States Dollars. However, since most of the Company's operations are based in Canada, the majority of our expenses are paid in Canadian dollars, and therefore reported expenses are affected by the Canadian/United States exchange rate. During fiscal 2004 and 2003, this had a negative impact on the Company's total operating expenses.

### **Discussion and analysis**

Below we provide information on the significant line items in our statement of operations for the past three fiscal years, as well as analysis of the changes year-on-year.

#### Revenues

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<i>Licensing and Royalty Revenues(in 000's)</i>	\$1,162	\$779	\$2,811
<i>Change year-on-year</i>	49%	(72%)	-

The increase in licensing and royalty revenues from 2003 to 2004 arose primarily from new microQ design wins. Royalty revenues actually declined in this period as a result of the expiration of one license in the hearing aid market.

#### Product Sales

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<i>Product Sales(in 000's)</i>	\$1,051	\$1,264	\$1,414
<i>Change year-on-year</i>	(17%)	(11%)	-

One distribution partner has accounted for 30.3%, 26.0% and 30.8% of the product sales revenue in 2004, 2003 & 2002 respectively. The decrease between 2002 and 2003 is directly attributable to the decline in sales during that period from this distributor.

The other major factor has been the steady decrease in revenues from our E-commerce business unit. We have chosen not to invest in marketing activities for this business unit, so consequently as subscriptions expire or are cancelled, we do not have sufficient replacement numbers to offset the decline in revenue.

#### Expenses

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<i>Marketing(in 000's)</i>	\$1,252	\$1,302	\$896
<i>Change year-on-year</i>	(4%)	45%	-

The significant increase from 2002 to 2003 occurred when we established our IP Telephony business unit in April 2003. We cutback on these expenditures in March 2004 so as to bring them more into line with revenues being generated from the IP Telephony business unit at that time.

<u>2004</u>	<u>2003</u>	<u>2002</u>
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<i>Product Research &amp; Development(in 000's)</i>	\$962	\$834	\$644
<i>Change year-on-year</i>	15%	30%	-

The large increase between 2002 and 2003 occurred when we established our IP Telephony business unit in April 2003. However between 2003 and 2004, we scaled back on our engineering budgets for both E-commerce and IP Telephony, bringing them more into line with revenues being generated from those business units. Offsetting that in 2004, was a 33% increase in engineering cost for the audio business unit. This was a result of the increased licensing activity brought on by the introduction of our microQ software product.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<i>Administration and foreign exchange in 000's)</i>	\$506	\$843	\$584
<i>Change year-on-year</i>	45%	16%	-

Most of the 45% increase in administration expense between 2004 and 2003 is due to the \$230,000 increase in compensation cost for options issued primarily to directors and employees. Similarly in comparing 2003 with 2002, compensation cost for options issued accounted for an \$85,000 increase in administrative expenses. Prior to 2003, the Company did not record such compensation costs for directors and employees in the Income Statement, hence the increases in the following years. During the two year period ended December 31, 2004 the US dollar has weakened considerably against the Canadian dollar, approximately 23%. This has also effected the Company's cost base since the majority of expenses are incurred in Canadian dollars.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<i>Impairment of Goodwill(in 000s)</i>	-	\$2,185	-

In 2003, management completed an analysis of the recorded goodwill asset in the e-commerce business segment and determined that an impairment charge of \$2,185,000 was necessary.

## **B. Liquidity and Capital Resources**

As at December 31, 2004 we had cash and cash equivalents of \$3,327,543. This is a increase of \$1,266,450 over the balance at December 31, 2003 of \$2,061,093. \$1,180,143 (\$439,693 in 2003) of cash was used in operations during the 2004 fiscal year. No significant changes in working capital levels occurred between the years. Financing activities generated \$3,050,467 in cash during fiscal 2004 (\$22,940 in 2003) from the exercise of options and the private placement.

Cash used in investing activities increased to \$578,083 in 2004 from \$143,359 in 2003. The largest increase in cash used in investing activities was due to the company updating it's computer equipment and investing in software and production tooling for new products to be introduced in 2005.

At December 31, 2004 we had working capital resources available of \$3,457,107 (December 31, 2003 - \$2,142,840) and management feels that with our current cash on hand and cash flows from operations we have sufficient capital to carry out our business plan for 2005.

## **C. Research and Development**

Audio Business: QSound carries out sustained research and development activities in the audio business segment, allowing us to maintain our position as a world leader in audio enhancement with cutting edge products and technologies. In 2004 and 2003 we concentrated on development and refinement of our QVE and microQ scalable software engines, as well continuing our previous research and development activities of developing new, and refining and upgrading existing, audio synthesis and enhancement technologies. Our audio research and development costs were \$784,496 in 2004, \$588,410 in 2003 and \$519,137 in 2002. We also work jointly with our licensees and business partners to adapt and optimize our technologies for their products.

E-commerce Business: Research and development expenditures in our e-commerce business segment have steadily decreased, reflecting the satisfactory performance of our products. Research and development activities in 2004, 2003 and 2002 consisted mainly of upgrading our products, with expenditures of \$ 39,032 in 2004, \$50,757 in 2003, and \$124,387 in 2002.

Internet Telephony Business: In 2004 we had expenditures of \$138,812 and in 2003 \$195,166 for activities consisting of upgrading and adding functionalities to our software, and re-designing the internal layout and external features of our gateways. We also had expenditures in 2004 of \$561,192 in cash and stock options in development of new telephony products. These costs have all been capitalized.

### **Share Capital**

During the 2004 fiscal year, our share capital increased from 7,199,244 common shares with a total book value of \$43,801,245 to 8,404,085 common shares with a book value of \$45,792,526. The increase of 1,204,841 shares was a result of the exercise of stock options for cash of \$1,174,218 and the private placement of 347,826 shares for \$2,000,000.

Prior to January 1, 2003 we accounted for stock options to employees, directors and officers using the intrinsic value method. Under the intrinsic value method, any consideration paid on the exercise of stock options or purchase of stock is credited to share capital and no compensation expense is recognized.

The CICA Accounting Standard Board amended CICA Handbook, Section 3870, to require companies to account for all stock options using the fair value based method beginning January 1, 2004. We used the fair value based method for stock options granted to non-employees prior to January 1, 2003, and we elected to early adopt the new handbook section. As a result, effective January 1, 2003 all stock options are accounted for using the fair value based method. Under the fair value based method, the fair value of granted options is estimated on the day of the grant using the Black-Scholes option pricing model. Compensation cost is then expensed over the options' vesting period

Warrants are similarly accounted for using the fair value based method. During the year 75,000 common share purchase warrants were issued for services rendered and the fair value of the warrants determined to be \$380,862 was charged to share capital as financing costs. As additional 660,869 warrants were issued as part of the private placement and were allocated consideration of \$904,019.

As at December 31, 2004 the company had 1,157,500 options outstanding at exercise prices ranging from \$0.47 to \$4.56 and expiring at various times up to 2010. Further details on stock options outstanding can be found in Note 5 to the financial statements.

Subsequent to the year end and up to February 25, 2005, 3,500 stock options have been exercised for total consideration of \$9,685. This brings the total shares outstanding to 8,407,585 with a book value of \$46,761,026 and reduces the total options outstanding to 1,154,000.

As at December 31, 2004 the company had 1,235,869 common share purchase warrants outstanding. 714,130 of the warrants entitle the holder to acquire one common share of the Company for \$1.04 to \$9.12 per share. The remaining 521,739 warrants entitle the holder to acquire one common share and 40% of a warrant for one common share exercisable for \$9.12. Further details on warrants outstanding can be found in Note 4 to the financial statements.

### **Private Placement**

On December 16, 2004, we completed a private placement of our common shares, warrants to purchase common shares, and additional rights to purchase common shares and warrants, with one investor. We issued (i) 347,826 common shares at a purchase price of \$5.75 per share, (ii) Series A warrants to purchase 139,130 common shares at the exercise price of \$9.12 per share, and (iii) Series B Warrants to purchase (x) 521,739 common shares at the purchase price of \$5.75 per share, and (y) Series C warrants. The \$5.75 per share purchase price represented a discount to the then market price of \$7.05 per share. The Series C warrants are exercisable for 208,696 common shares at an exercise price of \$9.12 per share. The Series A warrants are exercisable from June 16, 2005 until December 16, 2009, the Series B warrants are exercisable during the period ending on the later of July 16, 2005 and one hundred and eighty days after the registration statement which we filed in connection with the financing has been declared effective, and the Series C warrants are exercisable until December 16, 2009.



We filed a short form registration statement with the SEC on January 6, 2005 registering for resale of the common shares issued at the closing of the transaction and 125% of the common shares issuable upon the exercise of the Series A warrants and the Series B warrants. If the registration statement is not declared effective within ninety days of the filing date, we have agreed to pay penalties equal to one percent in the first month, and two percent in each succeeding month, of the aggregate purchase price of the common shares issued at closing of the transaction until such time as the registration statement is declared effective.

We have the right to require the investor to exercise the Series B warrants during the thirty-day period immediately preceding the expiration date of the Series B Warrant provided that certain conditions are met, including that the volume weighted average price of our common shares for the five trading days preceding the date of our notice to the investor is greater than \$10.14 per share. Upon the exercise of the Series B warrants and no later than the twentieth day following the earlier of the exercise of all of the Series B warrants and the expiration date of the Series B Warrant, we have agreed to file a second registration statement with the SEC registering resales of the common shares issuable upon exercise of the Series C warrants. The second registration statement carries the same time periods for effectiveness and penalties as apply to this Registration Statement.

The Series A warrants, Series B warrants and Series C warrants are subject to customary anti-dilution adjustments. Until the sixtieth day after the registration statement has been declared effective, we have agreed to not conduct financings involving rights to register equity securities on or before December 17, 2005.

If the Series A or Series B warrants are exercised, we will receive the exercise price of the warrants which will be used for working capital. The maximum aggregate exercise price of the Series A and Series B warrants is \$4,268,864.85. Except as described above, the investor is under no obligation to exercise the warrants and there can be no assurance that the investor will do so.

#### **D. Trends**

**Audio Segment:** Revenues for the past two years have decreased due to the expiration of the hearing aid license for North America in February 2003 and the rest of the world in August 2004. To counteract the anticipated slowdown in audio algorithm business, in 2001 the Company began developing audio software solutions rather than algorithms. There is a higher technological barrier to entry in these development efforts, which helps limit competition to those who are funded and possess a wider technological knowledge base. With the development efforts complete the Company now expects to grow revenue by exploiting two specific markets, namely PC and mobile devices. Both of these markets are primed for feature driven “soft-audio” solutions.

The PC market has been shipping basic soft-audio solutions as the standard audio playback device in PCs for several years. There has been little effort to improve on this baseline, since audio is not a feature that sells units. For those that want more, OEMs typically offer extra audio features by way of an upsell to the consumer. To date, these upsells have been in the form of hardware-based soundcards. There is no technological reason why these products could not be offered as software. From a marketing perspective, there has been a reluctance to adopt software-based soundcards since there is a value perception issue. OEMs make good margins on the upsell business and believe that consumers will pay more for hardware-based products than the equivalent in software, which would require additional expense to educate the consumer. The industry is now focused on “Entertainment PCs”. These are targeted for the consumers’ living room, will have a wireless “10 ft interface”, and will attempt to replace traditional consumer electronic devices. Consumers are used to a better standard of audio from consumer electronic devices than from their PCs. The PC is inherently at a disadvantage architecturally when compared to consumer electronic devices but the Company’s management believes there is a growing trend to improve the platform and add more features to the base solution.

The growth in mobile device shipments in the past few years has been staggering. Audio is an important component of these devices. The audio systems shipped in mobile devices today are basic, reminiscent of solutions shipped in PCs ten years ago. The growing trend is towards “smart” devices running on operating systems provided by either Microsoft or Symbian . In 2004, there were less than 16 million of these units shipped. This is expected to at least double in 2005. Fully featured software audio solutions are expected to be a key component of these devices.

The Company still licenses audio algorithms to the consumer electronics industry. This is a very competitive market. In the past few years, several larger corporations with consumer brand awareness have entered this arena. The popularity of digital devices, such as the DVD player, has attracted these companies. Countering this increased competition is the shift in manufacturing from Japan and Korea to China and the growing demand in emerging nations for these products. Typically, the Chinese manufacturers do not want to pay the royalties that companies with brand awareness demand,

especially in markets where the brand is not as entrenched as in traditional markets. Consequently, there is opportunity for the smaller companies to supply audio algorithms but competition is all price based.

Internet Telephony Segment: Over the past year, the media has presented Voice over IP to consumers and businesses as a more mature technology whose time has come. This trend bodes well for this industry as a whole as it implies an increase in user acceptance of the technology. Since we are focused on solutions for small businesses only, further analysis is restricted to that segment.

In the small business market, the industry is still marketing first generation devices. These typically are adjuncts to existing installed equipment, offering toll bypass and PBX extension. The smaller suppliers service this segment and a typical installation would have 30 or less telephone lines per office. As with all first generation products in a new category, there is a diversity of approach and a lack of standardization that restricts continued growth for these products. In fact, of all the market segments, this is currently the least serviced, as the larger suppliers have focused on solutions for the enterprise and the growing number of service providers.

It is expected that second generation products will offer much more. Features found in more expensive systems targeted for medium and large enterprises will be incorporated into so called “low-density” solutions. This will be possible since suppliers will have the ability to leverage existing customer networks and exploit the flexibility of complete digital environment. Solutions will be more flexible, modular and scalable. Additionally, suppliers will be able to offer these feature driven solutions at affordable prices for the small business market segment.

E-commerce Business Segment: Many e-commerce service providers have disappeared in the past three years. A lot have been acquired, as consolidation has become the principal method for acquiring new customers. Organic growth has proved difficult for most service providers as the fallout from the “dot com” implosion lingers on. Many Internet merchants have become disillusioned and given up on their dreams of riches. Those that remain are looking for consistent and stable service; technology is irrelevant. The merchants tend to gravitate towards the larger providers. The net effect for small providers is therefore a net loss of merchants annually.

#### **E. Off-Balance Sheet Arrangements**

We are not a party to and we do not have any off-balance sheet arrangements.

#### **F. Tabular Disclosure of Contractual Obligations**

	more	less			
	than 1	than 1	1-3	3-5	than
Contractual Obligations	year	year	years	years	
years					
\$	\$	\$	\$	\$	
Long-term Debt Obligations	-	-	-	-	-
Capital (Finance) Lease Obligations	-	-	-	-	-
Operating Lease Obligations	323,518	96,564	161,746	65,208	-
Purchase Obligations	-	-	-	-	-
Other Long-Term Liabilities	-	-	-	-	-

#### **G. Safe Harbour**

This document and other documents filed by the company with the SEC contain certain forward-looking statements with respect to the business of the company, including prospective financing arrangements. These forward-looking statements are subject to certain risks and uncertainties, including those mentioned above, which may cause actual results to differ significantly from these forward-looking statement.

#### **ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

## **A. Directors and Senior Management**

Mr. James Bonfiglio resigned from the board of directors on November 24, 2004 and Mr. Francis Munoz, Executive Vice President who acted as engineering manager responsible for project management, personnel assignment and customer technical interface, resigned on August 31, 2004. Mr. Louis W. MacEachern was appointed as a member and Chairman of the board of directors on January 17, 2005.

The following table sets forth certain information with respect to our executive officers and directors as of March 15, 2005. All positions indicated are with QSound Labs, Inc. only.

<u>Name</u>	<u>Position</u>
David J. Gallagher	President, Chief Executive Officer, Director
Robert Starr	Vice President – Business Development
Joanna Varvos	Corporate Secretary
Doug Drury	Controller
Louis W. MacEachern	Director, Chairman of the Board
Stanley E. MacDougall	Director
M. Patty Chakour	Director

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

Robert Starr joined QSound as Vice President-Business Development in June, 2002. Mr. Starr has over twenty-five years of high tech sales, marketing, and business development experience, including eighteen years in audio-related products. Prior to joining the company Mr. Starr was Director of Business Development at Beatnik Audio where he was responsible for licensing audio software into mobile phones, PDAs, and set top boxes. Prior to that, Mr. Starr was Vice President of Sales and Marketing at Staccato Systems, a start-up producing audio software for the PC and game developers, that was purchased by Analog Devices Inc. From 1986 to 1997 Mr. Starr was a member of and managed the Sales and Marketing division of Yamaha Systems Technology where, as the first American employee, he was instrumental in establishing Yamaha semiconductors and software as the defacto standard for PC sound cards. Mr. Starr has a BS.E.E. from Oklahoma State University and an M.B.A. from SIU Edwardsville.

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 twenty 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.

Louis W. MacEachern was appointed to act as a member and as Chairman of the board of directors on January 17, 2005. Mr. MacEachern has over 56 years of business experience and is the sole owner of Fortune Industries Ltd., a business management consulting firm which formerly held the majority of shares in the Servpro/Dalco Group of companies, of which he was founder and chairman. This group is involved in cleaning, salvage, construction and real estate. In addition Mr. MacEachern is a director of Elite Technical Inc., Mundoro Mining Inc., Nicer Canada Corp., PetroKazakhstan Inc., Regal Energy Corp. and Wellpoint Systems Inc.

Stanley E. McDougall was appointed to the board of directors on March 1, 2004. Mr. McDougall is Chairman of Western Crating International Ltd., a Calgary, Alberta based export packaging company. Mr. McDougall has thirty-six years of business experience in situations ranging from start-up companies to large multi-plant operations, and including leading operations, acquisitions, financings, restructuring and dispositions. Mr. McDougall is a member of the board of directors of Richer Systems Group, a private software company serving the international transportation and leasing industry, and Eagle Plains Resources Ltd., a junior mining and exploration company. Mr. McDougall has a B.Comm. (Honours) from the University of Saskatchewan.

M. Patty Chakour was appointed to the board of directors on March 10, 2004. Ms. Chakour is Controller of T.P Racing L.L.P., a \$350 million company that owns and operates Turf Paradise, a Phoenix, Arizona based horse racing track that includes an off-track betting network, and dining and entertainment facilities. Ms. Chakour has over twenty years experience in accounting including S.E.C. reporting, audits, budget preparation, internal accounting control implementation, consolidations, international operations and tax reporting. Ms. Chakour has a B.B.A in accounting from the University of Iowa and a C.P.A. certification in Iowa and Arizona.

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

## **B. Compensation**

Remuneration paid or payable to our directors and executive officers during fiscal year 2004 was an aggregate \$496,446 for compensation paid to Messrs. Gallagher, Drury, Munoz and Starr, and Ms. Varvos. No cash or other bonuses were paid to executive officers in 2004. Mr. Gallagher's salary for 2004 was \$184,432. 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.

Mr. Gallagher participates in a registered individual pension plan that was put in place in 2002 to resolve an outstanding contingency relating to his employment contract. In 2004 \$14,822 Cdn. was contributed to the plan for fiscal 2004. In 2003 \$56,301 Cdn. for past service and \$11,692 Cdn. for fiscal 2002, and \$11,692 for fiscal 2003, was contributed to the plan.

The following table gives information concerning stock options granted to officers during 2004.

<b>Name</b>	<b>Securities Under Options Granted</b>	<b>Exercise or Base Price</b>	<b>Market Value of Securities Underlying Options on Date of Grant</b>	<b>Expiration Date</b>
Joanna Varvos	50,000 <sup>1</sup>	\$2.05	\$2.05	March 10, 2009
Doug Drury	25,000 <sup>2</sup>	\$2.05	\$2.05	March 10, 2009

<sup>1</sup> These options are subject to shareholder approval, which we will seek to obtain at the annual meeting of shareholders scheduled to take place on April 29, 2005. 25,000 of these options vest upon shareholder approval and 25,000 options vest on July 1, 2005.

<sup>2</sup> 12,500 of these options are subject to shareholder approval, which we will seek to obtain at the annual meeting of shareholders scheduled to take place on April 29, 2005. 12,500 of these options have vested and 12,500 options vest on July 1, 2005.

The following table gives information concerning stock options granted to directors during 2004.

<b>Name</b>	<b>Securities Under Options Granted</b>	<b>Exercise or Base Price</b>	<b>Market Value of Securities Underlying Options on Date of Grant</b>	<b>Expiration Date</b>
James R. Bonfiglio	25,000	\$1.88	\$1.88	March 10, 2009
Stanley E. McDougall	25,000	\$1.88	\$1.88	March 10, 2009
M. Patty Chakour	25,000	\$1.88	\$1.88	March 10, 2009

### **C. Board Practices**

During 2004, the members of our board of directors were David J. Gallagher, James R. Bonfiglio until his resignation in November, and Stanley E. McDougall and M. Patty Chakour, both of whom joined the Board in March. 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: an audit committee and a compensation committee. Members of these committees are independent of management and qualify as independent under all relevant Canadian securities, SEC and Nasdaq Stock Market rules and regulations. These independent directors hold regularly scheduled meetings at which only independent directors are present. At the date of this annual report the members of these committees are Louis W. MacEachern, Stanley E. McDougall and M. Patty Chakour.

#### **Audit Committee**

All audit committee members must be able to read and understand fundamental financial statements and at least one member of the audit committee must have a background in financial reporting, accounting or auditing which results in the member's financial sophistication.

The primary duties and responsibilities of the audit committee are to:

- appoint, compensate and oversee our external auditors;
- review and discuss with our external auditors their independence;
- review and consider with our external auditors significant accounting principles and practices, alternate treatments of financial information and all material written communications between our external auditor and management;
- review our financial statements and disclosures with management and our external auditors;
- meet at least once a year in separate sessions with management, the internal auditor and our external auditors;
- review, monitor and control our information and reporting systems and financial risk exposures; and
- establish procedures for treatment of complaints regarding accounting and auditing matters

#### **Compensation Committee**

The primary duties and responsibilities of the compensation committee are:

- development of guidelines for compensation of officers and key executives and evaluation of compensation data for companies that are similar to us in size and scope of business;
- review and approval of corporate goals and objectives relevant to CEO compensation, evaluation of the CEO's performance in light of these goals and objectives, and determination of the CEO's compensation based on this evaluation;
- annual review and approval of the compensation of officers and other key executives of the Company; preparation of a report to shareholders for inclusion in our information circular relating to the annual shareholder meetings; and
- annual reassessment of the adequacy of the charter and recommendation of any proposed changes to the board.

We do not have any service contracts with directors, other than the employment contract with Mr. David J. Gallagher. Mr. Gallagher's contract provides for discretionary bonuses if approved by the compensation committee, and participation in any pension and profit sharing plan established from time to time by the Board. If terminated without cause, if Mr. Gallagher's employment contract is not renewed for at least one year following expiration, if there is a change in control of the Company and Mr. Gallagher elects not to continue his employment, and in the event of death or disability Mr. Gallagher is entitled to a lump sum payment equal to the greater of salary for the unexpired term of the employment agreement or one year. A lump sum contribution to fund the Mr. Gallagher's pension plan is also payable in the foregoing circumstances and in the event of retirement between the ages of 60 and 65. Mr. Gallagher's employment contract is subject to renewal on September 30, 2005. 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, 2004 we had 28 employees and persons engaged by contract on a fulltime basis, of whom 11 were in research, product development and technical support, 8 were in marketing and sales, 3 were in customer support and 6 were in administrative positions. Two of these employees were located in the United States and the remainder were located in Canada. At December 31, 2003 we had 31 employees and persons engaged by contract on a fulltime basis, of whom 9 were in research, product development and technical support, 11 were in marketing and sales, 5 were in customer support and 6 were in administrative positions. Six of these employees were located in the United States and the remainder were located in Canada. At December 31, 2002 we had 31 employees and persons engaged by contract on a fulltime basis, of whom 12 were in research, product development and technical support, 8 were in marketing and sales, 5 were in customer support and 6 were in administrative positions.

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 March 15, 2005.

##### Shares

<b><u>Name and Position</u></b>	<b><u>Common Shares Owned or Controlled</u></b>	<b><u>Percent of Class</u></b>
David J. Gallagher President and CEO and Director	531,000 <sup>1</sup>	6.3%
Robert Starr Vice President – Business Development	211,410 <sup>2</sup>	2.5%
Joanna Varvos Corporate Secretary	76,000 <sup>3</sup>	*
Doug Drury Controller	20,500 <sup>4</sup>	*
Louis W. MacEachern Chairman of the Board and Director	0	*
Stanley E. McDougall Director	25,000 <sup>5</sup>	*
M. Patty Chakour Director	25,000 <sup>5</sup>	*

<sup>1</sup> Includes options to purchase 519,000 common shares.

<sup>2</sup> Includes options to purchase 190,000 common shares.

<sup>3</sup> Includes options to purchase 76,000 common shares.

<sup>4</sup> Includes options to purchase 19,500 common shares.

<sup>5</sup> Includes options to purchase 25,000 common shares.

\* represents less than 1%

##### Options

The following tables show information as to options granted to directors and executive officers as of March 15, 2005.

<b><u>Name and Position</u></b>	<b><u>Options</u></b>	<b><u>Exercise Price</u></b>	<b><u>Expiry Date</u></b>
David J. Gallagher President and CEO and Director	253,190 175,810 100,000	\$1.04 \$0.47 \$1.65	July 22, 2006 December 2, 2006 December 30, 2007

Robert Starr Vice President – Business Development	190,000 <sup>1</sup>	\$0.62	June 30, 2008 to July 17, 2012
Joanna Varvos Corporate Secretary	25,467 50,533 50,000 <sup>2</sup>	\$1.04 \$0.47 \$2.05	July 22, 2006 December 2, 2006 April 1, 2009
Doug Drury Controller	5,536 1,464 25,000 <sup>3</sup>	\$1.04 \$0.47 \$2.05	July 22, 2006 December 2, 2006 April 1, 2009
Stanley E. McDougall Director	25,000	\$1.88	March 10, 2009
M. Patty Chakour Director	25,000	\$1.88	March 10, 2009

<sup>1</sup> 167,776 of these options are vested and the remaining options vest at the rate of 5,555 options per month.

<sup>2</sup> These options are subject to approval by the shareholders of the Company, which we will seek to obtain at the Annual Meeting of Shareholders scheduled to take place on April 29, 2005.

<sup>3</sup> 12,500 of these options are subject to approval by the shareholders of the Company, which we will seek to obtain at the Annual and Special Meeting of Shareholders scheduled to take place on April 29, 2005.

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 (“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 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 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 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 Plan. Pursuant to The Nasdaq Stock Market, all grants of options made by the Company outside of the Plan to officers, directors, employees or consultants require the approval of shareholders of the Company.

## **ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

### **A. Major Shareholders**

The following table discloses information regarding the beneficial ownership of our common shares as of March 15, 2005, by each person or entity known to own beneficially more than 5% of our outstanding common shares based on information provided to us by the holders or disclosed in public filings with the Securities and Exchange Commission

<b>Name</b>	<b>Number of Common Shares Beneficially Owned</b>	<b>Percentage of Outstanding Common Shares<sup>1</sup></b>
Philips Electronics North America Corporation	500,000 <sup>2</sup>	5.9%
Capital Ventures International <sup>3</sup>	869,565 <sup>4</sup>	9.9% <sup>5</sup>

Robert Sussman<sup>6</sup>

493,000

5.8%

1 The percentage of outstanding ordinary shares is based on 8,437,535 common shares outstanding as of March 15, 2005.

2 These shares are issuable to Philips upon the exercise of existing warrants, exercisable at the exercise price of \$1.04 per share until March 24, 2007.

3 Heights Capital Management, Inc. is the investment adviser to Capital Ventures International and, as such, may exercise voting and dispositive power over these shares. Martin Kobinger, in his capacity as Investment Manger of Heights Capital Management, Inc., may also be deemed to have investment discretion and voting power over the securities held by CVI. Mr. Kobinger disclaims any such beneficial ownership of the securities.

4 Shares beneficially owned include 521,739 common shares issuable upon the exercise of presently exercisable warrants. See "Item 5—Liquidity and Capital Resources— Private placement".

5 Warrant holders are contractually limited from exercising any warrants, or disposing of any portion of such warrants, to the extent that the exercise or disposition would result in the holder or any of its affiliates together beneficially owning more than 9.9% of the outstanding common shares.

6 Robert Sussman and Robynn Sussman jointly own these shares in part, and Bentley Capital Management, Inc. owns these shares in part, and these individuals and entity may exercise shared voting and dispositive power over these shares. This information is based on Mr. Sussmans's Form 13-G filing as of February 7, 2005.

At March 15, 2005 we had 8,437,535 common shares issued and outstanding. At such date, there were 380 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 2004 except for compensation of executive officers as employees or consultants. (See "Compensation" in Item 6. B of this report).

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 2004.

### **C. Interests of Experts and Counsel**

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### **A. Consolidated Statements and Other Financial Information**

See Item 17.

#### **Export Sales**

In the past three fiscal years we have derived over 97% of our revenues from export sales made to customers outside Canada. In 2004 66% of our export sales were made to the United States, 30% were made to Asian companies located in Japan, Hong Kong, Taiwan, Korea and China, and a further 4% were made to other areas. In 2003 76% of our export sales were made to the United States, 23% were made to Asian companies located in Japan, Hong Kong, and Taiwan, and a further 1% were made to other areas. In 2002, 86% of our export sales were made to the United States, and a further 14% were made to Asian companies located in Japan, Hong Kong and Taiwan.

#### **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.

#### **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 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.

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

<u>Fiscal Year</u>	<u>High</u>	<u>Low</u>
2004	8.40	1.52
2003	2.65	1.01
2002	2.28	0.53
2001	4.87	0.42
2000	21.50	1.37

The high and low market prices for each of the four quarters of 2004 and 2003:

<u>Quarter Ending</u>		<u>High</u>	<u>Low</u>
December	2004	8.40	4.55
September	2004	6.75	3.73
June	2004	7.54	1.91
March	2004	2.75	1.52
December	2003	2.65	1.08
September	2003	2.00	1.01
June	2003	1.80	1.20
March	2003	2.14	1.03

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

<u>Month</u>		<u>High</u>	<u>Low</u>
February	2005	7.80	6.57
January	2005	8.47	6.35
December	2004	8.40	6.55
November	2004	8.20	6.31
October	2004	7.70	4.55
September	2004	4.83	4.10

#### **B. Plan of Distribution**

Not Applicable

#### **C. Markets**

Our shares trade (since January, 1989) on The Nasdaq SmallCap Market under the symbol QSND (formerly QSNDP).

#### **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.

#### **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 report there are 8,437,535 common shares, and no preferred shares, outstanding.

#### **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 dividend, before they are paid to common shareholders.

#### **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 who voted on the resolution, or signed by all shareholders entitled to vote on that 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. 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.

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 holding or representing by proxy at least five percent of the shares entitled to vote at the meeting must be present. We have received an exemption from The Nasdaq Stock Market, stating that we are not required to comply with Nasdaq's quorum requirement which calls for a quorum of not less than thirty-three and one-third percent of the shares entitled to vote at the meeting.

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 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**

The following is a summary of the anticipated material U.S. federal income tax consequences to a U.S. Holder (as defined below) arising from and relating to the acquisition, ownership, and disposition of common shares of QSound (“Common Shares”).

This summary is does not purport to be a complete analysis or listing of all potential U.S. federal income tax consequences that may apply to a U.S. Holder as a result of the acquisition, ownership, and disposition of Common Shares. In addition, this summary does not take into account the individual facts and circumstances of any particular U.S. Holder that may affect the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares. Accordingly, this summary is not intended to be, and should not be construed as, legal or U.S. federal income tax advice with respect to any U.S. Holder. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. federal, U.S. state and local, and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares.

Scope of this Disclosure

### Authorities

This summary is based on 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 U.S. court decisions that are currently applicable. Any of the authorities on which this summary is based could be changed in a material and adverse manner at any time, and any such change could be applied on a retroactive basis. This summary does not discuss the potential effects, whether adverse or beneficial, of any proposed legislation that, if enacted, could be applied on a retroactive basis.

### U.S. Holders

For purposes of this summary, a “U.S. Holder” is a beneficial owner of Common Shares that, for U.S. federal income tax purposes, is (a) an individual who is a citizen or resident of the U.S., (b) a corporation, or other entity classified as a corporation for U.S. federal income tax purposes, that is created or organized in or under the laws of the U.S. or any state in the U.S., including the District of Columbia, (c) an estate if the income of such estate is subject to U.S. federal income tax regardless of the source of such income, or (d) a trust if (i) such trust has validly elected to be treated as a U.S. person for U.S. federal income tax purposes or (ii) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of such trust.

### Non-U.S. Holders

A “non-U.S. Holder” is a beneficial owner of Common Shares other than a U.S. Holder. This summary does not address the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares to non-U.S. Holders. Accordingly, a non-U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. federal, U.S. state and local, and foreign tax consequences (including the potential application of any tax treaties) of the acquisition, ownership, and disposition of Common Shares.

### U.S. Holders Subject to Special U.S. Federal Income Tax Rules Not Addressed

This summary does not address the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares to U.S. Holders that are subject to special provisions under the Code, including the following U.S. Holders: (a) U.S. Holders that are tax-exempt organizations, qualified retirement plans, individual retirement accounts, or other tax-deferred accounts; (b) U.S. Holders that are financial institutions, insurance companies, real estate investment trusts, or regulated investment companies or that are broker-dealers or dealers in securities; (c) U.S. Holders that have a “functional currency” other than the U.S. dollar; (d) U.S. Holders that are subject to the alternative minimum tax provisions of the Code; (e) U.S. Holders that own Common Shares as part of a straddle, hedging transaction, conversion transaction, constructive sale, or other arrangement involving more than one position; (f) U.S. Holders that acquired Common Shares through the exercise of employee stock options or otherwise as compensation for services; (g) U.S. Holders that are partners of partnerships or that are owners of other entities classified as partnerships or “pass-through” entities for U.S. federal income tax purposes; and (h) U.S. Holders that hold Common Shares other than as a capital asset within the meaning of Section 1221 of the Code. U.S. Holders that are subject to special provisions under the Code,

including U.S. Holders described immediately above, should consult their own financial advisor, legal counsel or accountant regarding the U.S. federal, U.S. state and local, and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares.

#### Tax Consequences Other than U.S. Federal Income Tax Consequences Not Addressed

This summary does not address the U.S. state and local or foreign tax consequences to U.S. Holders of the acquisition, ownership, and disposition of Common Shares. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the U.S. state and local and foreign tax consequences of the acquisition, ownership, and disposition of Common Shares. (See “Taxation—Canadian Federal Income Tax Consequences” above).

#### Treaty Application to Certain Individual U.S. Holder

Individual U.S. Holders who do not maintain a substantial presence, permanent home, or habitual abode in the U.S., or whose personal and economic relations are not closer to the U.S. than to any other country (other than Canada), may be unable to benefit from the provisions of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed September 26, 1980, as amended (the “Canada-U.S. Tax Convention”). An individual U.S. Holder described immediately above should consult its own financial advisor, legal counsel, or accountant regarding the availability of benefits under the Canada-U.S. Tax Convention.

#### U.S. Federal Income Tax Consequences of the Acquisition, Ownership, and Disposition of Common Shares

##### Distributions on Common Shares

###### *General Taxation of Distributions*

A U.S. Holder that receives a distribution, including a constructive distribution, with respect to the Common Shares will be required to include the amount of such distribution in gross income as a dividend (without reduction for any Canadian income tax withheld from such distribution) to the extent of the current or accumulated “earnings and profits” of QSound. To the extent that a distribution exceeds the current and accumulated “earnings and profits” of QSound, such distribution will be treated (a) first, as a tax-free return of capital to the extent of a U.S. Holder’s tax basis in the Common Shares and, (b) thereafter, as gain from the sale or exchange of such Common Shares. (See more detailed discussion at “Disposition of Common Shares” below).

###### *Reduced Tax Rates for Certain Dividends*

For taxable years beginning after December 31, 2002 and before January 1, 2009, a dividend paid by QSound generally will be taxed at the preferential tax rates applicable to long-term capital gains if (a) QSound is a “qualified foreign corporation” (as defined below), (b) the U.S. Holder receiving such dividend is an individual, estate, or trust, and (c) such dividend is paid on Common Shares that have been held by such U.S. Holder for at least 61 days during the 121-day period beginning 60 days before the “ex-dividend date” (i.e., the first date that a purchaser of such Common Shares will not be entitled to receive such dividend).

QSound generally will be a “qualified foreign corporation” under Section 1(h)(11) of the Code (a “QFC”) if (a) QSound is incorporated in a possession of the U.S., (b) QSound is eligible for the benefits of the Canada-U.S. Tax Convention, or (c) the Common Shares are readily tradable on an established securities market in the U.S. However, even if QSound satisfies one or more of such requirements, QSound will not be treated as a QFC if QSound is a “foreign personal holding company,” a “foreign investment company,” or a “passive foreign investment company” (each as defined below) for the taxable year during which QSound pays a dividend or for the preceding taxable year.

No assurance can be given that QSound will be a QFC because, although QSound believes that it is not a “passive foreign investment company,” there can be no assurance that the IRS will not challenge the determination made by QSound concerning its “passive foreign investment company” status or that QSound will not be a “passive foreign investment company” for the current or any future taxable year (See more detailed discussion at “Additional Rules that May Apply to U.S. Holders—Passive Foreign Investment Company” below). If QSound is not a QFC, a dividend paid by QSound to a U.S. Holder that is an individual, estate, or trust generally will be taxed at ordinary income tax rates (and not at the preferential tax rates applicable to long-term capital gains). The dividend rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the dividend rules.

### *Distributions Paid in Foreign Currency*

The amount of a distribution paid in foreign currency generally will be equal to the U.S. dollar value, based on the exchange rate, of such distribution on the date of receipt. A U.S. Holder that does not convert foreign currency received as a distribution into U.S. dollars on the date of receipt generally will have a tax basis in such foreign currency equal to the U.S. dollar value of such foreign currency on the date of receipt. Such a U.S. Holder generally will recognize ordinary income or loss on the subsequent sale or other taxable disposition of such foreign currency (including an exchange for U.S. dollars). However, an individual U.S. Holder whose realized gain does not exceed \$200 will not recognize such 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 or as an expense for the production of income.

### *Dividends Received Deduction*

Dividends paid on the Common Shares generally will not be eligible for the “dividends received deduction.” The availability of the dividends received deduction is subject to complex limitations that are beyond the scope of this discussion, and a U.S. Holder that is a corporation should consult its own financial advisor, legal counsel, or accountant regarding the dividends received deduction.

### Disposition of Common Shares

A U.S. Holder will recognize gain or loss on the sale or other taxable disposition of Common Shares equal to the difference, if any, between (a) the amount of cash plus the fair market value of any property received and (b) such U.S. Holder’s tax basis in the Common Shares sold or otherwise disposed of. Any such gain or loss generally will be capital gain or loss, which will be long-term capital gain or loss if the Common Shares are held for more than one year.

Preferential tax rates apply to long-term capital gains of a U.S. Holder that is an individual, estate, or trust. There are currently no preferential tax rates for long-term capital gains of a U.S. Holder that is a corporation. Deductions for capital losses and net capital losses are subject to complex limitations. For a U.S. Holder that is an individual, estate, or trust, capital losses may be used to offset capital gains and up to \$3,000 of ordinary income. An unused capital loss of a U.S. Holder that is an individual, estate, or trust generally may be carried forward to subsequent taxable years, until such net capital loss is exhausted. For a U.S. Holder that is a corporation, capital losses may be used to offset capital gains, and an unused capital loss generally may be carried back three years and carried forward five years from the year in which such net capital loss is recognized.

### Foreign Tax Credit

A U.S. Holder who pays (whether directly or through withholding) Canadian or other foreign income tax with respect to the Common Shares generally will be entitled, at the election of such U.S. Holder, to receive either a deduction or a credit for such Canadian or other foreign tax paid. Generally, a credit will reduce a U.S. Holder’s U.S. federal income tax liability on a dollar-for-dollar basis, whereas a deduction will reduce a U.S. Holder’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 (whether directly or through withholding) by a U.S. Holder during a year.

Complex limitations apply to the foreign tax credit, including the general limitation that the credit cannot exceed the proportionate share of a U.S. Holder’s U.S. federal income tax liability that such U.S. Holder’s “foreign source” taxable income bears to such U.S. Holder’s worldwide taxable income. In applying this limitation, a U.S. Holder’s various items of income and deduction must be classified, under complex rules, as either “foreign source” or “U.S. source.” In addition, this limitation is calculated separately with respect to specific categories of income (including “passive income,” “high withholding tax interest,” “financial services income,” “shipping income,” and certain other categories of income). Dividends paid by QSound generally will constitute “foreign source” income and generally will be classified as “passive income” or, in the case of certain U.S. Holders, “financial services income.” In addition, a U.S. Holder that is a corporation and that owns 10% or more of the voting stock of QSound may, subject to complex limitations, be entitled to an “indirect” foreign tax credit under Section 902 of the Code with respect to dividends paid by QSound. The foreign tax credit rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the foreign tax credit rules.

### Information Reporting; Backup Withholding

Payments made within the U.S. of dividends on, and proceeds arising from the sale or other taxable disposition of, Common Shares generally will be subject to information reporting and backup withholding, at the rate of 28%, if a U.S. Holder (a) fails to furnish such U.S. Holder's correct U.S. taxpayer identification number (generally on Form W-9), (b) furnishes an incorrect U.S. taxpayer identification number, (c) is notified by the IRS that such U.S. Holder has previously failed to properly report items subject to backup withholding, or (d) fails to certify, under penalty of perjury, that such U.S. Holder has furnished its correct U.S. taxpayer identification number and that the IRS has not notified such U.S. Holder that it is subject to backup withholding. However, U.S. Holders that are corporations generally are excluded from these information reporting and backup withholding rules. Any amounts withheld under the U.S. backup withholding tax rules will be allowed as a credit against a U.S. Holder's U.S. federal income tax liability, if any, or will be refunded, if such U.S. Holder furnishes required information to the IRS. Each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the information reporting and backup withholding rules.

#### Additional Rules that May Apply to U.S. Holders

If QSound is a "foreign personal holding company," a "foreign investment company," a "controlled foreign corporation," or a "passive foreign investment company" (each as defined below), the preceding sections of this summary may not describe the U.S. federal income tax consequences to U.S. Holders of the acquisition, ownership, and disposition of Common Shares.

#### Foreign Personal Holding Company

QSound generally will be a "foreign personal holding company" under Section 552 of the Code (a "FPHC") if (a) at any time during a taxable year, more than 50% of the total voting power or the total value of the outstanding shares of QSound is owned, directly or indirectly, by five or fewer individuals who are citizens or residents of the U.S. and (b) 60% (or 50% in certain cases) or more of the gross income of QSound for such taxable year is foreign personal holding company income. "Foreign personal holding company 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.

If QSound is a FPHC, a U.S. Holder generally will be required to include in gross income such U.S. Holder's allocable portion of the "undistributed foreign personal holding company income" (as defined in Section 556 of the Code) of QSound. QSound does not believe that it has previously been, or currently is, a FPHC. However, there can be no assurance that QSound will not be a FPHC for the current or any future taxable year.

#### Foreign Investment Company

QSound generally will be a "foreign investment company" under Section 1246 of the Code (a "FIC") if (a) 50% or more of the total voting power or the total value of the outstanding shares of QSound is owned, directly or indirectly, by citizens or residents of the U.S., domestic partnerships, domestic corporations, domestic estates, or domestic trusts (each as defined in Section 7701(a)(30) of the Code) and (b) QSound is engaged primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest in securities or commodities.

If QSound is a FIC, all or part of any gain recognized by a U.S. Holder on the sale or other taxable disposition of Common Shares will be treated as ordinary income rather than as capital gain. QSound does not believe that it has previously been, or currently is, a FIC. However, there can be no assurance that QSound will not be a FIC for the current or any future taxable year.

#### Controlled Foreign Corporation

QSound generally will be a "controlled foreign corporation" under Section 957 of the Code (a "CFC") if more than 50% of the total voting power or the total value of the outstanding shares of QSound is owned, directly or indirectly, by citizens or residents of the U.S., domestic partnerships, domestic corporations, domestic estates, or domestic trusts (each as defined in Section 7701(a)(30) of the Code), each of which own, directly or indirectly, 10% or more of the total voting power of the outstanding shares of QSound (a "10% Shareholder").

If QSound is a CFC, a 10% Shareholder generally will be subject to current U.S. federal income tax with respect to (a) such 10% Shareholder's pro rata share of the "subpart F income" (as defined in Section 952 of the Code) of QSound and (b) such 10% Shareholder's pro rata share of the earnings of QSound invested in "United States property" (as defined in Section 956 of the Code). In addition, under Section 1248 of the Code, any gain recognized on the sale or other taxable disposition of Common Shares by a U.S. Holder that was a 10% Shareholder at any time during the five-year period

ending with such sale or other taxable disposition generally will be treated as a dividend to the extent of the “earnings and profits” of QSound that are attributable to such Common Shares. If QSound is both a CFC and a “passive foreign investment company” (as defined below), QSound generally will be treated as a CFC (and not as a “passive foreign investment company”) with respect to any 10% Shareholder.

QSound does not believe that it has previously been, or currently is, a CFC. However, there can be no assurance that QSound will not be a CFC for the current or any future taxable year. The CFC rules are complex, and each U.S. Holder should consult its own financial advisor, legal counsel, or accountant regarding the CFC rules and how the CFC rules may affect the U.S. federal income tax consequences of the acquisition, ownership, and disposition of Common Shares.

#### Passive Foreign Investment Company

QSound generally will be a “passive foreign investment company” under Section 1297 of the Code (a “PFIC”) if, in a taxable year, (a) 75% or more of the gross income of QSound for such taxable year is passive income or (b) 50% or more of the assets held by QSound either produce passive income or are held for the production of passive income, based on the fair market value of such assets (or on the adjusted tax basis of such assets, if QSound is not publicly traded and either is a “controlled foreign corporation” or makes an election). “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 arising from the sale of commodities generally are excluded from passive income if (a) a foreign corporation holds the commodities directly (and not through an agent or independent contractor) as inventory or similar property or as dealer property, (b) such foreign corporation incurs substantial expenses related to the production, processing, transportation, handling, or storage of the commodities, and (c) gross receipts from sales of commodities that satisfy the requirements of clauses (a) and (b) constitute at least 85% of the total gross receipts of such foreign corporation.

For purposes of the PFIC income test and assets test described above, if QSound owns, directly or indirectly, 25% or more of the total value of the outstanding shares of another foreign corporation, QSound will be treated as if it (a) held a proportionate share of the assets of such other foreign corporation and (b) received directly its proportionate share of the income of such other foreign corporation. In addition, for purposes of the PFIC income test and asset test described above, “passive income” does not include any interest, dividends, rents, or royalties that are received or accrued by QSound from a “related person” (as defined in Section 954(d)(3) of the Code), to the extent such items are properly allocable to the income of such related person that is not passive income.

If QSound is a PFIC, the U.S. federal income tax consequences to a U.S. Holder of the acquisition, ownership, and disposition of Common Shares will depend on whether such U.S. Holder makes an election to treat QSound as a “qualified electing fund” or “QEF” under Section 1295 of the Code (a “QEF Election”) or a mark-to-market election under Section 1296 of the Code (a “Mark-to-Market Election”). A U.S. Holder that does not make either a QEF Election or a Mark-to-Market Election will be referred to in this summary as a “Non-Electing U.S. Holder.” A Non-Electing U.S. Holder generally will be required to

Under Section 1291 of the Code, any gain recognized on the sale or other taxable disposition of Common Shares, and any “excess distribution” (as defined in Section 1291(b) of the Code) paid on the Common Shares, must be ratably allocated to each day in a Non-Electing U.S. Holder’s holding period for the Common Shares. The amount of any such gain or excess distribution allocated to prior years of such Non-Electing U.S. Holder’s holding period for the Common Shares generally will be subject to U.S. federal income tax at the highest tax applicable to ordinary income in each such prior year. A Non-Electing U.S. Holder will be required to pay interest on the resulting tax liability for each such prior year, calculated as if such tax liability had been due in each such prior year.

A U.S. Holder that makes a QEF Election generally will not be subject to the rules of Section 1291 of the Code discussed above. However, a U.S. Holder that makes a QEF Election generally will be subject to U.S. federal income tax on such U.S. Holder’s pro rata share of (a) the “net capital gain” of QSound, which will be taxed as long-term capital gain to such U.S. Holder, and (b) and the “ordinary earnings” of QSound, which will be taxed as ordinary income to such U.S. Holder. A U.S. Holder that makes a QEF Election will be subject to U.S. federal income tax on such amounts for each taxable year in which QSound is a PFIC, regardless of whether such amounts are actually distributed to such U.S. Holder by QSound.

A U.S. Holder that makes a Mark-to-Market Election generally will not be subject to the rules of Section 1291 of the Code discussed above. A U.S. Holder may make a Mark-to-Market Election only if the Common Shares are “marketable stock” (as defined in Section 1296(e) of the Code). A U.S. Holder that makes a Mark-to-Market Election will include in



gross income, for each taxable year in which QSound is a PFIC, an amount equal to the excess, if any, of (a) the fair market value of the Common Shares as of the close of such taxable year over (b) such U.S. Holder's tax basis in such Common Shares. A U.S. Holder that makes a Mark-to-Market Election will, subject to certain limitations, be allowed a deduction in an amount equal to the excess, if any, of (a) such U.S. Holder's adjusted tax basis in the Common Shares over (b) the fair market value of such Common Shares as of the close of such taxable year.

QSound does not believe that it was a PFIC for the taxable year ended December 31, 2003 and does not expect that it will be a PFIC for the taxable year ending December 31, 2004. There can be no assurance, however, that the IRS will not challenge the determination made by QSound concerning its PFIC status or that QSound will not be a PFIC for the current or any future taxable year.

### **Canadian Federal Income Tax Considerations**

The following is a general summary of certain Canadian federal income tax considerations generally applicable to a holder of QSound common shares that is not a resident of Canada and holds such common shares as capital property, both for the purposes of the Income Tax Act (Canada) (the "Act"). The discussion does not address all of the potentially relevant Canadian federal income tax matters and it does not address consequences peculiar to persons subject to special provisions of Canadian 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 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 provides 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 United States that beneficially owns at least 10 percent of the voting stock of the corporation paying the dividend shall not exceed 5 percent. Otherwise, for persons that are resident in the United States for the purposes of the 1980 Convention, 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 the 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, 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 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 taxable 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:

Room 1200  
450 Fifth Street N.W.  
Washington D.C. 20549

Copies of these materials can also be obtained by mail at prescribed rates from the Public Reference Section of the SEC at the same address, or by calling the SEC at 1-800-SEC-0330.

#### **I. Subsidiary Information**

Not Applicable

### **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **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 estimated requirement for Canadian dollar denominated cash is kept equal to the amount of Canadian dollar cash on hand. 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 is placed in bank term deposits. 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. CONTROLS AND PROCEDURES**

Based on their evaluation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) as of December 31, 2004, our Chief Executive and Financial Officer has concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and are operating in an effective manner.

There were no changes in our internal control over financial reporting that occurred during the period covered by this report that materially affected or were reasonably likely to have materially affected our internal control over financial reporting for the fiscal year ended December 31, 2004.

#### **ITEM 16. [RESERVED]**

##### **ITEM 16A. Audit Committee Financial Expert**

M. Patty Chakour, who became a director on March 1, 2004, serves as the audit committee financial expert.

##### **ITEM 16B. Code of Ethics**

We have adopted a Code of Ethics which applies to all of our officers, directors and employees. The Code of Ethics may be viewed on our Web site [www.qsound.com](http://www.qsound.com). We will mail a copy of the Code of Ethics to you without charge upon request.

##### **ITEM 16C. Principal Accountant Fees and Services**

###### **Audit Fees**

KPMG, our external accountants, billed \$89,000 in 2004, \$55,000 Cdn. in 2003 and \$53,300 Cdn. in 2002 for audit services and services related to statutory filings.

###### **Audit-Related Fees, Tax Fees and All Other Fees**

KPMG did not bill any audit-related, tax or other fees in 2004 or 2003.

#### **Audit Committee Approval**

The audit committee approves the engagement of our external auditors for all services on an engagement by engagement basis.

#### **ITEM 16D. Exemptions from Listing Standards for Audit Committees**

Not Applicable.

#### **ITEM 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

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, 2004 and 2003.

Consolidated Statements of Operations and Deficit – Years ended December 31, 2004, 2003 and 2002.

Consolidated Cash Flows– Years ended December 31, 2004, 2003 and 2002.

Notes to Consolidated Financial Statements – Years ended December 31, 2004, 2003 and 2002.

#### **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 July 2, 2002. (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)

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 Form of Stock Option Agreement (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)
- 4.2 QSound Labs, Inc. 1998 Stock Option Plan (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)
- 4.3 Employment Agreement dated September 30, 2002 between David J. Gallagher and QSound Labs, Inc. (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)
- 4.4 Employment Agreement dated April 19, 1999 between Francis Munoz and QSound Labs, Inc.
- 4.5 Employment Agreement dated June 17, 2002 between Robert Starr and QSound Labs, Inc.
- 5.1 Not Applicable.
- 6.1 Not Applicable.
- 7.1 Not Applicable.
- 8.1 List of Subsidiaries (Incorporated by reference to our Annual Report on Form 20-F filed May 20, 2003.)
- 9.1 Not Applicable.
- 10.1 Not Applicable
- 11.1 Code of Ethics (Incorporated by reference to our Annual Report on Form 20-F filed March 31, 2004.)
- 12.1 Certification under section 302 of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification under section 906 of the Sarbanes-Oxley Act of 2002.
- 14.1 KPMG Consent of Auditors
- 15.1 Audit Committee Charter

**SIGNATURE**

The registrant hereby 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 J. Gallagher  
David J. Gallagher  
President and Chief Executive Officer  
March 21, 2005

## EXHIBITS INDEX

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**Consolidated Financial Statements**

Consolidated Financial Statements of

**QSOUND LABS, INC.**

Years ended December 31, 2004, 2003 and 2002  
(Expressed in United States dollars)



**KPMG LLP**  
**Chartered Accountants**  
200 – 205 5 Avenue SW  
Calgary AB T2P 4B9

Telephone (403) 691-8000  
Fax (403) 691-8008  
Internet [www.kpmg.ca](http://www.kpmg.ca)

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheets of QSound Labs, Inc. as at December 31, 2004 and 2003 and the consolidated statements of operations and deficit and cash flows for each of the years in the three year period ended December 31, 2004. 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 the standards of the Public Company Accounting Oversight Board (United States). 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, 2004 and 2003 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2004, 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, 2004 and total assets and shareholders' equity as at December 31, 2004 and 2003 to the extent summarized in note 12 to the consolidated financial statements.

/s/ KPMG LLP

Chartered Accountants

Calgary, Canada  
February 25, 2005

### **Comments by Auditor for U.S. Readers on Canada-US Reporting Difference**

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when there is a change in accounting principles that has a material effect on the comparability of the Company's financial statements, such as the change described in the significant accounting policy note to the financial statements. Our report to the shareholders dated February 25, 2005 is expressed in accordance with Canadian reporting standards which do not require a reference to such a change in accounting principles in the auditor's report when the change is properly accounted for and adequately disclosed in the financial statements.

/s/ KPMG LLP

Chartered Accountants

Calgary, Canada  
February 25, 2005

# QSOUND LABS, INC.

## Consolidated Balance Sheets

December 31, 2004 and 2003  
(Expressed in United States dollars)

	2004	2003
<b>ASSETS</b>		
<i>Current assets</i>		
Cash and cash equivalents	\$ 3,327,543	\$ 2,061,093
Accounts receivable	210,967	221,194
Inventory	162,568	107,377
Deposits and prepaid expenses	61,438	82,921
	<u>3,762,516</u>	<u>2,472,585</u>
Capital assets (note 1)	1,302,598	1,114,992
Other intangible assets (note 2)	162,720	189,002
	<u>\$ 5,227,834</u>	<u>\$ 3,776,579</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<i>Current liabilities</i>		
Accounts payable and accrued liabilities	\$ 245,664	\$ 233,198
Deferred revenue	59,745	96,547
	<u>305,409</u>	<u>329,745</u>
<i>Shareholders' equity</i>		
Share capital (note 3)	45,792,526	43,801,245
Warrants (note 4)	1,502,331	217,450
Contributed surplus	1,329,136	1,203,761
Deficit	(43,701,568)	(41,775,622)
	<u>4,922,425</u>	<u>3,446,834</u>
Commitments and contingencies (note 11)		
	<u>\$ 5,227,834</u>	<u>\$ 3,776,579</u>

See accompanying notes to consolidated financial statements.

Approved by the Board:

/s/ L. W. MacEachern Director

/s/ David Gallagher Director

# QSOUND LABS, INC.

Consolidated Statements of Operations and Deficit

Years ended December 31, 2004, 2003 and 2002

(Expressed in United States dollars)

	2004	2003	2002
<b>REVENUE</b>			
Royalties and license fees	\$ 1,162,303	\$ 779,396	\$ 2,810,717
Product sales	1,050,875	1,263,692	1,413,594
	2,213,178	2,043,088	4,224,311
Cost of product sales	419,290	419,837	271,530
	1,793,888	1,623,251	3,952,781
<b>EXPENSES</b>			
Marketing	1,251,695	1,301,890	895,820
Operations	240,691	174,558	235,201
Product research and development	962,340	834,333	643,524
Administration	800,611	578,805	502,861
Foreign exchange loss (gain)	41,955	4,958	3,167
Depreciation and amortization	457,572	308,717	382,662
	3,754,864	3,203,261	2,663,235
Operating (loss) income	(1,960,976)	( 1,580,010)	1,289,546
Interest and other income	78,727	41,164	29,833
(Loss) gain on sale of capital assets	(15,616)	2,204	740
Other	(28,081)	123,754	(35,978)
Impairment of assets	—	(108,154)	(100,000)
Impairment of goodwill (note 6)	—	(2,184,589)	—
Funding of past service pension costs	—	—	(55,189)
	35,030	( 2,125,621)	( 160,594)
Net (loss) income for the year	(1,925,946)	(3,705,631)	1,128,952
Deficit, beginning of year	(41,775,622)	(38,069,991)	(39,198,943)
Deficit, end of year	\$(43,701,568)	\$(41,775,622)	\$( 38,069,991)
Income (loss) per common share, basic	\$ (0.25)	\$ (0.52)	\$ 0.16
Income (loss) per common share, diluted	\$ (0.25)	\$ (0.52)	\$ 0.15

See accompanying notes to consolidated financial statements.

# QSOUND LABS, INC.

## Consolidated Statements of Cash Flows

Years ended December 31, 2004, 2003 and 2002

(Expressed in United States dollars)

	2004	2003	2002
Cash provided by (used in):			
<b>Operations:</b>			
Net income (loss) for the year	\$(1,925,946)	\$(3,705,631)	\$ 1,128,952
Items not requiring (providing) cash:			
Depreciation and amortization	457,572	308,717	382,662
Impairment of assets	—	108,154	100,000
Impairment of goodwill	—	2,184,589	—
Compensation cost of options issued	320,432	90,439	4,870
Loss (gain) on sale of capital assets	15,616	(2,204)	(740)
Changes in non-cash working capital balances (note 7)	(47,817)	576,243	(423,054)
	(1,180,143)	(439,693)	1,192,690
<b>Financing:</b>			
Issuance of common shares	2,120,657	22,940	34,815
Issuance of warrants	904,019	—	—
	3,024,676	22,940	34,815
<b>Investments:</b>			
Purchase of capital assets	(536,480)	(98,026)	(113,880)
Purchase of intangible asset	(46,033)	(51,394)	(41,052)
Note receivable	—	—	(500,000)
Proceeds from sale of capital assets	4,430	6,061	740
	(578,083)	(143,359)	(654,192)
Increase (decrease) in cash and cash equivalents	1,266,450	(560,112)	573,313
Cash and cash equivalents, beginning of year	2,061,093	2,621,205	2,047,892
Cash and cash equivalents, end of year	\$ 3,327,543	\$ 2,061,093	\$ 2,621,205

See accompanying notes to consolidated financial statements.

# QSOUND LABS, INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2004, 2003 and 2002  
(Expressed in United States dollars)

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## 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 12. 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. All intercompany transactions and balances have been eliminated on consolidation.

## 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%

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Software and production tooling is amortized against the related expected revenue as that revenue is recognized.

The Company assesses impairment of capital assets by determining whether their recoverable amounts are less than their unamortized balance. When a potential impairment is identified, the amount of impairment is calculated by reference to the fair value of the asset and charged to period earnings.

**Significant accounting policies (continued):****Goodwill and other intangible assets:**

Effective January 1, 2002, the Corporation adopted the new Canadian Institute of Chartered Accountants standards relating to goodwill and other intangible assets. Under the new standards, the Company is required to use the purchase method to account for all business combinations and identify separate from goodwill, other intangible assets that arise. Pursuant to the new goodwill standard, goodwill is no longer amortized, but is tested for impairment on an annual basis. In 2003 an analysis of the recorded goodwill was completed and an assessed goodwill impairment of the remaining balance was recognized as at December 31, 2003.

Intangible assets are amortized over a five year period starting in the year after acquisition, and it's carrying value is assessed whenever event or changes in circumstances indicate that it's carrying amount may not be recoverable..

**Foreign currency translation:**

The Company translates monetary assets and liabilities into United States dollars 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 on translation of these amounts are included in the determination of net income or loss for the year.

**Revenue recognition:**

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

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.

Revenue from product sales is recognized when products are shipped pursuant to sales arrangements with customers (which is when title passes), collectibility is reasonably assured and the Company does not have obligations for additional deliverables that are essential to the functionality of the product.

**Research and development costs:**

Research costs are expensed as incurred. Development costs are expensed as incurred except if they relate to a specific product or process that management believes will be technically and economically feasible and recoverable, in which case these costs are capitalized. No costs have been capitalized at December 31, 2004 and 2003.

**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 or substantively 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 as a result of a change in tax rates is recognized as part of the provision for income taxes in the period that includes the substantive enactment date.



To the extent that future income tax assets are not considered to be realized more likely than not, a valuation allowance is provided.

**Per share amounts:**

Per share amounts are calculated using the weighted average number of common shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock method.

The basic weighted average shares outstanding for the year ended December 31, 2004 was 7,628,238 (2003 – 7,171,217, 2002 – 7,095,552). The diluted weighted average shares outstanding for the year ended December 31, 2004 was 9,583,173 (2003 – 7,900,030, 2002 – 7,455,833).

**Comparative figures:**

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

**Change in accounting policy:**

Prior to January 1, 2003, the Company applied the fair value based method of accounting prescribed by CICA Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments, only to stock options granted to non-employees, and applied the intrinsic value method of accounting for employee stock options. Under the intrinsic value method, any consideration paid by employees on the exercise of stock options or purchase of stock is credited to share capital and no compensation expense was recognized.

The CICA Accounting Standards Board has amended CICA Handbook Section 3870 – Stock-based Compensation and Other Stock-based Payments – to require entities to account for employee stock options using the fair value based method, beginning January 1, 2004. Under the fair value based method, compensation cost is measured at fair value at the date of grant and is expensed over the award's vesting period. In accordance with one of the transitional options permitted under amended Section 3870, the Company elected to early adopt the fair value based method for all employee stock options granted on or after January 1, 2003, and accordingly, recognized compensation expense related to stock options granted to employees beginning in 2003. Pro forma disclosure of the fair value of stock options granted to employees during 2002 has been provided (note 5).

**1. Capital assets:**

<b>2004</b>	<b>Cost</b>	<b>Accumulated depreciation</b>	<b>Net book value</b>
Sound source and control equipment	\$ 545,463	\$ 523,174	\$ 22,289
Real time systems	905,534	899,563	5,971
Furniture and fixtures	228,654	203,298	25,356
Computer equipment	997,224	728,490	268,734
Software and production tooling	2,424,155	1,443,907	980,248
	<b>\$ 5,101,030</b>	<b>\$ 3,798,432</b>	<b>\$ 1,302,598</b>

<b>2003</b>	<b>Cost</b>	<b>Accumulated depreciation</b>	<b>Net book value</b>
Sound source and control equipment	\$ 556,615	\$ 521,679	\$ 34,936
Real time systems	905,534	897,004	8,530
Furniture and fixtures	355,990	315,488	40,502
Computer equipment	898,239	662,394	235,845
Software and production tooling	1,941,126	1,145,947	795,179
	<b>\$ 4,657,504</b>	<b>\$ 3,542,512</b>	<b>\$ 1,114,992</b>

In accordance with the accounting policy of the Company, included in the software and production tooling cost are \$428,453 in 2004 and \$108,725 in 2003 that are not yet generating revenue and therefore not subject to amortization.

Included in the accumulated depreciation above for software and production tooling is a 2003 year asset impairment charge of \$102,900 (2002 - \$100,000). The impairment charge was measured based on projected future operating cash flows of purchased software.

**2. Other intangible assets:**

<b>2004</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</b>
Patents and trademarks	\$ 877,929	\$ 728,976	\$ 148,953
Purchased customer list	34,418	20,651	13,767
	<b>\$ 912,347</b>	<b>\$ 749,627</b>	<b>\$ 162,720</b>

<b>2003</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</b>
Patents and trademarks	\$ 831,895	\$ 663,544	\$ 168,351
Purchased customer list	34,418	13,767	20,651
	<b>\$ 866,313</b>	<b>\$ 677,311</b>	<b>\$ 189,002</b>

### 3. Share capital:

Authorized:

The Company is authorized to issue an unlimited number of common shares without par value and an unlimited number of first and second preferred shares.

Common shares issued and outstanding:

	<b>Number of Shares</b>	<b>Consideration</b>
Balance at December 31, 2001	7,085,574	\$ 43,737,626
Issued for cash on exercise of options	70,500	34,815
Balance at December 31, 2002	7,156,074	43,772,441
Issued for cash on exercise of options	43,170	22,940
Reclassification from contributed surplus on exercise of stock options	–	5,864
Balance December 31, 2003	7,199,244	43,801,245
Issued for cash:		
On exercise of options	857,015	1,174,218
Private placement		
Cash received	347,826	2,000,000
Less financing costs paid in cash	–	(149,541)
Less warrants valued under Black-Scholes as part of financing costs(note 4)	–	(380,862)
Less deemed allocation to warrants (note 4)	–	(904,019)
Reclassification from contributed surplus on exercise of stock options	–	251,485
Balance December 31, 2004	8,404,085	\$ 45,792,526

### 4. Warrants:

	<b>Number of Warrants</b>	<b>Consideration</b>
Balance at December 31, 2001	–	\$ –
Issued for services received	250,000	108,725
Balance at December 31, 2002	250,000	108,725
Issued for services received	250,000	108,725
Balance December 31, 2003	500,000	217,450
Issued for services received	75,000	380,862
Issued for cash	660,869	904,019
Balance December 31, 2004	1,235,869	\$ 1,502,331

#### 4. Warrants (continued):

The warrants issued in 2004 for services received were allocated to financing costs. The warrants issued in 2003 and 2002 for services received were capitalized to software and production tooling.

The fair value of the warrants issued for services received was calculated using the Black-Scholes pricing model with the following weighted average assumptions:

	2004	2003	2002
Risk free interest rate	4.5%	4.5%	4.5%
Volatility	93%	80%	80%
Life of the warrant	7 months to 5 years	4.5 Years	4.5 Years
Dividend yield	0%	0%	0%

The amount contributed to the warrants issued for cash was calculated taking the total cash proceeds of the shares issued in the private placement on a pro-rata basis with the fair value of the warrants issued using the Black-Scholes pricing model using the assumptions stated above and the market value of the shares issued in the private placement.

The following table summarizes the information about warrants outstanding at December 31, 2004:

Number Outstanding	Exercise price	Remaining Term (years)
500,000	\$ 1.04	3.25
521,739	5.75	0.63
75,000	7.77	4.95
139,130	9.12	4.95
1,235,869	\$ 4.35	2.44

Each warrant is exercisable for one common share of the Company with the exception of the 521,739 warrants at an exercise price of \$5.75 which are exercisable for one common share of the Company and 40% of a warrant for one common share exercisable for \$9.12, exercisable until December 16, 2009.

#### 5. Stock option plan:

The Company has a stock option plan under which the Board of Directors may grant stock options to directors, officers, consultants and employees for the purchase of authorized but unissued common shares. At December 31, 2004, stock options to purchase 1,157,500 common shares are outstanding and 2,963 shares are reserved for issuance under the option plan. The stock options are exercisable at prices ranging from \$0.47 to \$4.56 per share and expire on various dates between 2005 and 2009.

During the year ended December 31, 2004, the Company granted 570,720 options to employees and directors (2003 – 280,000, 2002 – 411,310) with exercise prices at or greater than the market price of the Company's stock on the date of grant. Of these 570,720 options, 245,720 vested immediately. The remaining 325,000 options vest at various times depending upon individual specified performance criteria being met. At December 31, 2004, 179,400 of these options had vested. In 2004, the Company also granted an additional 60,000 options to non-employees (2003 – 55,000, 2002 – 35,000) in connection with services to be performed. All of these options vest depending upon specified performance criteria being met. At December 31, 2004 37,494 of these options had vested.

The fair value of the vested options granted during 2004 and 2003 is estimated on the day of grant using the Black-Scholes option pricing model with the following assumptions;

	2004	2003
Risk free interest rate	4.5%	4.5%
Weighted average volatility	94%	105%
Expected life of option	15 days to 5 years	3 to 5 years
Dividend yield	0%	0%

For the year ended December 31, 2004, \$320,432 (2003 – \$30,820, 2002 – nil) has been recognized as compensation cost related to options granted to employees and directors, and \$56,429 (2003 – \$59,619, 2002 - \$4,870) has been recognized as compensation cost related to options issued to non-employees. In 2004, the compensation costs related to options issued to non-employees has been capitalized to software and production tooling.

No compensation cost was recorded in the Company's statement of operations and deficit for options granted in 2002 to employees, directors and officers. Had compensation cost for stock options granted in 2002 been determined based on the fair value method, the Company's pro-forma net loss for the year ended December 31, 2004 would have been increased by \$81,620 to \$1,954,625, the net loss for 2003 would have increased by \$103,602 to \$3,809,233, and the net income for the year ended December 31, 2002 would have decreased by \$8,478 to \$1,120,474.

Changes in options granted during the years ended December 31, 2004, 2003 and 2002 were as follows:

	Number of Shares	Exercise price per share	Weighted average exercise price
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
Granted	335,000	1.00 – 1.48	1.24
Exercised	(43,170)	0.47 – 1.00	0.53
Cancelled or expired	(148,987)	1.21 – 12.24	5.97
Balance at December 31, 2003	1,738,765	0.47 – 1.75	0.87
Granted	630,720	1.65 – 5.00	2.58
Exercised	(857,015)	0.47 – 5.00	1.37
Cancelled or expired	(354,970)	1.21 – 1.72	1.36
Balance at December 31, 2004	1,157,500	\$ 0.47 – 4.56	\$ 1.29

**5. Stock option plan (continued):**

The following table summarizes the information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2004	Weighted Average Remaining Term (years)	Weighted Average Exercise Price	Number Exercisable at December 31, 2004	Weighted Average Exercise Price
\$ 0.47 to 0.62	429,307	2.8	\$ 0.54	390,408	\$ 0.53
1.04 to 1.75	451,693	2.0	1.22	433,193	1.20
1.88 to 2.05	217,500	4.2	2.01	120,894	1.98
4.56	59,000	4.8	4.56	6,000	4.56
	1,157,500	2.9	\$ 1.29	950,495	\$ 1.05

**6. Impairment of goodwill:**

In accordance with the Company's accounting policy, an analysis of the recorded goodwill was completed in 2003. As a result of the declining activity in the E-Commerce operating segment, an assessed goodwill impairment of \$2,184,589 was recognized as at December 31, 2003.

**7. Changes in non-cash working capital balances:**

	2004	2003	2002
Accounts receivable	\$ 10,227	\$ 708,325	\$ (490,274)
Inventory	(55,191)	(96,174)	12,132
Deposits and prepaid expenses	21,483	(24,247)	26,691
Accounts payable and accrued liabilities	12,466	12,303	(83,832)
Deferred revenue	(36,802)	(23,964)	112,229
	\$ (47,817)	\$ 576,243	\$ (423,054)

## 8. 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:

	2004	2003	2002
Income (loss) for the year	\$(1,925,946)	\$(3,705,631)	\$ 1,128,952
Combined Canadian Federal and Provincial statutory rate	33.87%	36.75%	39.24%
Computed tax (recovery)	(652,318)	(1,361,819)	443,001
Increase (decrease) resulting from:			
Unrealized (realized) benefit of future tax assets	452,000	946,000	(450,988)
Income taxes computed at different rates in the United States	(320)	33,428	7,987
Reduction of unrealized future tax assets for enacted changes in income tax rates	205,226	119,201	–
Other permanent differences	(4,588)	263,190	–
Actual expense (recovery)	\$ –	\$ –	\$ –

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

	Canada	United States	2004	2003
Future income tax assets:				
Capital assets	\$ 981,000	\$ –	\$ 981,000	\$ 867,000
Share issue costs	45,000	–	45,000	6,000
Loss and SRED carryforwards	3,107,000	4,484,000	7,591,000	7,278,000
Intangible assets	183,000	1,957,000	2,140,000	2,154,000
Investments	–	158,000	158,000	158,000
	4,316,000	6,599,000	10,915,000	10,463,000
Less: Valuation allowance	(4,316,000)	(6,599,000)	(10,915,000)	(10,463,000)
Net future tax assets	\$ –	\$ –	\$ –	\$ –

The Company has Canadian non-capital loss carry-forwards in the amount of \$4,925,000 which expire at various dates between 2005 and 2010 and Canadian Scientific Research and Experimental Development (SRED) expenditure carry-forwards in the amount of \$4,271,000 which have no expiry. The Company also has United States net operating loss carry-forwards in the amount of \$12,812,000 which expire at various dates between 2005 and 2023.

## 9. Segmented information:

The Company operates in three operating segments consisting of Audio Products (Audio), E-Commerce Products ("E-Commerce"), and Voice Over Internet Protocol Products (Telephony). The Company began operations in the Telephony segment in 2003. Audio involves the developing and marketing of sound enhancement technology for use in various industries. E-Commerce involves the developing and marketing of internet business services. Telephony involves the developing and marketing of telecommunication over internet equipment and software.

For Audio products, during 2004 52% of total audio revenue arose from four customers, each of which individually provided greater than 10% of total revenues. For 2003, 74% of total revenue arose from three customers, each of which individually provided greater than 10% of total revenues. For 2002, 76% of total revenue arose from two customers, each of which individually provided greater than 10% of total revenues.

For E-Commerce products, during 2004, 2003 and 2002 no one customer contributed to more than 10% of total E-Commerce revenue.

For Telephony products, during 2004, 37% of total telephony revenue arose from three customers, each of which individually provided greater than 10% of total revenues. For 2003, 61% of total telephony revenue arose from two customers, each of which individually provided greater than 10% of total revenues.

<b>2004</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Telephony</b>	<b>Total</b>
Revenues	\$ 1,820,028	\$ 245,238	\$ 147,912	\$ 2,213,178
Interest revenue	78,254	12	461	78,727
Amortization of capital assets	186,089	28,239	170,929	385,257
Segment operating loss	(653,710)	(138,369)	(1,168,897)	(1,960,976)
Segment assets	4,037,007	109,600	1,081,227	5,227,834
Expenditures for segment capital assets	154,884	811	437,215	592,910

<b>2003</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Telephony</b>	<b>Total</b>
Revenues	\$ 1,511,312	\$ 346,456	\$ 185,320	\$ 2,043,088
Interest revenue	41,132	–	32	41,164
Amortization of capital assets	192,584	39,970	–	232,554
Segment operating loss	(749,972)	(65,628)	(764,410)	(1,580,010)
Segment assets	2,731,693	175,363	869,523	3,776,579
Expenditures for segment capital assets	129,406	867	576,477	706,750



**9. Segmented information (continued):**

<b>2002</b>	<b>Audio</b>	<b>E-Commerce</b>	<b>Total</b>
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 operating income	1,183,447	106,099	1,289,546
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

  

<b>Geographic information</b>	<b>2004 Revenue</b>	<b>2003 Revenue</b>	<b>2002 Revenue</b>
Canada	\$ 73,294	\$ 64,449	\$ 3,443
United States	1,418,029	1,515,602	3,636,657
Asia	644,503	456,194	584,211
Europe	72,102	4,365	—
Other	5,250	2,478	—
	\$ 2,213,178	\$ 2,043,088	\$ 4,224,311

As at December 31, 2004, substantially all of the Company's product assets and employees were located in Canada. As at December 31, 2003 substantially all of the Company's Audio and E-Commerce product assets and employees were located in Canada and all of the Company's Telephony product assets were located in Canada. In 2003 25% of the Company's Telephony employees were located in Canada and 75% were located in the United States. As at December 31, 2002 substantially all of the Company's product assets and employees were located in Canada.

**10. Financial instruments and risk management:**

The fair values of financial assets and liabilities approximate their carrying values at December 31, 2004.

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, 2004, 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, 2004 there were outstanding accounts receivable balances from four entities which comprised 61% of the total balance. These entities are located in the United States and Asia. 13% of these amounts have been collected subsequent to the year end.

As at December 31, 2003 there were outstanding accounts receivable balances from two entities which comprised 57% of the total balance. These entities are located in the United States and Asia. These amounts have been collected subsequent to the year end.

As at December 31, 2002 there were outstanding accounts receivable balances from one entity which comprised 74% of the total balance. These amounts have been collected subsequent to the year end.

**11. 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 2002 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. \$ 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, 2004 to make the following minimum lease payments over the next four years:

2005	\$	96,564
2006		83,497
2007		78,249
2008		65,208
	\$	323,518

## 12. United States accounting principles:

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian 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 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. For all periods presented, comprehensive income (loss) equals net income (loss).

## 12. United States accounting principles (continued):

(b) Prior to 2003, the Company had applied 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 had elected to continue to apply the intrinsic value-based method of accounting described above and 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. In accordance with the adoption of the fair value-based method for Canadian GAAP purposes, the Company elected to prospectively adopt the fair value-based method under US GAAP, as provided for under SFAS No. 123, effective January 1, 2003.

There are no differences in net income reported between Canadian and United States accounting principles for each of the years in the three year period ended December 31, 2004.

Other differences between Canadian and United States accounting principles are summarized as follows:

On the Canadian GAAP presentation of the statement of operations, the calculation of operating profit (loss) has excluded impairment of asset charges and gain (loss) on sale of capital assets. 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, 2004, 2003 and 2002 under Canadian and United States GAAP.

## 12. United States accounting principles (continued):

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

<b>December 31, 2004</b>	<b>As reported in accordance with Canadian GAAP</b>	<b>Differences</b>	<b>Under US GAAP</b>
Current assets	\$ 3,762,516	\$ —	\$ 3,762,516
Capital assets	1,302,598	—	1,302,598
Intangible assets	162,720	—	162,720
	<b>\$ 5,227,834</b>	<b>\$ —</b>	<b>\$ 5,227,834</b>
Current liabilities	\$ 305,409	\$ —	\$ 305,409
Shareholder's equity:			
Common shares	45,792,526	202,058	45,994,584
Warrants	1,502,331	—	1,502,331
Contributed Surplus	1,329,136	—	1,329,136
Deficit	(43,701,568)	(202,058)	(43,903,626)
	<b>\$ 5,227,834</b>	<b>\$ —</b>	<b>\$ 5,227,834</b>
<b>December 31, 2003</b>	<b>As reported in accordance with Canadian GAAP</b>	<b>Differences</b>	<b>Under US GAAP</b>
Current assets	\$ 2,472,585	\$ —	\$ 2,472,585
Capital assets	1,114,992	—	1,114,992
Intangible assets	189,002	—	189,002
	<b>\$ 3,776,579</b>	<b>\$ —</b>	<b>\$ 3,776,579</b>
Current liabilities	\$ 329,745	\$ —	\$ 329,745
Shareholder's equity:			
Common shares	43,801,245	202,058	44,003,303
Warrants	217,450	—	217,450
Contributed surplus	1,203,761	—	1,203,761
Deficit	(41,775,622)	(202,058)	(41,977,680)
	<b>\$ 3,776,579</b>	<b>\$ —</b>	<b>\$ 3,776,579</b>

Included in the current liabilities above are accrued liabilities of \$95,360 in 2004 and \$71,672 in 2003.

## 12. United States accounting principles (continued):

During the years ended December 31, 2004, 2003 and 2002 the Company granted options to employees, directors and officers. Compensation cost is recorded in the Company's statement of operations and deficit for options granted and vested during 2004 and 2003 in accordance with the adoption of the fair value based method effective January 1, 2003. During 2002, 411,000 options 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 had been recorded in the Company's statement of operations and deficit for options granted during 2002.

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:

	2004	2003	2002
Risk free interest rate	4.5%	4.5%	4.5%
Weighted Average Volatility	94%	105%	80%
Expected option life	15 days to 5 years	3 to 6 years	2 years
Dividend yield	0%	0%	0%

Had the Company determined compensation cost based on the fair value at the grant date for its stock options issued in 2002 under SFAS No. 123, the Company's net income (loss) and basic income (loss) per share would have been reduced to the pro forma amounts indicated below:

	2004	2003	2002
Net income (loss) under US GAAP:			
As reported	\$ (1,925,946)	\$ (3,705,631)	\$ 1,128,952
Pro forma	(2,007,566)	(3,809,233)	1,120,474
Basic income (loss) per common share:			
As reported	\$ (0.25)	\$ (0.52)	\$ 0.16
Pro forma	(0.26)	(0.54)	0.16