
QSOUND
QSoundLabs
First Quarter 2002

# Message to the shareholders

The Company continues to operate in a stable fashion despite the continuing uncertainty in the technology sector. We have maintained an effective cost control program while at the same time continuing with our product development plans. Several new product lines will be delivered in the second quarter, one of which will be the first delivery pursuant to the recently announced agreement with Philips.

The revenue mix by customer for each quarter over the past year has been ever changing. In the latest quarter, royalties received from our hearing aid license increased over previous periods as a result of new product releases by Starkey. This was partially offset by reduced iQfx®3 revenues from RealNetworks caused by reduced exposure of the product to consumers on their site. The uncertainty in the PC and CE markets, when added to this mix, provides an unclear picture of trends for later in the year; however in the short term, management expects financial results to be similar to this quarter.

**Financials**

Revenues for the three months ended March 31, 2002 were $755,000 as compared to $843,000 for the same period in FY2001. The operating profit for the quarter was $168,000 or $0.02 per share as compared to $33,000 or $0.00 per share for the same period last year. Including non-cash items such as depreciation and amortization of goodwill, net income for the period was $88,000 or $0.01 per share as compared to a loss of $(179,000) or $(0.02) per share for the same period in FY2001.

The Company reported a working capital surplus of $2,383,000 compared to $2,288,000 as at December 31, 2001. Cash and cash equivalents decreased from $2,048,000 to $1,904,000 during the quarter as funds were expended on fixed asset acquisitions and general working capital.

**David Gallagher**
President and
Chief Executive Officer

# Consolidated balance sheets

As at March 31, 2002 and December 31, 2001
(Expressed in United States dollars under Canadian GAAP)

| | | March 31, 2002 (unaudited) | | December 31, 2001 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| *Current Assets* | | | | |
| Cash and cash equivalents | $ | 1,904,315 | $ | 2,047,892 |
| Accounts receivable | | 581,539 | | 439,245 |
| Inventory | | 28,195 | | 28,587 |
| Deposits and prepaid expenses | | 91,936 | | 85,365 |
| | | 2,605,985 | | 2,601,089 |
| Capital assets (note 2) | | 1,140,747 | | 1,145,911 |
| Intangible assets (note 3) | | 2,217,286 | | 2,219,007 |
| | $ | 5,964,018 | $ | 5,966,007 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | |
| *Current Liabilities* | | | | |
| Accounts payable and accrued liabilities | $ | 187,710 | $ | 304,726 |
| Deferred revenue | | 34,960 | | 8,282 |
| | | 222,670 | | 313,008 |
| *Shareholders' equity* | | | | |
| Share capital (7,085,574 common shares) | | 43,737,626 | | 43,737,626 |
| Contributed surplus | | 1,114,316 | | 1,114,316 |
| Deficit | | (39,110,594) | | (39,198,943) |
| | | 5,741,348 | | 5,652,999 |
| | $ | 5,964,018 | $ | 5,966,007 |

See accompanying notes to consolidated financial statements.

# Consolidated
## statements of operations and deficit

For the Periods Ended March 31, 2002 and 2001
(Expressed in United States dollars under Canadian GAAP)

| | For three months ended March 31, 2002 (unaudited) | For three months ended March 31, 2001 (unaudited) |
|---|---|---|
| **REVENUE** | | |
| Royalties, license fees and product sales | $ 755,162 | $ 842,541 |
| Cost of product sales | 9,271 | 24,426 |
| | 745,891 | 818,115 |
| **EXPENSES** | | |
| Marketing | 194,016 | 239,915 |
| Operations | 81,532 | 139,161 |
| Product engineering | 180,560 | 251,780 |
| Administration | 121,594 | 154,593 |
| | 577,702 | 785,449 |
| Operating profit | 168,189 | 32,666 |
| Other Items | | |
| Depreciation and amortization | (80,037) | (234,254) |
| Other | 197 | 22,518 |
| | (79,840) | (211,736) |
| Net income (loss) for the period | 88,349 | (179,070) |
| Deficit beginning of period | (39,198,943) | (38,466,033) |
| Deficit end of period | $ (39,110,594) | (38,645,103) |
| Income (loss) per common share | $ 0.01 | (0.02) |

See accompanying notes to consolidated financial statements.

# Consolidated

## statements of cash flows

For the Periods Ended March 31, 2002 and 2001
(Expressed in United States dollars under Canadian GAAP)

| | For three months ended March 31, 2002 (unaudited) | For three months ended March 31, 2001 (unaudited) |
|---|---|---|
| Cash provided by (used in) | | |
| **OPERATIONS** | | |
| Income (loss) for the period | $ 88,349 | $ (179,070) |
| Items not requiring (providing) cash: | | |
| Depreciation and amortization | 80,037 | 234,254 |
| Changes in working capital balances | (238,811) | 162,438 |
| | (70,425) | 217,622 |
| **FINANCING** | | |
| Repurchase of common shares, net | — | (210,917) |
| Repayment of debt | — | (275,000) |
| | — | (485,917) |
| **INVESTMENTS** | | |
| Purchase of capital assets | (73,152) | (15,474) |
| Purchase of intangible assets | — | (9,153) |
| | (73,152) | (24,627) |
| Increase (decrease) in cash | (143,577) | (292,922) |
| Cash and cash equivalents beginning of period | 2,047,892 | 2,264,639 |
| Cash and cash equivalents end of period | $ 1,904,315 | $ 1,971,717 |

See accompanying notes to consolidated financial statements.

(Expressed in United States dollars under Canadian GAAP)

## 1. Basis of presentation:

These consolidated financial statements include the accounts of QSound Labs, Inc. a public company organized under the laws of the Province of Alberta, Canada and its wholly-owned subsidiaries QCommerce Inc., QSound Ltd., QSound Electronics, Inc. and QKidz, Inc. All significant inter-company transactions and balances have been eliminated.

The statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles for interim financial statements. These financial statements follow the same accounting policies and methods of applications as the most recent annual financial statements dated December 31, 2001 with the exception of the following accounting standard changes adopted effective January 1, 2002: - Goodwill and Other Intangibles (note 3). These interim financial statements should be read in conjunction with the Company's December 31, 2001 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

## 2. Capital assets:

| March 31, 2002 | Cost | Accumulated depreciation | Net book value |
|---|---|---|---|
| Sound source and control equipment | $ 543,994 | $ 508,866 | $ 35,128 |
| Real time systems | 905,534 | 889,432 | 16,102 |
| Furniture and fixtures | 353,827 | 299,706 | 54,121 |
| Computer equipment | 797,184 | 562,702 | 234,482 |
| Software and production tooling | 1,236,729 | 643,294 | 593,435 |
| Patents and trademarks | 733,067 | 525,588 | 207,479 |
| | $ 4,570,335 | $ 3,429,588 | $ 1,140,747 |

## 3. Intangible assets:

| March 31, 2002 | Cost | Accumulated amortization | Net book value |
|---|---|---|---|
| Goodwill | $ 9,894,777 | $ 7,710,188 | $ 2,184,589 |
| Purchased customer list | 34,418 | 1,721 | 32,697 |
| | $ 9,929,195 | $ 7,711,909 | $ 2,217,286 |

Effective January 1, 2002, the Corporation adopted the new Canadian Institute of Chartered Accountants standard No. 3062 - Goodwill and Other Intangibles ("CICA 3062"), which no longer permits the amortization of goodwill and other indefinite life intangibles. The new standard requires that a fair value impairment test be performed annually on goodwill and other indefinite life intangibles. On transition, goodwill and indefinite life intangibles are tested for impairment as of the beginning of the fiscal year in which CICA 3062 is first applied. As such, an impairment test will be performed to evaluate the carrying values as at January 1, 2002 on goodwill and indefinite life intangibles. As permitted under CICA 3062, this test will be completed by June 30, 2002. Barring unforeseen circumstances, it is not expected that any impairment charges will be recorded as a result of the adoption of CICA 3062 in 2002. The new standard is applied prospectively. There has been no change in the carrying value of goodwill ($2,184,589) since December 31, 2001. The purchased customer list is amortized on a straight line basis over its estimated useful life of 5 years.

## 4. Changes in non-cash working capital balances:

| | March 31, 2002 | March 31, 2001 |
|---|---|---|
| Accounts receivable | $ (142,294) | $ 217,719 |
| Inventory | 392 | 344 |
| Deposits and prepaid expenses | (6,571) | (70,916) |
| Accounts payable and accrued liabilities | (117,016) | 9,267 |
| Deferred revenue | 26,678 | 6,024 |
| | $ (238,811) | 162,438 |

## 5. Segmented information:

For the three month period ended March 31, 2002

| | Audio | E-Commerce | Total |
|---|---|---|---|
| Revenue | | | |
| Royalties, license fees and product sales | $ 594,364 | $ 160,798 | $ 755,162 |
| Cost of product sales | 8,495 | 776 | 9,271 |
| | 585,869 | 160,022 | 745,891 |
| Expenses | | | |
| Marketing | 184,110 | 9,906 | 194,016 |
| Operations | — | 81,532 | 81,532 |
| Product engineering | 138,115 | 42,445 | 180,560 |
| Administration | 96,388 | 25,206 | 121,594 |
| | 418,613 | 159,089 | 577,702 |
| Operating profit | 167,256 | 933 | 168,189 |
| Other Items | | | |
| Depreciation and amortization | (64,015) | (16,022) | (80,037) |
| Other | 197 | — | 197 |
| | (63,818) | (16,022) | (79,840) |
| Net income for the period | $ 103,438 | $ (15,089) | $ 88,349 |
| Segment assets | $ 3,512,820 | $ 2,451,198 | $ 5,964,018 |

## 5. Segmented information (continued):

For the three month period ended March 31, 2001

| | Audio | E-Commerce | Total |
|---|---|---|---|
| Revenue | | | |
| Royalties, license fees and product sales | $ 705,665 | $ 136,876 | $ 842,541 |
| Cost of product sales | 24,426 | — | 24,426 |
| | 681,239 | 136,876 | 818,115 |
| Expenses | | | |
| Marketing | 186,808 | 53,107 | 239,915 |
| Operations | — | 139,161 | 139,161 |
| Product engineering | 134,167 | 117,613 | 251,780 |
| Administration | 124,101 | 30,492 | 154,593 |
| | 445,076 | 340,373 | 785,449 |
| Operating profit | 236,163 | (203,497) | 32,666 |
| Other Items | | | |
| Depreciation and amortization | (76,906) | (157,348) | (234,254) |
| Other | 22,518 | — | 22,518 |
| | (54,388) | (157,348) | (211,736) |
| Net income for the period | $ 181,775 | $ (360,845) | $ (179,070) |
| Segment assets | $ 3,958,259 | $ 3,248,920 | $ 7,207,179 |

**QSOUND LABS, INC.**

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

www.qsound.com

Printed in Canada