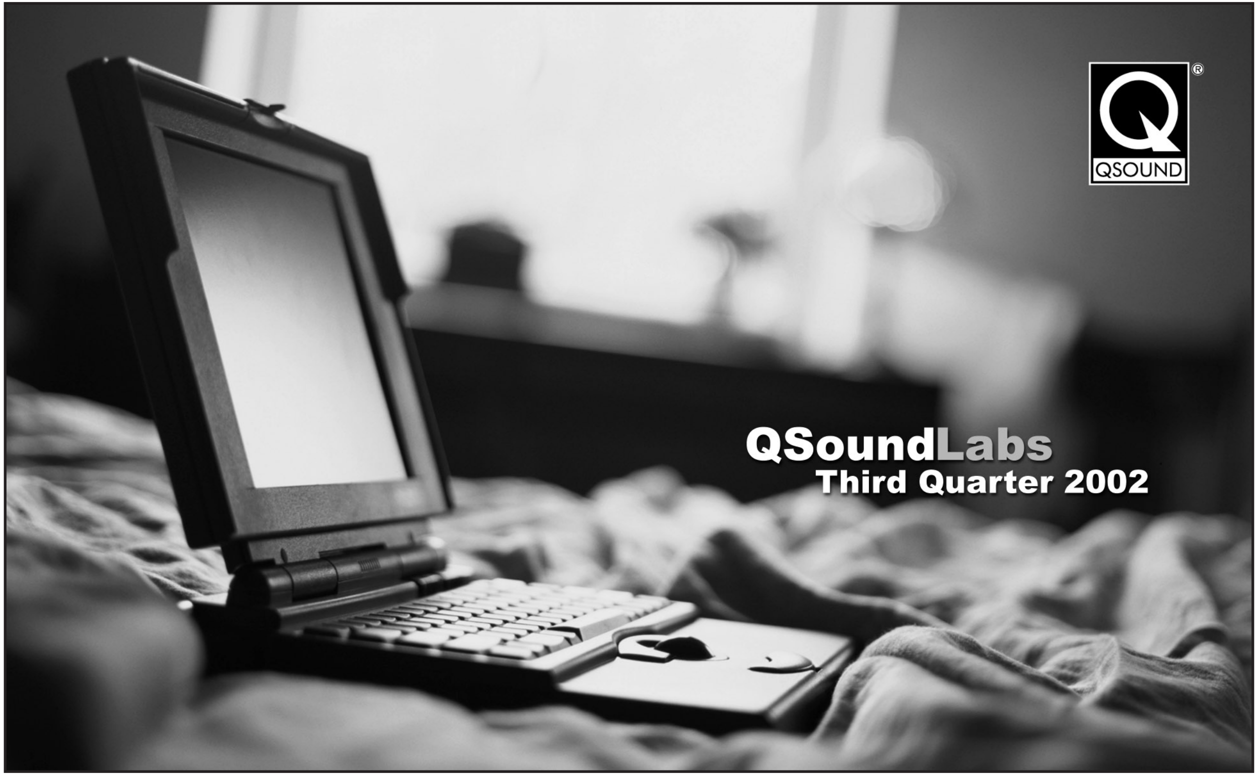
QSOUND
QSoundLabs
Third Quarter 2002

Message
to the shareholders

Fiscal year 2002 has certainly highlighted the effectiveness of our licensing business model. Earlier in the year, we were able to contain costs at a level that provided us with profitable operations. Now, in the third quarter, revenue growth falls straight to the bottom line.

For the second quarter in a row, royalties received from our hearing aid license and RealNetworks partnership were strong. As well, during the quarter, our technology began shipping in Toshiba's new DVD players. These accomplishments have resulted in the Company exceeding previous guidance. Management believes that the Company will sustain these revenue levels throughout the remainder of this year.

Even within the framework of our cost containment program, we have continued to develop new business and product opportunities for fiscal year 2003, reducing our dependency on existing revenue streams. Specifically, as previously outlined in the presentation to the shareholders at the AGM, the Company has focussed most of its development resources on complete software solutions for audio and voice applications. The Company is now exploiting opportunities for these solutions, and, as a first step, Philips entered the market with its new soundcard product based on QSound's software solutions at the end of the quarter. Management believes that this will be the first of several opportunities for our new technology.

David Gallagher

David Gallagher
President and
Chief Executive Officer

Management's
Discussion and Analysis
Third Quarter ended September 30, 2002

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the quarter ended September 30, 2002 should be read in conjunction with the interim unaudited consolidated financial statements of the company, and the annual audited financial statements of the company and Annual Report on Form 20-F for the fiscal year ended December 31, 2001. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2001 which is contained in the Form 20-F referred to above.

The company reports its unaudited consolidated financial statements in United States dollars and in accordance with Canadian Generally Accepted Accounting Principles (GAAP).

Operations

Revenues for the three months ended September 30, 2002 were $1,308,727 as compared to $765,188 for the same period in 2001. The audio segment had revenues of $1,173,848 for the quarter as compared to $624,411 for the same period in 2001. The increase was due primarily to strong royalties received from the hearing aid license and increased integrated circuit sales. The e-commerce segment had revenues of $134,879 as compared to $140,777 for 2001.

The operating profit for the quarter was $635,796 as compared to $109,204 for the same period last year. The audio segment had operating profits of $619,688 as compared to $226,370 in 2001. The increase in operating profit is due primarily to strong royalties received from the hearing aid license and increased integrated circuit sales. The e-commerce segment had operating profits of $16,108 compared to operating losses of $117,166 in 2001. The increase in operating profits is due to the realized savings in moving the operations to Canada and the cost cutting measures taken. The year to date figures reflect both the cost cutting measures and the increase in profits as referred to above.

Net income for the quarter ended September 30, 2002 was $503,556 or $0.07 per share as compared to a loss of $95,181 or $0.01 per share for the same period in 2001.

The company continues to generate cash flow from operations and in the quarter ended September 30, 2002 generated $194,503 in cash from operations as compared to $235,977 for the previous year.

Financial Condition

The company had a working capital surplus of $3,135,826 as compared to $2,288,081 as at December 31, 2001. The company has entered into a strategic relationship with a private corporation and the parties plan to co-develop software applications for the converging telephony and network industries. As part of this co-operation, the company has advanced funds totaling $500,000 and these advances are secured by the assets of the private corporation. At this time no further advances are planned. The working capital surplus referred to above includes this note receivable.

Cash resources at the end of the third quarter of 2002 were $1,632,502 and liabilities for the same period were $311,661, which consisted of $158,736 in accounts payable and accrued liabilities and $152,925 in deferred revenue. Management feels that with our current cash on hand and cash flows from operations the company has sufficient capital to carry out its business plan for the remainder of 2002 and 2003.

Capital Expenditures

The company continues to ensure that its technology is current and up to date. To facilitate that goal and ongoing research and development, as well as protecting its technology through the registration of patents, the company invested $21,602 in the quarter in new computer equipment and software, sound source and control equipment, and patents. In addition, the company issued warrants valued at $108,725 for services received in the development of new products. This amount has been added to software and production tooling. Advance royalties of $125,000 have been received against this new product and have been allocated to deferred revenue. The amount allocated to software and production tooling will be amortized at the same rate as the advance royalties are recognized as revenue.

Consolidated balance sheets

As at September 30, 2002 and December 31, 2001
(Expressed in United States dollars under Canadian GAAP)

		September 30, 2002		December 31, 2001
ASSETS		(unaudited)		
Current Assets				
Cash and cash equivalents	$	1,632,502	$	2,047,892
Accounts receivable		1,228,845		439,245
Note receivable (note 2)		500,000		—
Inventory		27,728		28,587
Deposits and prepaid expenses		58,412		85,365
		3,447,487		2,601,089
Capital assets (note 3)		1,087,674		1,145,911
Intangible assets (note 4)		2,214,418		2,219,007
	$	6,749,579	$	5,966,007
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current Liabilities				
Accounts payable and accrued liabilities	$	158,736	$	304,726
Deferred revenue		152,925		8,282
		311,661		313,008
Shareholders' equity:				
Share capital (note 5)		43,846,351		43,939,684
Contributed surplus		1,114,316		1,114,316
Deficit		(38,522,749)		(39,401,001)
		6,437,918		5,652,999
	$	6,749,579	$	5,966,007

See accompanying notes to consolidated financial statements.

Consolidated
statements of operations and deficit

For the Periods Ended September 30, 2002 and 2001
(Expressed in United States dollars under Canadian GAAP)

	For three months ended September 30, 2002 (unaudited)	For three months ended September 30, 2001 (unaudited)	For nine months ended September 30, 2002 (unaudited)	For nine months ended September 30, 2001 (unaudited)
REVENUE				
Royalties, license fees				
and product sales	$ 1,308,727	$ 765,188	$ 2,934,054	$ 2,429,180
Cost of product sales	133,684	7,754	192,320	44,083
	1,175,043	757,434	2,741,734	2,385,097
EXPENSES				
Marketing	217,134	240,665	670,266	819,917
Operations	49,069	52,259	192,703	234,618
Product engineering	164,304	212,544	505,021	683,381
Administration	108,740	142,762	381,874	446,623
	539,247	648,230	1,749,864	2,184,539
Operating profit	635,796	109,204	991,870	200,558
Other Items				
Depreciation and amortization	(135,749)	(207,728)	(306,796)	(676,045)
Gain on sale of capital assets	652	—	681	6,515
Other	2,857	3,343	(9,561)	34,502
	(132,240)	(204,385)	(315,676)	(635,028)
Net income (loss) for the period	503,556	(95,181)	676,194	(434,470)
Deficit beginning of period	(39,026,305)	(38,805,322)	(39,198,943)	(38,466,033)
Deficit end of period	$ (38,522,749)	$ (38,900,503)	$ (38,522,749)	$ (38,900,503)
Income (loss) per common share	$ 0.07	$ (0.01)	$ 0.10	$ (0.06)

See accompanying notes to consolidated financial statements.

Consolidated statements of cash flows

For the Periods Ended September 30, 2002 and 2001
(Expressed in United States dollars under Canadian GAAP)

	For three months ended September 30, 2002 (unaudited)	For three months ended September 30, 2001 (unaudited)	For nine months ended September 30, 2002 (unaudited)	For nine months ended September 30, 2001 (unaudited)
Cash provided by (used in)				
OPERATIONS				
Income (loss) for the period	$ 503,556	$ (95,181)	$ 676,194	$ (434,470)
Items not requiring (providing) cash:				
Depreciation and amortization	135,749	207,728	306,796	676,045
Gain on sale of capital assets	(652)	—	(681)	(6,515)
Changes in working capital balances (note 8)	(444,150)	123,430	(763,135)	179,329
	194,503	235,977	219,174	414,389
FINANCING				
Repurchase of common shares, net	—	(56,755)	—	(350,494)
Repayment of debt	—	—	—	(550,000)
	—	(56,755)	—	(900,494)
INVESTMENTS				
Purchase of capital assets	(5,034)	(16,164)	(100,002)	(61,381)
Purchase of intangible assets	(16,568)	—	(35,243)	—
Change in working capital for investment purposes (note 2)	(150,000)	—	(500,000)	—
Proceeds from sale of capital assets	652	—	681	6,515
	(170,950)	(16,164)	(634,564)	(54,866)
Increase (decrease) in cash	23,553	163,058	(415,390)	(540,971)
Cash and cash equivalents beginning of period	1,608,949	1,560,610	2,047,892	2,264,639
Cash and cash equivalents end of period	$ 1,632,502	$ 1,723,668	$ 1,632,502	$ 1,723,668

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 4). 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. Note receivable:

The company has advanced $500,000 to a private company. The advance is secured by all of the assets of the private company.

3. Capital assets:

September 30, 2002	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	$ 544,872	$ 512,920	$ 31,952
Real time systems	905,534	892,043	13,491
Furniture and fixtures	353,827	305,078	48,749
Computer equipment	806,054	591,260	214,794
Software and production tooling	1,367,454	783,342	584,112
Patents and trademarks	763,412	568,836	194,576
	$ 4,741,153	$ 3,653,479	$ 1,087,674

4. Intangible assets:

September 30, 2002	Cost	Accumulated amortization	Net book value
Goodwill	$ 9,894,777	$ 7,710,188	$ 2,184,589
Purchased customer list	34,418	4,589	29,829
	$ 9,929,195	$ 7,714,777	$ 2,214,418

Effective January 1, 2002, the Corporation adopted the new Canadian Institute of Chartered Accountants standard No. 3062 - Goodwill and Other Intangibles ("CICA 3062"), which no longer permits the amortization of goodwill and other indefinite life intangibles. The new standard requires that a fair value impairment test be performed annually on goodwill and other indefinite life intangibles. As required by CICA 3062, goodwill and indefinite life intangibles are tested for impairment as of January 1, 2002. This transitional impairment test was completed, and it has been determined that the fair values of the Corporation's goodwill and indefinite life intangibles exceeded their carrying values. Consequently, no impairment loss was recorded. 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.

5. Share Capital:

	Number of Shares	Consideration
Balance June 30, 2002	7,085,574	$ 43,737,626
Value attributed to warrants issued for services rendered	—	108,725
Balance September 30, 2002	7,085,574	$ 43,846,351

6. Stock Option Plan:

	Number of Shares	Exercise price per share	Weighted average exercise price
Balance at June 30, 2002	1,314,100	$ 0.47 - 12.24	$ 1.87
Granted	275,000	$ 0.57 - 0.62	0.61
Cancelled or expired	(85,194)	$ 2.12 - 9.00	8.92
Balance at September 30, 2002	1,503,906	$ 0.47 - 12.24	$ 1.24

The following table summarized the information about stock options outstanding at September 30, 2002:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at Sept. 30, 2002	Weighted-Average Remaining Terms (Years)	Weighted-Average Exercise Price	Number Exercisable at Sept. 30, 2002	Weighted-Average Exercise Price
$ 0.47 to 0.62	904,797	5.3	$ 0.51	557,797	$ 0.47
1.04	471,638	3.81	1.04	405,203	1.04
2.12 to 6.00	38,000	1.2	2.63	38,000	2.63
8.00 to 12.24	89,471	2.2	9.05	89,471	9.05
	1,503,906			1,090,471	

7. Warrants:

During the three month period ended September 30, 2002 the company issued 250,000 warrants, each one warrant entitling the holder to receive one common share of the Company. The warrants are exercisable at $1.04 and expire March 25, 2007

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

Risk free interest rate	4.5%
Volatility	82%
Life of the warrant	4.5 years
Dividend yield	0%

8. Changes in non-cash working capital balances:

	For the three months ended Sept. 30, 2002	For the three months ended Sept. 30, 2001	For the nine months ended Sept. 30, 2002	For the nine months ended Sept. 30, 2001
Accounts receivable	$ (574,308)	$ 134,802	$ (789,600)	$ 346,163
Inventory	252	(8,931)	859	(8,346)
Deposits and prepaid expenses	54,984	24,170	26,953	(19,333)
Accounts payable and accrued liabilities	(46,788)	(25,328)	(145,990)	(144,555)
Deferred revenue	121,710	(1,283)	144,643	5,400
	$ (444,150)	$ 123,430	$ (763,135)	$ 179,329

9. Segmented Information:

For the three month period ended September 30, 2002

	Audio	E-Commerce	Total
Revenue			
Royalties, license fees and product sales	$ 1,173,848	$ 134,879	$ 1,308,727
Cost of product sales	133,163	521	133,684
	1,040,685	134,358	1,175,043
Expenses			
Marketing	208,236	8,898	217,134
Operations	—	49,069	49,069
Product engineering	128,083	36,221	164,304
Administration	84,678	24,062	108,740
	420,997	118,250	539,247
Operating profit	619,688	16,108	635,796
Other Items			
Depreciation and amortization	(125,068)	(10,681)	(135,749)
Gain on sale of capital assets	652	—	652
Other	2,857	—	2,857
	(121,559)	(10,681)	(132,240)
Net income for the period	$ 498,129	$ 5,427	$ 503,556
Segment assets	$ 4,298,958	$ 2,450,621	$ 6,749,579

9. Segmented Information (continued):

For the three month period ended September 30, 2001

	Audio	E-Commerce	Total
Revenue			
Royalties, license fees and product sales	$ 624,411	$ 140,777	$ 765,188
Cost of product sales	7,754	—	7,754
	616,657	140,777	757,434
Expenses			
Marketing	176,940	63,725	240,665
Operations	—	52,259	52,259
Product engineering	112,177	100,367	212,544
Administration	101,170	41,592	142,762
	390,287	257,943	648,23 0
Operating profit	226,370	(117,166)	109,204
Other Items			
Depreciation and amortization	(51,816)	(155,912)	(207,728)
Gain on sale of capital asset	—	—	—
Other	3,343	—	3,343
	(48,473)	(155,912)	(204,385)
Net income for the period	$ 177,897	$ (273,078)	$ (95,181)
Segment assets December 31, 2001	$ 3,463,729	$ 2,502,278	$ 5,966,007

9. Segmented Information (continued):

For the nine month period ended September 30, 2002

	Audio	E-Commerce	Total
Revenue			
Royalties, license fees and product sales	$ 2,482,986	$ 451,068	$ 2,934,054
Cost of product sales	190,482	1,838	192,320
	2,292,504	449,230	2,741,734
Expenses			
Marketing	641,765	28,501	670,266
Operations	—	192,703	192,703
Product engineering	388,345	116,676	505,021
Administration	301,423	80,451	381,874
	1,331,533	418,331	1,749,864
Operating profit	960,971	30,899	991,870
Other Items			
Depreciation and amortization	(264,071)	(42,725)	(306,796)
Gain on sale of capital assets	681	—	681
Other	(9,561)	—	(9,561)
	(272,951)	(42,725)	(315,676)
Net income for the period	$ 688,020	$ (11,826)	$ 676,194

9. Segmented Information (continued):

For the nine month period ended September 30, 2001

	Audio	E-Commerce	Total
Revenue			
Royalties, license fees and product sales	$ 1,997,792	$ 431,388	$ 2,429,180
Cost of product sales	44,083	—	44,083
	1,953,709	431,388	2,385,097
Expenses			
Marketing	550,229	269,688	819,917
Operations	—	234,618	234,618
Product engineering	360,931	322,450	683,381
Administration	335,038	111,585	446,623
	1,246,198	938,341	2,184,539
Operating profit	707,511	(506,953)	200,558
Other Items			
Depreciation and amortization	(205,438)	(470,607)	(676,045)
Gain on sale of capital asset	6,515	—	6,515
Other	34,502	—	34,502
	(164,421)	(470,607)	(635,028)
Net income for the period	$ 543,090	$ (977,560)	(434,470)

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