



**QSoundLabs**  
Third Quarter 2003



# Message to the shareholders

During this quarter the Company began seeing the results of its marketing efforts in the mobile device and Internet Telephony markets. Specifically, the Company gained its first OEM mobile phone design win for microQ, as well as negotiating partnerships with several semiconductor companies to co-develop and market microQ silicon solutions in 2004. More specific details will be made available as products are released to the market.

Revenue from our Internet Telephony product line increased in line with managements' expectations. The Company also made progress in sourcing a suitable hardware manufacturing partner for the future. It is the Company's goal to focus on value added software for this growth market while relying on partners for manufacturing expertise.

Revenue from other business segments has remained flat as anticipated. With the extension of our Toshiba license as previously announced and Philips continued marketing efforts to the PC market, management expects some growth in 2004 in these areas to complement the mobile and Internet Telephony markets.



**David Gallagher**  
President and  
Chief Executive Officer

# **Management's**

**Discussion and Analysis**

**Third Quarter ended September 30, 2003**

This Management Discussion and Analysis ("MD&A") of the results of operations of QSound Labs, Inc. (the company) for the quarter ended September 30, 2003 should be read in conjunction with the interim unaudited consolidated financial statements of the company for the quarter ended September 30, 2003, and the annual audited financial statements of the company for the fiscal year ended December 31, 2002. Management has prepared these notes with the understanding that readers are already familiar with the MD&A for the fiscal year ended December 31, 2002.

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, 2003 were \$465,667 as compared to \$1,308,727 for the same period in 2002. The audio segment had revenues of \$284,579 for the quarter as compared to \$1,173,848 for the same period in 2002. The decrease was due primarily to the expiration of the North American portion of royalties received from the hearing aid license. The e-commerce segment had revenues of \$83,231 as compared to \$134,879 for 2002. The decrease was due to a decrease in the number of subscribers for the e-commerce services. The telephony segment had revenues of \$97,857, an increase of \$60,000 over the previous quarter. The increase is due to the building and implementation of our dealer network for the telephony product line.

The Company experienced an operating loss for the quarter of \$382,774 as compared to an

operating profit of \$630,441 for the same period last year. The decrease was due primarily to the expiration of the North American portion of royalties received from the hearing aid license, the start-up costs related to the telephony segment, and the marketing and engineering costs related to our new revenue streams.

Net loss for the quarter ended September 30, 2003 was \$463,516 or \$0.06 per share as compared to a net profit of \$503,556 or \$0.07 per share for the same period in 2002. The audio segment had a loss of \$353,568 in 2003 as compared to a profit of \$498,129 in 2002. The decrease in profit is due primarily to the expiration of the North American portion of royalties received from the hearing aid license. The e-commerce segment had profits of \$26,465 in 2003 compared to profits of \$5,427 in 2002. The increase in profits is due to cost cutting measures taken. The telephony segment had losses of \$136,413 for the third quarter.

The company used \$542,900 of cash in operations for the quarter ended September 30, 2003, as compared to cash generated from operations of \$194,503 in 2002.

### **Financial Condition**

The company had a working capital surplus of \$2,774,065 at September 30, 2003 as compared to \$3,284,448 as at December 31, 2002.

Cash resources at the end of the third quarter of 2003 were \$2,488,449 and liabilities for the same period were \$274,699, which consisted of \$176,863 in accounts payable and accrued liabilities and \$97,836 in deferred revenue. Management feels that with our current cash on hand the company has sufficient capital to carry

out its business plan for the remainder of 2003 and 2004.

The company continues to hold sufficient Canadian dollar denominated cash to meet its estimated requirement for Canadian dollar funds for the remainder of the year.

During 2002 the company entered into a strategic relationship with a private corporation whereby the parties planned to co-develop software applications for the converging telephony and network industries. As part of this co-operation, the company had advanced funds totaling \$500,000 and these advances were secured by the assets of the private corporation. Subsequent to the end of the 2002 year the company advanced a further \$25,000 to a receiver to enforce its security. At the beginning of the second quarter of 2003 the company collected on the note by acquiring title to software, inventory, in process research and development, and furniture and equipment.

### **Capital Expenditures**

The company continues to take steps 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 trademarks and patents, the company invested \$52,712 in the quarter in new computer equipment and software, trademarks and patents.

# Consolidated balance sheets

As at September 30, 2003 and December 31, 2002  
(Expressed in United States dollars under Canadian GAAP)

	September 30, 2003	December 31, 2002
<b>ASSETS</b>	(unaudited)	
<i>Current Assets</i>		
Cash and cash equivalents	\$ 2,488,449	\$ 2,621,205
Accounts receivable	306,459	929,519
Inventory	129,234	16,455
Deposits and prepaid expenses	124,622	58,674
	3,048,764	3,625,853
Note receivable (note 2)	—	500,000
Capital assets (note 3)	1,204,592	747,553
Goodwill	2,184,589	2,184,589
Intangible assets (note 4)	190,787	213,771
	\$ 6,628,732	\$ 7,271,766
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<i>Current Liabilities</i>		
Accounts payable and accrued liabilities	\$ 176,863	\$ 220,894
Deferred revenue	97,836	120,511
	274,699	341,405
<i>Shareholders' equity</i>		
Share capital (note 5)	44,012,266	43,886,036
Contributed surplus	1,114,316	1,114,316
Deficit	(38,772,549)	(38,069,991)
	6,354,033	6,930,361
	\$ 6,628,732	\$ 7,271,766

See accompanying notes to consolidated financial statements.

# Consolidated statements of operations and deficit

For the periods ended September 30, 2003 and 2002  
(Expressed in United States dollars under Canadian GAAP)

	For the three months ended Sept. 30, 2003	For the three months ended Sept. 30, 2002	For the nine months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2002
<b>REVENUE</b>	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Royalties and license fees	\$ 114,879	\$ 898,977	\$ 691,287	\$ 1,890,911
Product sales	350,788	409,750	988,538	1,043,143
	465,667	1,308,727	1,679,825	2,934,054
Cost of product sales	136,749	133,684	283,762	192,320
	328,918	1,175,043	1,396,063	2,741,734
<b>EXPENSES</b>				
Marketing	287,549	217,134	866,796	670,266
Operations	45,667	49,069	121,921	192,703
Product engineering	244,753	164,304	598,703	505,021
Administration	133,723	114,095	414,190	381,874
	711,692	544,602	2,001,610	1,749,864
Operating (loss) profit	(382,774)	630,441	(605,547)	991,870
<b>Other Items</b>				
Depreciation and amortization	(74,904)	(135,749)	(237,628)	(306,796)
Interest and other income	11,031	6,006	34,153	19,298
Gain (loss) on sale of capital assets	179	652	(1,729)	681
Other	(17,048)	2,206	108,193	(28,859)
	(80,742)	(126,885)	(97,011)	(315,676)
Net (loss) income for the period	(463,516)	503,556	(702,558)	676,194
Deficit beginning of period	(38,309,033)	(39,026,305)	(38,069,991)	(39,198,943)
Deficit end of period	\$ (38,772,549)	\$ (38,522,749)	\$ (38,772,549)	\$ (38,522,749)
Income (loss) per common share	\$ (0.06)	\$ 0.07	\$ (0.10)	\$ 0.10

See accompanying notes to consolidated financial statements.

# Consolidated statements of cash flows

For the periods ended September 30, 2003 and 2002  
(Expressed in United States dollars under Canadian GAAP)

	For the three months ended Sept. 30, 2003 (unaudited)	For the three months ended Sept. 30, 2002 (unaudited)	For the nine months ended Sept. 30, 2003 (unaudited)	For the nine months ended Sept. 30, 2002 (unaudited)
Cash provided by (used in)				
<b>OPERATIONS</b>				
(Loss) income for the period	\$ (463,516)	\$ 503,556	\$ (702,558)	\$ 676,194
Items not requiring (providing) cash:				
Depreciation and amortization	74,904	135,749	237,628	306,796
Compensation cost of options issued to non-employees	—	—	5,864	—
Loss (gain) on sale of capital assets	(179)	(652)	1,729	(681)
Changes in working capital balances (note 8)	(154,109)	(444,150)	394,536	(763,135)
	(542,900)	194,503	(62,801)	219,174
<b>FINANCING</b>				
Issuance of common shares, net	1,645	—	11,642	—
	1,645	—	11,642	—
<b>INVESTMENTS</b>				
Purchase of capital assets	(40,810)	(5,034)	(51,219)	(100,002)
Purchase of intangible assets	(11,902)	(16,568)	(36,179)	(35,243)
Change in working capital for investment purposes	—	(150,000)	—	(500,000)
Proceeds from sale of capital assets	179	652	5,801	681
	(52,533)	(170,950)	(81,597)	(634,564)
(Decrease) increase in cash	(593,788)	23,553	(132,756)	(415,390)
Cash and cash equivalents beginning of period	3,082,237	1,608,949	2,621,205	2,047,892
Cash and cash equivalents end of period	\$ 2,488,449	\$ 1,632,502	\$ 2,488,449	\$ 1,632,502

See accompanying notes to consolidated financial statements.



# NOTES to consolidated financial statements

For the period ended September 30, 2003  
Unaudited

(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., QKidz, Inc., and QTeINet Inc. All significant inter-company transactions and balances have been eliminated. During 2002 QKidz, Inc. was wound up and during 2003 QSound Electronics, Inc. was wound up.

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, 2002. These interim financial statements should be read in conjunction with the Company's December 31, 2002 audited annual financial statements. The disclosures provided below are incremental to those included in the annual financial statements.

## 2. Note receivable:

The company had advanced \$525,000 to a private company. During the previous period the company enforced its security and collected on the note by acquiring title to all of the private company's assets.

## 3. Capital assets:

September 30, 2003	Cost	Accumulated depreciation	Net book value
Sound source and control equipment	\$ 555,653	\$ 519,754	\$ 35,899
Real time systems	905,534	896,090	9,444
Furniture and fixtures	353,321	313,339	39,982
Computer equipment	818,678	647,745	170,933
Software and production tooling	1,956,929	1,008,595	948,334
	\$ 4,590,115	\$ 3,385,523	\$ 1,204,592

#### 4. Other Intangible assets:

<b>September 30, 2003</b>	<b>Cost</b>	<b>Accumulated amortization</b>	<b>Net book value</b>
Patents and trademarks	\$ 816,679	\$ 648,264	\$ 168,415
Purchased customer list	34,418	12,046	22,372
	\$ 851,097	\$ 660,310	\$ 190,787

#### 5. Share Capital:

	<b>Number of Shares</b>	<b>Consideration</b>
Balance June 30, 2003	7,177,344	\$ 44,010,621
Issued for cash on exercise of options	3,500	1,645
Balance at September 30, 2003	7,180,844	\$ 44,012,266

#### 6. Stock Option Plan:

	<b>Number of shares</b>	<b>Exercise price per share</b>	<b>Weighted average exercise price</b>
Balance at June 30, 2003	1,522,152	\$ 0.47 - 12.24	\$ 0.87
Granted	365,000	1.21 - 1.48	1.24
Exercised	(3,500)	0.47	0.47
Cancelled or expired	(3,487)	12.24	12.24
Balance at September 30, 2003	1,800,165	\$ 0.47 - 6.00	\$ 0.92

## 6. Stock Option Plan (continued):

The following table summarized the information about stock options outstanding at September 30, 2003:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at Sept. 30, 2003	Weighted-Average Remaining Terms (Years)	Weighted-Average Exercise Price	Number Exercisable at Sept. 30, 2003	Weighted-Average Exercise Price
\$ 0.47	540,527	3.1	\$ 0.47	506,297	\$ 0.47
0.57 - 1.00	280,000	7.3	0.61	81,666	1.00
1.04 - 1.65	1,016,638	3.2	1.19	625,203	1.19
1.75 - 6.00	43,000	0.4	2.53	43,000	2.53
	1,880,165			1,256,166	

## 7. Warrants:

During the three month period ended March 31, 2003 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, was capitalized to software and production tooling, and was calculated using the Black Scholes pricing model with the following weighted average assumptions:

Risk free interest rate	4.5%
Volatility	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, 2003	For the three months ended Sept. 30, 2002	For the nine months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2002
Accounts receivable	\$ (57,686)	\$ (574,308)	\$ 623,060	\$ (789,600)
Inventory	(1,925)	252	(95,870)	859
Deposits and prepaid expenses	(50,539)	54,984	(65,948)	26,953
Accounts payable and accrued liabilities	(42,317)	(46,788)	(44,031)	(145,990)
Deferred revenue	(1,642)	121,710	(22,675)	144,643
	\$ (154,109)	\$ (444,150)	\$ 394,536	\$ (763,135)

## 9. Segmented Information:

	Audio	E-Commerce	Telephony	Total
<b>For the three month period ended September 30, 2003</b>				
Revenues	\$ 284,579	\$ 83,231	\$ 97,857	\$ 465,667
Interest revenue	11,031	—	—	11,031
Amortization of capital assets	45,192	9,992	—	55,184
Segment profit (loss)	(353,568)	26,465	(136,413)	(463,516)
Segment assets	3,549,909	2,346,904	731,919	6,628,732
Goodwill	—	2,184,589	—	2,184,589
Expenditures for segment capital assets	10,280	—	28,486	38,766

## 9. Segmented Information (continued):

	Audio	E-Commerce	Telephony	Total
<b>For the three month period ended September 30, 2002</b>				
Revenues	\$ 1,173,848	\$ 134,879	\$ —	\$ 1,308,727
Interest revenue	4,617	1,389	—	6,006
Amortization of capital assets	71,232	6,023	—	77,255
Segment profit (loss)	498,129	5,427	—	503,556
Segment assets	4,298,958	2,450,621	—	6,749,579
Goodwill	—	2,184,589	—	2,184,589
Expenditures for segment capital assets	113,759	—	—	113,759
<b>For the nine month period ended September 30, 2003</b>				
Revenues	\$ 1,268,655	\$ 276,039	\$ 135,131	\$ 1,679,825
Interest revenue	34,153	—	—	34,153
Amortization of capital assets	148,489	29,977	—	178,466
Segment profit (loss)	(504,091)	90,560	(289,027)	(702,558)
Expenditures for segment capital assets	121,016	867	511,576	633,459

## 9. Segmented Information (continued):

For the nine month period ended September 30, 2002				
	Audio	E-Commerce	Telephony	Total
Revenues	\$ 2,482,986	\$ 451,068	\$ —	\$ 2,934,054
Interest revenue	17,909	1,389	—	19,298
Amortization of capital assets	210,235	38,067	—	248,302
Segment profit (loss)	688,020	(11,826)	—	676,194
Expenditures for segment capital assets	208,626	—	—	208,626

## Geographic Information - Revenue

	For the three months ended Sept. 30, 2003	For the three months ended Sept. 30, 2002	For the nine months ended Sept. 30, 2003	For the nine months ended Sept. 30, 2002
Canada	\$ 50,884	\$ —	\$ 60,489	\$ 2,104
United States	293,140	1,088,615	1,271,990	2,528,415
Asia	121,634	220,112	347,346	403,535
	\$ 465,667	\$ 1,308,727	\$ 1,679,825	\$ 2,934,054

## 10. Comparative figures:

Certain of the prior period figures, provided for the purpose of comparison, have been reclassified to conform to the current period's presentation.





**QSOUND LABS, INC.**

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