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SORRENTO NETWORKS CORP
Form 10-Q
September 17, 2003

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
 X OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JULY 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER: 0-15810

SORRENTO NETWORKS CORPORATION
(Exact name of Registrant as specified in charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-3757589
(I.R.S. Employer
Identification Number)

9990 Mesa Rim Road
San Diego, California
(Address of principal executive offices)

92121
(Zip Code)

Registrant's telephone number, including area code: (858) 558-3960

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 X No

Indicate the number of shares outstanding of each of the issuer's classes
of common stock, as of the latest practicable date:

Common Stock, \$0.001 par value per share, Outstanding: 10,335,800 shares
at September 5, 2003.

Indicate by check mark whether the registrant is an accelerated filer as

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defined in rule 12-b2 of the Securities Exchange Act of 1934. Yes No -----

This Form 10-Q, future filings of the registrant, and oral statements made with the approval of an authorized executive officer of the Registrant may contain forward looking statements. In connection therewith, please see the cautionary statements and risk factors contained in Item 2. "Fluctuations in Revenue and Operating Results" and "Forward Looking Statements -- Cautionary Statement", which identify important factors which could cause actual results to differ materially from those in any such forward-looking statements.

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SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In Thousands, except share information)

| | |
|--|---------------|
| | July 31, 2003 |
| | ----- |
| | (Unaudited) |
| ASSETS | |
| CURRENT ASSETS | |
| Cash and equivalents..... | \$ 5 |
| Accounts receivable, net..... | 3 |
| Inventory, net..... | 12 |
| Prepaid expenses and other current assets..... | |
| Investment in marketable securities..... | |
| | ----- |
| TOTAL CURRENT ASSETS..... | 21 |
| | ----- |
| PROPERTY AND EQUIPMENT, NET..... | 13 |
| | ----- |
| OTHER ASSETS | |
| Purchased technology, net..... | |
| Investment in non-marketable securities..... | 5 |
| Other assets..... | |
| | ----- |
| TOTAL OTHER ASSETS..... | 6 |
| | ----- |
| TOTAL ASSETS..... | \$ 41 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' DEFICIT

| | |
|--|----|
| CURRENT LIABILITIES | |
| Current maturities of long term debt..... | \$ |
| Accounts payable..... | 2 |
| Deferred revenue..... | |
| Accrued professional fees..... | 2 |
| Other accrued liabilities and current liabilities..... | 5 |
| Due on redemption of preferred security of subsidiary..... | |

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| | |
|---|-------|
| TOTAL CURRENT LIABILITIES..... | 11 |
| Long-term debt and capital lease obligations..... | 3 |
| Debentures payable..... | 13 |
| Dividends payable..... | |
| TOTAL LIABILITIES..... | 28 |
| COMMITMENTS AND CONTINGENCIES | |
| STOCKHOLDERS' EQUITY | |
| Preferred stock, \$.01 par value; liquidation preference \$1,353..... | |
| Common stock, \$.001 par value; 150,000,000 shares authorized; 8,942,849 shares issued 8,942,405 shares outstanding at July 31, 2003; 886,494 shares issued 886,050 shares outstanding at January 31, 2003..... | 194 |
| Additional paid-in capital..... | |
| Deferred stock compensation..... | |
| Accumulated deficit..... | (181) |
| Accumulated other comprehensive income (loss) | |
| Treasury stock, at cost; 444 shares at July 31, 2003 and January 31, 2003, respectively..... | |
| TOTAL STOCKHOLDERS' EQUITY..... | 13 |
| TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT..... | \$ 41 |

See accompanying notes to consolidated financial statements.

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(In Thousands, except per share amounts)

| | Three Months Ended July 31, | |
|-----------------------|--------------------------------|----------|
| | 2003 | 2002 |
| NET SALES | \$ 4,476 | \$ 5,199 |
| COST OF SALES | 3,113 | 7,499 |
| GROSS PROFIT | 1,363 | (2,300) |
| OPERATING EXPENSES | | |
| Selling and marketing | 1,891 | 3,645 |

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| | | |
|--|----------|-------------|
| Engineering, research and development | 1,550 | 2,339 |
| General and administrative | 1,912 | 5,911 |
| Deferred stock compensation | 0 | 109 |
| Other operating expenses | 103 | 93 |
| <hr/> | | |
| TOTAL OPERATING EXPENSES | 5,456 | 12,097 |
| <hr/> | | |
| (LOSS) FROM OPERATIONS | (4,093) | (14,397) |
| <hr/> | | |
| OTHER INCOME (EXPENSES) | | |
| Investment income | 8 | 93 |
| Interest expense | (1,139) | (1,541) |
| Other income (expenses) | 13,712 | 39 |
| Gain on sale of marketable securities | 4,026 | - |
| <hr/> | | |
| TOTAL OTHER INCOME (EXPENSES) | 16,607 | (1,409) |
| <hr/> | | |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAX | 12,514 | (15,806) |
| PROVISION FOR INCOME TAXES | - | - |
| <hr/> | | |
| NET INCOME (LOSS) | \$12,514 | \$ (15,806) |
| <hr/> | | |
| EARNINGS (LOSS) PER SHARE: | | |
| BASIC WEIGHTED AVERAGE COMMON SHARES OUTSTANDING | 5,869 | 740 |
| <hr/> | | |
| BASIC NET INCOME (LOSS) PER COMMON SHARE | \$ 2.13 | \$ (21.35) |
| <hr/> | | |
| DILUTED WEIGHTED AVERAGE COMMON SHARES OUTSTANDING | 7,366 | 964 |
| <hr/> | | |
| DILUTED NET INCOME (LOSS) PER COMMON SHARE | \$ 1.72 | \$ (45.20) |
| <hr/> | | |
| COMPREHENSIVE INCOME AND ITS COMPONENTS CONSIST OF THE FOLLOWING: | | |
| Net income (loss) | \$12,514 | \$ (15,806) |
| Unrealized gains(losses) from marketable securities: | | |
| Unrealized holding gains(losses) arising during the period | 110 | (6,812) |
| Reclassification adjustment for gains included in net income | (4,026) | |
| <hr/> | | |
| NET COMPREHENSIVE INCOME (LOSS) | \$ 8,598 | \$ (22,618) |
| <hr/> | | |

See accompanying notes to consolidated financial statements.

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SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES
For the three months ended July 31, 2003

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(In Thousands)

| | Common Stock | | Prefer |
|---|--------------|---------|--------|
| | Shares | Amount | Shares |
| Balance at January 31, 2003 | 886 | \$5,318 | 2 |
| Common stock par value re-valuation | | (5,317) | |
| Restructuring adjustment | | | |
| Stock option and warrant exercises | | | |
| Common stock issuance | 8,030 | 8 | |
| Unrealized gains (losses) on available for sale securities | | | |
| Realized gains on available for sale securities | | | |
| Deferred stock compensation of subsidiary | | | |
| Expenses paid with stock issuances | 27 | 0 | |
| Amortization of deferred stock compensation | | | |
| Net income (loss) | | | |
| Balance at July 31, 2003 | 8,943 | \$9 | 2 |

| | Deferred | Accumulated | Treasury Stock | | O |
|---|--------------|--------------|----------------|---------|-------|
| | Stock | | Shares | Amount | |
| | Compensation | Deficit | | | Incom |
| Balance at January 31, 2003. | \$ (5) | \$ (187,536) | 1 | \$ (69) | |
| Common stock par value re-valuation | | | | | |
| Restructuring adjustment | | | | | |
| Stock option and warrant exercises | | | | | |
| Common stock issuance | | | | | |
| Unrealized gains (losses) on available for sale securities | | | | | |
| Realized gains on available for sale securities | | | | | |
| Deferred stock compensation of subsidiary | (46) | | | | |
| Expenses paid with stock issuances | | | | | |
| Amortization of deferred stock compensation | 51 | | | | |
| Net income (loss) | | 6,293 | | | |
| Balance at July 31, 2003 | \$-- | \$ (181,243) | 1 | \$ (69) | |

See accompanying notes to consolidated financial statements.

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SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES
For the three months ended July 31, 2002

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(In Thousands)

| | Common Stock | | Preferred Stock | |
|---|--------------|---------|-----------------|--------|
| | Shares | Amount | Shares | Amount |
| Balance at January 31, 2002 | 710 | \$4,263 | 2 | \$1 |
| Stock option and warrant exercises | 1 | 9 | | |
| Unrealized losses on available for sale securities | | | | |
| Realized gains (loss) on available for sale securities | | | | |
| Deferred stock compensation of subsidiary | | | | |
| Expenses paid with stock issuances | 57 | 335 | | |
| Amortization of deferred stock compensation | | | | |
| Net loss | | | | |
| Balance at July 31, 2002 | 768 | \$4,607 | 2 | \$1 |

| | Deferred Stock Compensation | Accumulated Deficit | Treasury Stock | | Other Comprehens Income (L |
|---|-----------------------------------|------------------------|-------------------|--------|----------------------------------|
| | | | Shares | Amount | |
| Balance at January 31, 2002 | \$(255) | \$(161,326) | 1 | \$(69) | \$ 24,16 |
| Stock option and warrant exercises | | | | | |
| Unrealized losses on available for sale securities | | | | | (8,21 |
| Realized gains (loss) on available for sale securities | | | | | (11,65 |
| Deferred stock compensation of subsidiary | (91) | | | | |
| Expenses paid with stock issuances | | | | | |
| Amortization of deferred stock compensation | 215 | | | | |
| Net loss | | \$(11,830) | | | |
| Balance at July 31, 2002 | \$(131) | \$(173,156) | 1 | \$(69) | \$ 4,29 |

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See accompanying notes to consolidated financial statements.

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SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
 (In Thousands)

| | Si |
|---|----------------------|
| | ----- 20 ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net income (loss)..... | \$ 6, |
| | ----- |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | |
| Depreciation and amortization..... | 1, |
| Accounts receivable and inventory reserves..... | (1, |
| Expenses paid through issuance of securities..... | (4, |
| Gain on sale of marketable securities..... | 2, |
| Non-cash interest on debentures..... | (13, |
| Gain on restructuring..... | (13, |
| Deferred and other stock compensation..... | (13, |
| Changes in assets and liabilities: | |
| (Increase) decrease in accounts receivable..... | 2, |
| Decrease in inventories..... | 2, |
| Decrease in other current assets..... | (2, |
| Decrease in accounts payable..... | (2, |
| Increase (decrease) in accrued and other current liabilities..... | (4, |
| | ----- |
| NET CASH USED IN OPERATING ACTIVITIES..... | (9, |
| | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| (Purchase) disposal of property and equipment..... | 1, |
| Cash received from sale of marketable securities and other investments..... | 4, |
| Other assets..... | (1, |
| | ----- |
| NET CASH PROVIDED BY INVESTING ACTIVITIES..... | 6, |
| | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Payments of short-term debt, net..... | (2, |
| Repayment of long-term debt..... | (1, |
| Proceeds from common stock..... | (1, |
| | ----- |
| NET CASH USED IN FINANCING ACTIVITIES..... | (4, |
| | ----- |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS..... | (2, |
| CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD..... | 7, |
| | ----- |
| CASH AND CASH EQUIVALENTS - END OF PERIOD..... | \$ 5, |

See accompanying notes to consolidated financial statements.

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SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND SIX MONTHS ENDED JULY 31, 2003 AND 2002

The Company

Sorrento Networks Corporation (the "Company," "We," "Our," or "Us") through its subsidiaries designs, manufactures and markets integrated networking and bandwidth aggregation products for enhancing the performance of data and telecommunications networks. Our products are deployed in telephone companies, Internet Service Providers, governmental bodies and the corporate/campus networks that make up the "enterprise" segment of the networking marketplace. We have facilities in San Diego, California and various sales offices located in the United States and Europe. We market and sell our products and services through a broad array of channels including worldwide distributors, value added resellers, local and long distance carriers and governmental agencies.

Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial data for the three months and six months ended July 31, 2003 and 2002 along with financial data for January 31, 2003, has been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The January 31, 2003 balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, we believe that the disclosures we have made are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K/A for the year ended January 31, 2003.

We have incurred significant losses and negative cash flows from operations for the past two years. SNI, our principal operating subsidiary, has primarily been the operating entity responsible for these losses and negative cash flows. The losses have been generated as SNI continues to develop its technology, marketing, sales and operations in its effort to become a major supplier of metro and regional optical networks worldwide. We fund our operations primarily through a combination of internal funds, investments, and

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debt and equity financing. There can be no assurance that similar funding will be available in the future. Further, with the recent downturn in the economic environment and decreases in capital spending by telecom carriers, we believe our current and future revenues could be negatively impacted. However, orders for the six months ended July 31, 2003 were substantially higher than for the same comparable six months last year and as a result we believe this upward trend could indicate a potential recovery from the lingering telecom capital expenditure downturn. In either case, future increases in working capital will be required to both maintain and grow our business along with a continued and substantial focus on reducing operating expenses. Given the uncertainty and/or unpredictability of the telecom market and the limited amount of our existing working capital there can be no assurance that our existing financial resources will be sufficient to cover our operational needs for the next twelve months. If however, our revenues continue to show improvement, we implement our plans on expense reductions and attract additional working capital through the issuance of stock or debt, our balance sheet will be significantly improved and will provide us with the necessary financial resources to meet our operational plans for a period exceeding one year. Our future capital requirements may vary materially from those now planned including the need for additional working capital to accommodate planned growth, hiring and infrastructure needs. There can be no assurances that our working capital requirements will not exceed our ability to generate sufficient cash internally to support our requirements and that external financing will be available or that, if available, such financing can be obtained on terms favorable to us and our shareholders.

Use of Estimates

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The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities. Actual results could materially differ from these estimates. In the opinion of Management, all adjustments (which include normal recurring adjustments and charges described in the notes to the financial statements) necessary to present fairly the financial position, results of operations and cash flows for the quarter and six months ended July 31, 2003 and 2002 have been made. The results of operations for the three and six months ended July 31, 2003 are not necessarily indicative of the operating results for the full year.

Certain reclassifications have been made to prior year presentations to conform to the 2004 presentation.

Digi International, Inc. and NETsilicon, Inc.

Digi International, Inc. and NETsilicon, Inc. -- On September 15, 1999, NETsilicon, Inc. ("NSI") completed an initial public offering in which 6,037,500 shares of its common stock were sold (3,537,500 shares by NSI and 2,500,000 shares by us). NSI received net proceeds of \$22.3 million and we received net proceeds of \$15.4 million. In addition, NSI repaid advances due us of \$5.9 million. In connection with the initial public offering by NSI, our remaining 55% interest became non-voting shares. Accordingly, our financial statements reflected the results of operations of NSI through September 14, 1999 at which

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time our remaining interest was accounted for as an "available for sale security." Under this accounting, the 7.5 million shares of NSI held by us were marked-to-market at the end of each reporting period with the difference between our basis and the fair market value, as reported on NASDAQ, reported as a separate element of stockholders' equity and included in the computation of comprehensive loss.

In October 2000, we sold 350,000 shares of our investment in NSI for \$4.2 million. The purchasers had the right to receive additional NSI shares from us if the three-day average high for the NSI common stock, as quoted on NASDAQ, at December 31, 2000 was less than the price paid to us by the purchasers but not less than \$8.00 per share. We issued an additional 177,344 shares of NSI to the purchasers, reducing the price per share we received to \$8.00 per share. Our former Chairman and CEO purchased 100,000 of these shares of NSI for \$1.2 million and received an additional 45,546 shares pursuant to the price protection provision. As a result of this transaction, our remaining interest was approximately 7.0 million shares of NSI, or 51% of the outstanding shares of NSI as of January 31, 2002 and continued to be accounted for as a marked-to-market security.

On February 13, 2002, NSI completed a merger with Digi International, Inc. ("DIGI"). In connection with the merger, we exchanged our 6,972,656 shares of NSI for 2,324,683 shares of DIGI and \$13.6 million in cash. On December 9, 2002, we sold one-half of our holdings in DIGI for \$3.10 per share. The purchaser of the stock was DIGI, itself. The proceeds from this sale, in the amount of \$3.6 million, were deposited on December 13, 2002. The remaining 1,162,341 DIGI shares were sold on May 2, 2003 for \$4.26 per share. The purchaser of the stock was again DIGI. The proceeds from this sale, in the amount of approximately \$5.0 million, were deposited on May 7, 2003.

Entrada Networks, Inc.--On August 31, 2000, we completed a merger of our then subsidiary Entrada Networks with Sync Research, Inc. ("Sync"), a NASDAQ listed company in which we received 4,244,155 shares of the merged entity, which changed its name to Entrada Networks, Inc. ("ENI"). We purchased 93,900 shares of Sync in the open market during June and July 2000 for \$388 and on August 31, 2000 purchased an additional 1,001,818 shares directly from ENI for \$3.3 million. After these transactions and ENI's issuance of additional shares to outside investors in connection with the merger we owned 49% of ENI. Accordingly, our financial statements reflected the results of operations of ENI through August 31, 2000.

Pursuant to a plan adopted by our Board of Directors prior to the merger we distributed 3,107,155 of our ENI shares on December 1, 2000 to our shareholders of record as of November 20, 2000. The distribution was made at the rate of one-fourth (0.25) of an ENI share for each of our outstanding shares. At exercise, options and warrants to acquire our common shares, which were granted and unexercised as of November 20, 2000, would have received a similar number of ENI shares. Prior to January 31, 2001 we distributed 20,182 of our ENI shares upon the exercise of options and as of January 31, 2003 we reserved 826,000 shares for future exercises of options and warrants. The cost basis of these reserved shares and related liability to the option and warrant holders was included in the investment in former subsidiary and dividends payable in our balance sheet. The aggregate distribution of our ENI shares including the shares reserved for option and warrant holders was accounted for at our original cost of \$5.1

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million. In addition, we granted options to purchase 410,000 of our ENI shares for \$3.19 per share (the merger price) to several of our then officers and consultants. In April 2003, our Board of Directors determined that the 826,000 ENI shares should be made available for general corporate purposes, and we are no longer reserving any for distribution to option and warrant holders.

In accordance with a settlement agreement reached between Sorrento Networks and our former Chairman and Founder, Par Chadha, 566,000 shares of ENI stock were transferred to Mr. Chadha in exchange for mutual releases by the Company and Mr. Chadha and certain of his affiliates. The stock transfer was completed on July 1, 2003 and had a value of \$88 thousand. In addition, we transferred 128,214 shares of ENI stock to settle a dispute between a former employee and the Company. The value of the transfer was \$20 thousand and was completed on July 16, 2003.

The remaining 458,286 ENI shares owned by us are accounted for as an "available for sale security". Under this accounting, these shares are marked-to-market at the end of each reporting period. The difference between our basis and the fair market value, as reported on NASDAQ, is a separate element of stockholders' equity and is included in the computation of comprehensive income.

Deferred Stock Compensation

We account for employee-based stock compensation utilizing the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, compensation cost for stock options issued to employees is measured as the excess, if any, of the fair market price of our common stock at the date of grant over the amount an employee must pay to acquire the stock. This amount appears as a separate component of stockholders' equity and is being amortized on an accelerated basis by charges to operations over the vesting period of the options in accordance with the method described in Financial Accounting Standards Board Interpretation No. 28. All such amounts relate to options to acquire common stock of our subsidiary Sorrento Networks, Inc. ("SNI") granted by it to its employees; during the three and six months ended July 31, 2003 and 2002 it amortized \$0 and \$63 thousand, and \$5 thousand and \$157 thousand, respectively, of the total \$2.6 million initially recorded for deferred stock compensation. As of April 30, 2003 the deferred stock compensation amount of \$2.6 million has been fully amortized.

For non-employees, we compute the fair value of stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," and Emerging Issues Tax Force (EITF) 96-18, "Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." All such amounts relate to options to acquire common stock of our subsidiary Sorrento Networks, Inc. ("SNI") granted by it to its consultants; during the three and six months ended July 31, 2003 and 2002 it recorded \$0 and \$46 thousand, and \$46 and \$58 thousand, respectively, for options granted to consultants. As of April 30, 2003 the deferred stock compensation for non-employees was fully amortized.

Recent Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards ("SFAS") No. 150. "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 clarifies the accounting for certain financial

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instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities in the balance sheets. Previously, many of those financial instruments were classified as equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We expect this pronouncement will not have a material impact on our results of operations and financial condition.

In April 2003, the FASB issued SFAS No. 149, "Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). In particular, it (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in SFAS 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to the language used in FASB Interpretation No. ("FIN") 45, "Guarantor Accounting and

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Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others" ("FIN 45") and (4) amends certain other existing pronouncements. SFAS 149 will be effective for contracts entered into or modified after June 30, 2003, except as stated below, and for hedging relationships designated after June 30, 2003. The provisions of SFAS 149 that relate to guidance in SFAS 133 Implementation Issues that have been effective for fiscal quarters which began prior to June 15, 2003, will continue to be applied in accordance with their respective effective dates. In addition, certain provisions relating to forward purchases or sales of when-issued securities or other securities that do not yet exist, will be applied to both existing contracts as well as new contracts entered into after June 30, 2003. We will apply the provision of SFAS 149 on a prospective basis to contracts entered into or modified after June 30, 2003 and expect that this pronouncement will not have a material impact on our results of operations and financial condition.

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities", and interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements", FIN No. 46 explains how to identify variable interest entities and how an enterprise assesses its interests in a variable interest entity to decide whether to consolidate that entity. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. FIN No. 46 is effective immediately for variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. The Interpretation applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. We have adopted FIN No. 46 with no material effect on our financial position or results of operations.

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In November 2002, the FASB Emerging Issues Task Force ("EITF") reached a consensus on Issue 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). In the absence of higher level accounting literature, EITF 00-21 governs how to separate and allocate revenue to goods or services or both that are to be delivered in a bundled sales arrangement. EITF 00-21 applies to revenue arrangements entered into after June 30, 2003 and allows for either prospective application or cumulative adjustment upon adoption. We will apply the guidance of EITF 00-21 on a prospective basis and expect that this pronouncement will not have a material impact on our results of operations and financial condition.

Balance Sheet Detail

Inventories at July 31, 2003 and January 31, 2003 consist of:

| | (thousands) | |
|------------------------------|------------------|---------------------|
| | July 31, 2003 | January 31, 2003 |
| | ----- | ----- |
| Raw material..... | \$9,849 | \$10,767 |
| Work in process..... | 1,511 | 2,804 |
| Finished goods..... | 6,054 | 6,326 |
| | ----- | ----- |
| | 17,414 | 19,897 |
| Less: Valuation reserve..... | (4,697) | (5,963) |
| | ----- | ----- |
| | \$12,717 | \$13,934 |
| | ===== | ===== |

Marketable Securities--Marketable securities, which consist of equity securities that have a readily determinable fair value and do not have sale restrictions lasting beyond one year from the balance sheet date, are classified into categories based on our intent. Our investments in DIGI and Entrada are classified as available for sale and are carried at fair value, based upon quoted market prices, with net unrealized gains reported as a separate component of stockholders' equity until realized. Unrealized losses are charged against income when a decline in fair value is determined to be other than temporary. At July 31, 2003, and January 31, 2003, marketable securities were as follows:

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| | Cost | Gains | Value |
|-------------------|---------|---------|---------|
| | ----- | ----- | ----- |
| July 31, 2003: | | | |
| Entrada | 13 | 72 | 85 |
| | ----- | ----- | ----- |
| | \$13 | \$72 | \$85 |
| | ===== | ===== | ===== |
| January 31, 2003: | | | |
| Digi | \$1,009 | \$2,884 | \$3,893 |
| Entrada | 22 | 44 | 66 |
| | ----- | ----- | ----- |
| | \$1,031 | \$2,928 | \$3,959 |
| | ===== | ===== | ===== |

Intangible Assets--Goodwill and indefinite life intangible assets are no longer amortized but are subject to periodic impairment tests. We have no goodwill or indefinite life intangible assets. Other intangible assets with finite lives, such as our purchased technology, are amortized over their useful lives.

The carrying value of finite life intangible assets, consisting of purchased technology of our subsidiary Meret Optical, as of July 31, 2003, is \$225 thousand, net of amortization. The change in the net carrying amount of finite life intangible assets during the six months ended July 31, 2003 is due to amortization of \$206 thousand. Annual estimated finite life intangible asset amortization expense for each of the remaining fiscal years is expected to approximate \$40 thousand, \$40 thousand, and \$30 thousand.

Debentures - During August 2001, we completed a private placement of our 9.75% convertible debentures receiving net proceeds of \$29.8 million. The debentures, due August 2, 2004 had a face value of \$32.2 million, which was convertible into our common stock at \$144.20 per share. At maturity, we could have elected to redeem the debentures for cash and we had the option of paying the interest on these debentures in shares of our common stock. In addition, the purchasers received four year warrants to acquire an additional 167,592 shares of our common stock at \$144.20 per share and the placement agent received five year warrants to acquire 5,583 shares of our common stock, equity securities, options or warrants at a price less than \$144.20 per share or at a discount to the then market price. The conversion price and warrant exercise were subject to adjustment.

In accordance with Emerging Issues Task Force ("EITF") No. 00-27 we accounted for the fair value of warrants issued to the purchasers and placement agent and the fair value of the deemed beneficial conversion feature, which resulted solely as a result of the required accounting, of the debenture as a reduction to the face value of the debentures with an offsetting increase to additional paid in capital. These amounts, as well as the issuance costs paid in cash, were amortized as additional interest expense over the period the debentures were outstanding. Interest expense during the three and six months ended July 31, 2003 of \$2.6 million included the stated 9.75% interest of \$765, amortization of issuance costs of \$203, and amortization of the fair value of the warrants issued to the purchasers and placement agent and the deemed beneficial conversion feature of \$1.6 million.

On March 6, 2003, we and our wholly-owned subsidiary Sorrento Networks, Inc. entered into an Exchange Agreement with the holders of our 9.75% Senior Convertible Debentures (the "Debentures") and the Series A Convertible Preferred Stock (the "Preferred Stock") of Sorrento Networks, Inc. The Exchange Agreement and associated documents contemplated an exchange (the "Exchange") of the Debentures and the Preferred Stock at closing into shares of common stock and

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\$12.5 million of our new 7.5% secured convertible debentures (the "New Debentures"). Certain holders of the Preferred Stock would also receive additional New Debentures of approximately \$600 thousand to pay certain legal fees.

The Exchange Agreement was approved by shareholders on May 29, 2003 and was completed and became effective on June 4, 2003 pursuant to which we exchanged current outstanding debentures and Series A Preferred Stock for common stock and an issuance of a smaller principal amount of new debentures.

Interest expense during the three and six months ended July 31, 2003 was \$1.1 million and \$3.6 million, respectively.

At July 31, 2003 and January 31, 2003 debentures payable on the 9.75% debentures consisted of:

| | (thousand July 31, 2003 | Jan 2003 |
|---|-------------------------------|-------------|
| | ----- | ----- |
| Face value..... | \$ -- | \$ -- |
| Issuance costs..... | -- | -- |
| Value of warrants and deemed beneficial conversion feature..... | -- | (--) |
| | ----- | ----- |
| Debenture book value at issuance..... | -- | -- |
| Accumulated amortization of issuance costs..... | -- | -- |
| Accumulated amortization of the value of warrants and deemed beneficial conversion feature..... | -- | -- |
| | ----- | ----- |
| | \$ -- | \$ -- |
| | ===== | ===== |

The \$12.5 million, 7.5% debentures are convertible at any time at the option of the holders into shares of common stock at a conversion price of \$5.42, the fair value on the date of the exchange. The debentures mature on August 2, 2007 and are secured by substantially all of our assets and those of our subsidiaries (with certain exceptions).

At July 31, 2003 and January 31, 2003 debentures payable on the 7.5% debentures consisted of:

| | (thousands) July 31, 2003 | January 31, 2003 |
|--|---------------------------------|---------------------|
| | ----- | ----- |

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| | | |
|--|----------|-------|
| Face value of 7.5% convertible debentures..... | \$12,500 | \$ -- |
| Face value of new debentures for legal fees..... | 600 | -- |
| | ----- | ----- |
| Book value of debentures at issuance | \$13,100 | \$ -- |
| | ===== | ===== |

Stockholders' Equity

We are authorized to issue the following shares of stock:

150,000,000 shares of Common Stock (\$0.001 par value)

2,000,000 shares of Preferred Stock (\$.01 par value) of which the following series have been designated:

3,000 shares of Preferred Stock, Series D

1,000,000 shares of Preferred Stock, Series F

As of July 31, 2003, we had outstanding the following shares of preferred stock:

| | Shares Outstanding | Par Value | Liq Pre |
|---------------|-----------------------|--------------|------------|
| | ----- | ----- | ----- |
| Series D..... | 1,353 | \$ 0.01 | \$ |
| | ----- | ----- | ----- |
| | 1,353 | \$ 0.01 | \$ |
| | ===== | ===== | ===== |

Other Capital Stock Transactions

Stock Split - In October 2002, approval was granted for a one-for-twenty reverse stock split effective October 28, 2002. The effect of this stock split was reflected in the financial statements retroactively as if the stock split occurred at the beginning of the earliest period reported.

Each share of SNI's Series A Convertible Preferred Stock was convertible into one share of SNI's common stock at the option of the holder, voted on an "as converted" basis except for election of directors, and had a liquidation preference of \$5.45 per share. The shares were automatically convertible into SNI's common stock upon an underwritten public offering by SNI with an aggregate offering price of at least \$50.0 million. As SNI did not complete a \$50.0 million public offering by March 1, 2001, the holders of more than 50% of the then outstanding Series A shares had the right to request in writing that SNI redeem them at the adjusted liquidation preference. On

receipt of such a request, SNI had the obligation to redeem the shares in cash, if funds were lawfully available for such a redemption, or to redeem such pro rata portion as to which a lesser amount of lawfully available funds existed. In April 2001, SNI received written redemption requests from holders of a majority of the Series A shares. The difference between the net proceeds received on the sale of these shares and their liquidation preference of \$48.8 million was recorded as a deemed dividend during the period from issuance to March 31, 2001.

On June 4, 2003, we consummated the Exchange Agreement and cancelled all outstanding Series A Convertible Preferred Stock.

In connection to our capital and corporate restructuring plan, we issued 8,029,578 shares of common stock to the holders of the 9.75% debentures and the Series A Convertible Preferred Stock upon consummation of the Exchange. The Company's \$32.2 million in convertible debentures were converted into common shares of the Company and a portion of \$12.5 million in secured convertible 7.5% debentures that mature in August 2007. In addition, all Series A Convertible Preferred Stock were converted into common shares of the Company and a portion of the \$12.5 million in secured convertible debentures. The outstanding Series A Convertible Preferred Stock "put" of \$48.8 million against SNI was withdrawn. Certain Series A Convertible Preferred stockholders also received a total of \$600 thousand in additional secured convertible 7.5% debentures to pay certain legal fees.

There was an aggregate gain, net of tax, on the capital restructuring transaction of \$13.8 million. The conversion of the SNI Series A Convertible Preferred Stock into common stock and a portion of the \$12.5 million 7.50% convertible debenture resulted in a net gain of \$48.8 million. The gain was off-set by the loss on the value of the warrants and beneficial conversion feature on the \$32.2 million, 9.75% convertible debentures, converted to common stock and a portion of the 7.50% convertible debenture. The consolidated net gain on the capital restructuring transaction was \$13.8 million or \$2.35 per share for the quarter ending July 31, 2003.

Stock Option Plans

We have five stock option plans in effect: The 2003 Equity Incentive Plan, the 2000 Stock Incentive Plan, the 1988 Stock Option Plan, the 1997 Incentive and Non-Qualified Stock Option Plan and the 1997 Director Stock Option Plan. The stock options have been made available to certain employees and consultants. All options are granted at not less than fair value at the date of grant and have terms varying from 3 to 10 years. The purpose of these plans is to attract, retain, motivate and reward our officers, directors, employees and consultants to maximize their contribution towards our success. We account for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net loss, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

In order to provide more prominent and frequent disclosures about the effects of stock-based compensation as required under SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", the following table summarizes the pro forma effect of stock-based compensation on net loss and earnings (loss) per share if the optional expense recognition provisions of SFAS 123 had been adopted.

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The fair value of stock options used to compute pro forma net loss and pro forma loss per share disclosures is estimated using the Black-Scholes option-pricing model, which was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, this model requires the input of subjective assumptions, including the expected price volatility of the underlying stock. Projected data for expected volatility and expected life of stock options is based upon historical and other data. Changes in these subjective assumptions can materially affect the fair value estimate, and therefore the existing valuation models may not provide a reliable single measure of the fair value of the Company's employee stock options.

| | (thousands, except p Three Months Ended July 31, ----- | |
|---|---|--------------|
| | 2003 ---- | 2002 ---- |
| Reported net income (loss): | | |
| As reported | 12,514 | (15,806) |
| Add: Stock-based employee compensation included in reported net income (loss), net of related tax effect | - | 109 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (976) | (1,428) |
| | ----- | ----- |
| Pro forma | \$11,538 | \$(17,125) |
| | ----- | ----- |
| Earnings (loss) per share: | | |
| Basic EPS as reported | \$ 2.13 | \$ (21.35) |
| | ===== | ===== |
| Pro forma basic EPS | \$ 1.97 | \$ (23.29) |
| | ===== | ===== |
| Diluted EPS as reported | \$ 1.70 | \$ (45.20) |
| | ===== | ===== |
| Pro forma diluted EPS | \$ 1.57 | \$ (17.88) |
| | ===== | ===== |

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The following data show the amounts used in computing basic earnings per share for the three and six months ended July 31, 2003 and 2002.

| | (thousands, except per share amount) | | |
|--|--------------------------------------|-------------|---------|
| | Three Months Ended July 31, | | Six |
| | 2003 | 2002 | 2003 |
| Earnings Per Share Calculation | | | |
| Net income (loss) available to common shareholders used in basic EPS | \$ 12,514 | \$ (15,806) | \$ 6,2 |
| Average number of common shares used in basic EPS | 5,868,756 | 740,457 | 3,418,6 |

Basic income (loss) per common share is calculated by dividing the net loss by the weighted average number of common shares outstanding during the period. Diluted loss per common share is calculated by dividing the applicable net income (loss) by the sum of the weighted average number of common shares outstanding and all additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period. Our convertible debentures create a dilutive situation even though the company had a net loss for the three and six months ended July 31, 2002. The following data shows the effect on income and the weighted average number of shares of dilutive potential common stock.

| | (thousands, except per share amount) | | |
|---|--------------------------------------|-------------|---------|
| | Three Months Ended July 31, | | Six |
| | 2003 | 2002 | 2003 |
| Net income (loss) available for common shareholders used in basic EPS | \$ 12,514 | \$ (15,806) | \$ 6,2 |
| Less: Convertible debt issuance costs | (12,260) | (28,622) | (12,2 |
| Plus: Convertible debt interest | 420 | 783 | 1,0 |
| Net loss available to common shareholders used in diluted EPS | \$ 674 | \$ (43,645) | \$ (4,9 |
| Average number of common shares used in basic EPS | 5,868,756 | 740,457 | 3,418,6 |
| Effect of dilutive securities: | | | |
| Convertible debentures | 1,497,473 | 223,301 | 761,1 |
| Average number of common shares and dilutive potential common stock used in diluted EPS | 7,366,229 | 963,758 | 4,179,8 |

Common stock options and warrants of 1,298,112 are excluded from the computation as the effect was anti-dilutive.

Litigation

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On June 4, 2003, we consummated the exchange transaction and cancelled all outstanding Series A Convertible Preferred Stock and 9.75% Senior Convertible Debentures. The Exchange Agreement provides that the litigation instituted by the former holders of Series A stock be dismissed without prejudice against the Company, its subsidiaries, its current officers and directors, and other defendants who execute an appropriate release, and without prejudice against all other defendants. This dismissal will require court approval, which is in the process of being obtained by counsel for all parties.

In accordance with a settlement agreement reached between us and our former Chairman and Founder, Par Chadha, 566,000 shares of ENI stock were transferred to Mr.Chadha in exchange for mutual releases by the Company and Mr. Chadha and certain of his affiliates. The stock transfer was completed on July 1, 2003 and had a value of \$88 thousand.

In addition, claims in arbitration were filed by two of our former financial officers and employees who worked in our former Santa Monica office, which has since been closed, alleging that their resignations in May 2002 were for "good reason" as defined in their employment agreements, all of which were to expire on May 22, 2002. One of the claims was settled in May 2003 for \$45 thousand. The other claim was resolved by an August 2003 arbitrator ruling in favor of the Company.

A former officer of our SNI subsidiary brought suit alleging breach of a consulting agreement we entered into with him in March 2002, following his resignation "for good reason" as defined in his employment agreement. He is seeking acceleration of consulting fees due to him under his consulting agreement in the amount of \$229 thousand. We feel these claims are without merit and are vigorously defending the claims. We have also filed counterclaims. In May 2002, the former officer's motion for summary judgment was denied. Currently, the matter is in discovery.

From time to time, we are involved in various other legal proceedings and claims incidental to the conduct of our business. Although it is impossible to predict the outcome of any outstanding legal proceedings, we believe that such legal proceedings and claims, individually and in the aggregate, are not likely to have a material adverse effect on our financial position, results of operations, or cash flows.

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Contingent Liabilities

In the merger agreement between our predecessor corporation and Sync Research, we agreed to indemnify and hold our former subsidiary, Entrada, harmless against any liability arising after the merger in connection with the termination of a certain pension plan previously maintained by Entrada. In the third quarter of 2003, we were advised by a consultant retained by us and by the successor corporation to the entity from whom we originally purchased the company that became Entrada that the cost of termination of the pension plan in question is in excess of \$3.0 million. While we do not believe that we are liable for this cost, it is possible that the successor corporation, which has been funding the pension plan since 1996, may seek a substantial contribution from us towards this liability. We have not recorded a reserve to cover this contingency.

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Concentration Of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of temporary cash investments and trade receivables. As regards the former, we place our temporary cash investments with high credit financial institutions and limits. At times such amounts may exceed the F.D.I.C. limits. We limit the amount of exposure with any one financial institution and believe that no significant concentration of credit risk exists with respect to cash investments.

Although we are directly affected by the economic well being of significant customers listed in the following tables, we do not believe that significant credit risk exists at July 31, 2003. We perform ongoing evaluations of our customers and require letters of credit or other collateral arrangements as appropriate. Accordingly, trade receivable credit losses have not been significant.

The following data shows the customers accounting for more than 10% of net consolidated receivables:

| | July 31, 2003 | January 31, 2003 |
|-----------------|------------------|---------------------|
| | ----- | ----- |
| Customer A..... | 28.4% | 15.9% |
| Customer B..... | 25.5% | 14.8% |

The following data shows the customers accounting for more than 10% of net consolidated sales:

| | Three Months Ended July 31, | | Six M J |
|--------------------------------|--------------------------------|-------|------------|
| 10% of net consolidated sales: | 2003 | 2002 | 2003 |
| | ----- | ---- | ----- |
| Customer A | 32.7% | 22.8% | 16.9% |
| Customer B | 31.4% | 0.0% | 18.6% |
| Customer C | 5.7% | 8.5% | 15.9% |
| Customer D | 0.6% | 19.7% | 22.3% |

Segment Information

| | Sorrento Networks | Meret Optical | O |
|----------------------------------|----------------------|------------------|-------|
| | ----- | ----- | ----- |
| Three Months Ended July 31, 2003 | | | |
| Revenues from external customers | \$ 4,007 | \$ 469 | \$ |
| Cost of goods sold | 2,879 | 234 | ----- |
| Gross Profit | \$ 1,128 | \$ 235 | \$ |
| | ===== | ===== | ===== |

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| | | |
|---|---------|-------|
| Segment income (loss) from operations | (3,015) | 192 |
| Depreciation and amortization expense | 818 | 129 |
| Valuation allowance additions (reductions): | | |
| Receivables and inventory | (797) | (459) |
| Capital asset additions (disposals), net | (682) | - |
| Total assets | 22,469 | 5,375 |

Three Months Ended July 31, 2002

| | | |
|---------------|------------|----------|
| Net sales | \$ 4,547 | \$ 652 |
| Cost of sales | 6,221 | 1,278 |
| | ----- | ----- |
| Gross Profit | \$ (1,674) | \$ (626) |
| | ===== | ===== |

| | | |
|---|----------|---------|
| Segment income (loss) from operations | (12,158) | (1,044) |
| Depreciation and amortization expense | 804 | 129 |
| Valuation allowance additions (reductions): | | |
| Receivables and inventory | 6,350 | 1,017 |
| Capital asset additions (disposals), net | (501) | (155) |
| Total assets | 29,104 | 6,417 |

Six Months Ended July 31, 2003

| | | |
|---------------|-----------|----------|
| Net sales | \$ 10,768 | \$ 1,569 |
| Cost of sales | 7,932 | 1,088 |
| | ----- | ----- |
| Gross Profit | \$ 2,836 | \$ 481 |
| | ===== | ===== |

| | | |
|---|---------|-------|
| Segment income (loss) from operations | (5,976) | 312 |
| Depreciation and amortization expense | 1,715 | 258 |
| Valuation allowance additions (reductions): | | |
| Receivables and inventory | (797) | (469) |
| Capital asset additions (disposals), net | (1,458) | - |
| Total assets | 22,469 | 5,375 |

Six Months Ended July 31, 2002

| | | |
|---------------|----------|----------|
| Net sales | \$ 9,341 | \$ 1,861 |
| Cost of sales | 9,990 | 2,024 |
| | ----- | ----- |
| Gross Profit | \$ (649) | \$ (163) |
| | ===== | ===== |

| | | |
|---|----------|---------|
| Segment income (loss) from operations | (17,877) | (1,022) |
| Depreciation and amortization expense | 1,573 | 262 |
| Valuation allowance additions (reductions): | | |
| Receivables and inventory | 6,620 | 1,464 |
| Capital asset additions (disposals), net | 1,161 | 57 |
| Total assets | 29,104 | 6,417 |

Subsequent Events

On August 8, 2003 we successfully closed the acquisition of LuxN, Inc. LuxN supplies optical access equipment for the network edge using coarse and dense wavelength division multiplexing (CWDM and DWDM) technology. LuxN's OSMINE-certified products enable delivery of high-bandwidth data, storage, video, and voice services for service providers, cable MSOs, and enterprises.

We acquired LuxN for a combination of stock, warrants, and cash previously held by LuxN. Stockholders of LuxN were given the option of exchanging shares of LuxN stock for either their pro-rata portion of LuxN's net cash or shares of Sorrento's common stock. Stockholders with an aggregate pro-rata portion of \$3.8 million of LuxN's net cash elected to receive Sorrento's common stock. In addition to the cash or Sorrento common stock, stockholders of LuxN have the right to receive warrants to purchase an aggregate of 400,000 shares of Sorrento common stock, with an exercise price of \$3.05 per share, the fair market value on the date of acquisition. The warrants will be held in escrow for a period of six months to satisfy any successful indemnification claims. At closing, Sorrento issued approximately 1.4 million shares of common stock with the remaining approximately 500,000 shares of common stock to be issued subject to stockholder approval.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the consolidated unaudited financial statements and related notes thereto. Further reference should be made to our Form 10-K/A for the year ended January 31, 2003, including the consolidated audited financial statements and notes thereto.

The results of operations reflect our activities and our wholly owned subsidiaries; this consolidated group is referred to individually and collectively as "We" and "Our".

Forward-Looking Statements--Cautionary Statement

All statements other than statements of historical fact contained in this Form 10-Q, in our future filings with the Securities and Exchange Commission, in our press releases and in our oral statements made with the approval of an authorized executive officer are forward-looking statements. Words such as "propose," "anticipate," "believe," "estimate," "expect," "plan", "intend," "may," "should", "could," "will" and similar expressions are intended to identify such forward-looking statements. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Although we believe that our expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risk and uncertainties and no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those forward-looking statements include without limitation: (1) our ability to fund our operations until such time that revenue and orders improve, including its ability to raise additional equity or debt financing; (2) unanticipated technical problems relating to our products; (3) our ability, or lack thereof, to make, market and

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sell optical networking products that meet with market approval and acceptance; (4) the greater financial, technical and other resources of our many, larger competitors in the marketplace for optical networking products; (5) changed market conditions, new business opportunities or other factors that might affect our decisions as to the best interests of our shareholders; (6) other risks detailed from time to time in our reports filed with the U.S. Securities and Exchange Commission.

We wish to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. We specifically decline any obligation to publicly release the result of any revisions, which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements, or to update the reasons why actual results could differ from those projected in the forward-looking statements.

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Results of Operations/Comparison of the Quarters and Six Months ended July 31, 2003 and 2002.

Net sales. Our consolidated net sales decreased \$723 thousand or 14% to \$4.5 million for the quarter ended July 31, 2003 compared to net sales of \$5.2 million for the quarter ended July 31, 2002. Net sales for Sorrento Networks Inc. ("SNI"), the Company's primary operating subsidiary, decreased \$539 thousand or 12% to \$4.0 million for the quarter ended July 31, 2003 as compared to net sales of \$4.5 million for the quarter ended July 31, 2002. This decrease is attributable to two of SNI's major customers delaying capital expenditures due to merger or internal restructuring. We don't expect this to be an ongoing problem. During the six months ended July 31, 2003 our net sales increased to \$12.3 million from \$11.2 million for the comparable six months ended July 21, 2002, an increase of 10%. This increase reflects higher domestic sales in the first quarter, resulting from a substantial backlog at the end of the previous year.

During the three months ended July 31, 2003, SNI shipped product to twelve customers of which six customers represented a combined 88% of our revenues. During the quarter ended July 31, 2002, we shipped product to twelve customers of which five customers represented a combined 79% of our net sales. During the six months ended July 31, 2003, we shipped to product to sixteen customers of which five represented 84% of SNI's net sales. For the comparable six months ended July 31, 2002, we shipped to twelve customers, of which five represented 71% of net sales. We expect to continue experiencing significant fluctuations in our quarterly revenues as a result of our long and variable sales cycle as well as our highly concentrated customer base.

Net sales for Meret decreased to \$469 thousand or by 28%, for the quarter ended July 31, 2003 from \$652 thousand for the comparable quarter last year. For the six months ended July 31, 2003 sales decreased to \$1.6 million or by 19%, from \$1.9 million in the comparable period last year. The reduction in sales volume reflects the transfer of one of Meret's product line to SNI. This transfer was done for conformity of products within the two segments.

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Gross profit. Cost of sales consists principally of the costs of components, subcontract assembly from outside manufacturers, and in-house system integration, quality control, final testing and configuration costs. Gross margin percent on a consolidated basis increased to 30% for the quarter ended July 31, 2003 compared to a negative 44% consolidated gross margin for the quarter ended July 31, 2002. Consolidated gross profit was \$1.4 million for the quarter ended July 31, 2003 versus a consolidated gross loss of \$2.3 million for the quarter ended July 31, 2002. During the quarter ended July 31, 2002 we took reserves against the book value of our inventory and an adjustment to the market prices on many of our components held in inventory, as well as the write-down of obsolete and slow-moving inventories. A \$4.0 million reserve was taken to cover this reduction in value. The gross margin percent on a consolidated basis for the six months ended July 31, 2003 increased to 27% compared to a negative 7% consolidated gross margin for the six months ended July 31, 2002. Consolidated gross profit was \$3.3 million, an increase of \$4.1 million from the comparable six months period ended July 31, 2002. This increase reflects the obsolescence and inventory value reserves taken in the second quarter of the prior year.

Gross profit for SNI increased to \$1.1 million the quarter ended July 31, 2003, as compared to a gross loss of \$1.7 million in the quarter ended July 31, 2002. For the six months ended July 31, 2003 gross profit increased \$0.5 million compared to a gross loss of \$0.65 million for the six months ended July 31, 2002. The gross profit increases were primarily the result of lower inventory reserves versus the prior period and a reduction in manufacturing costs during the current period. We continue to monitor our costs of production and reduce costs wherever possible.

For the quarter ended July 31, 2003, gross profit for Meret was \$235 thousand versus a gross loss of \$626 thousand for the comparable quarter last year. Meret's gross margins increased to 50% for the quarter ended July 31, 2003 from negative 74% for the comparable quarter last year. For the six months ended July 31, 2003, the gross margin increased to \$482 thousand compared to a gross loss of \$163 thousand in the six months ended July 31, 2002. The gross profit increases were primarily the result of product mix and the obsolescence reserves taken in the prior period.

Selling and marketing. Selling and marketing expenses consist primarily of employee compensation and related costs, commissions to sales representatives, tradeshow expenses and travel expenses. Consolidated selling and marketing expenses decreased to \$1.9 million, or 42% of net sales, for the quarter ended July 31, 2003 from \$3.6 million, or 70% of net sales, for the quarter ended July 31, 2002. For the six months ended July 31, 2003 consolidated selling and marketing expenses decreased to \$4.1 million, or 33% of net sales, compared to \$7.1

million, or 63% of net sales, for the six months ended July 31, 2002. This decrease was primarily the result of cost reduction efforts implemented and included reductions in travel expenses, advertising expenses and personnel costs.

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Engineering, research and development. Engineering, research and development expenses consist primarily of compensation related costs for engineering personnel, facilities costs and materials used in the design, development and support of our technologies. All research and development costs are expensed as incurred. We continue to manage our research and development cost in relation to the changes in our sales volume and available capital resources in our development efforts to enhance existing products and introduce new products to our product offering. Our consolidated engineering, research and development expenses decreased to \$1.5 million, or 35% of net sales, for the quarter ended July 31, 2003, from \$2.3 million, or 45% of net sales, for the quarter ended July 31, 2002. For the six months ended July 31, 2003 our consolidated engineering, research and development expenses decreased to \$3.2 million, or 25% of net sales, compared to \$4.9 million, or 44% of net sales for the six months ended July 31, 2002. The decline can primarily be attributed to decreases in product development material and personnel related costs reflecting managements planned reduction in operating expense levels.

General and administrative. General and administrative expenses consist primarily of employee compensation and related costs, legal and accounting fees, public company costs and allocable occupancy costs. Consolidated general and administrative expenses decreased to \$1.9 million, or 43% of net sales, for the quarter ended July 31, 2003 from \$5.9 million, or 114% of net sales, for the quarter ended July 31, 2002. The decrease was a combination of our ongoing expense reduction plan and the finalization of our capital restructuring. For the six months ended July 31, 2003, consolidated general and administrative expenses decreased to \$3.5 million, or 28% of net sales, compared to \$7.8 million or 69.4% of net sales in the six month period ending July 31, 2002. The decrease in general and administrative expenses can be attributed to reductions in investment banking, professional fees and personnel related costs due to our ongoing operating expense reduction efforts and the completion of our capital restructuring.

Deferred stock compensation and other. Deferred and other stock compensation for the quarter ended July 31, 2003 includes \$0 of amortization of deferred stock compensation resulting from the amortization of the value of stock options granted to consultants as compared with \$109 of amortization of deferred stock compensation and expenses for the comparable quarter last year. For the six months ended July 31, 2003 we recorded \$51 thousand of amortization of deferred stock compensation compared to \$ 215 thousand for the comparable six months last year. These costs were incurred in connection with the grants of stock options with exercise prices determined to be below the fair value of Sorrento's common stock on the date of grant, Sorrento recorded deferred stock compensation of \$2.6 million, which the amount was fully amortized at April 30, 2003.

Other operating expenses. Other operating expenses were \$103 thousand for the quarter ended July 31, 2003 as compared to \$93 thousand for the same comparable quarter last year. For the six months ended July 31, 2003, other operating expenses were \$206 as compared to \$190 for the six months ended July 31, 2002. These costs represent the amortization of purchased technology related to prior acquisitions.

Other income (charges). Other income (charges) from operations was \$16.6 million in income for the quarter ended July 31, 2003 compared to \$1.4 million of expense for the quarter ended July 31, 2002. The increase was primarily attributable to a net gain of \$13.7 million on the capital restructuring that was completed June 4, 2003 and a gain on the sale of marketable securities of \$4.0 million. This gain was partially offset by \$1.1 million in interest expense associated with the Company's convertible debentures. During the six months ended July 31, 2003, other income was \$14.0 million compared to \$9.1 million for the same period in the prior year. This increase was primarily due to the net gain on the capital restructuring and a gain on the sale of marketable

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securities. This gain was partially offset by \$3.6 million in costs associated with the Company's 9.75% convertible debentures.

Income taxes. There was no provision for income taxes for the quarters and six months ended July 31, 2003 and 2002, respectively. We have carry forwards of domestic federal net operating losses, which may be available, in part, to reduce future taxable income in the United States. These carry forwards have been adjusted due to the capital restructuring that occurred in June 2003. However, due to potential adjustments to the net operating loss carry forwards as provided by the Internal Revenue Code with respect to future ownership changes, future availability of the tax benefits is not assured. In addition, we provided a valuation allowance in full for our deferred tax assets, as it is our opinion that it is more likely than not that some portion or all of the deferred tax assets will not be realized.

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Liquidity and Capital Resources

We finance our operations through a combination of internal funds, investments and debt and equity financing. At July 31, 2003, our working capital was \$9.8 million including \$5.0 million in cash and cash equivalents and \$85 thousand of investments in marketable securities.

Operations

Our operations used cash flows of \$9.3 million during the six months ended July 31, 2003. During the quarter ended July 31, 2002 continuing operations used cash flows of \$10.9 million. The decrease in cash flows used by operations resulted from a gain on the sale of marketable securities, a gain on the capital restructuring, a decrease in accounts receivable and inventories, partially offset by a decrease in accounts payables and accrued liabilities.

We have incurred significant losses and negative cash flows from operations for the past two years. Sorrento Networks, Inc., ("SNI") our principal operating subsidiary, has primarily been the operating entity responsible for these high losses and negative cash flows. The losses have been generated as SNI continues to develop its technology, marketing and sales and operations in its effort to become a major supplier of metro and regional optical networks world-wide.

We have funded our operations primarily through a combination of internal funds, the sale of investments and debt and equity financing. There can be no assurance that similar funding will be available in the future. In addition, now that our capital restructuring efforts are completed, there are certain restrictions on us in both the amount of debt we can incur in future periods and the types of securities that we can issue to raise additional capital in future periods. Both of these restrictions could have a negative impact on our ability to raise the additional working capital that we will require in future periods. Further, with the downturn in the economic environment and decreases in capital spending by telecom carriers, our revenue has been negatively impacted and our future revenues could also be negatively impacted. As a result, our need for additional working capital could be accelerated in the future. If such capital is not available, we will need to substantially decrease our operating costs and

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capital spending in order to fund operations. There can be no assurance that our available cash, future funding or reduction in operating costs will be sufficient to fund our operations in the future.

Our standard payment terms range from net 30 to net 60 days. Receivables from international customers have frequently taken longer to collect. In addition, the downturn in the telecom market has impacted many of the telecom carriers ability to purchase or pay for outstanding commitments within standard payment terms. Despite these negative factors we have improved our collection on receivables to 45 days of average sales days outstanding as compared to 92 days outstanding for the same period in the prior year, helping improve our cash flows. There can be no assurance; however, that this continued economic environment will not impact either current or future receivables negatively, or our ability to control inventory levels. We do not provide long-term financing to customers buying our equipment.

Investing Activities

Our investing activities during the six months ended July 31, 2003 provided cash flows of \$6.8 million from the sale of \$5.0 million in marketable securities, the disposal of \$1.5 million property and equipment and a \$349 thousand decrease in other assets. During the six months ended July 31, 2002, investing activities provided cash flows of \$12.1 million. We purchased property and equipment of \$1.9 million and received \$13.6 million on the sale of marketable securities and \$542 thousand on the sale of other assets.

Financing Activities

Our financing activities during the six months ended July 31, 2003 used cash of \$128 thousand consisting primarily of the repayment of long-term debt. During the comparable six months in the prior year, financing activities used cash flows of \$1.0 million, which also consisted primarily of repayment of debt.

We anticipate that we will need additional working capital to fulfill our capital working requirements for the next year. While we have made significant cost reductions to bring our losses more in line with our anticipated or projected revenues, there is no assurance the volume of future revenues will be sufficient to allow us to meet our financial obligations for future periods. We continue to reduce our operating costs and have initiated activities to raise additional working capital. If revenues do not improve from second quarter results for future periods, we will not have sufficient working capital to finance our operations for the next twelve months given our existing expense base. Our future capital requirements may vary materially from those now planned including the need for working capital to accommodate planned growth, hiring and infrastructure needs. There can be no assurances that our working capital requirements will not exceed our ability to generate sufficient cash internally to support our requirements and that external financing will be available or that, if available, such financing can be obtained on terms favorable to us and our shareholders.

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Contractual Cash Obligations

The following tables quantify our future contractual obligations and commercial commitments as of July 31, 2003:

Contractual Obligations

| | Payments due in fiscal years | | | | | |
|-----------------------------|------------------------------|-------------------|-------|-------|----------|-------|
| | Total | Remainder 2004 | 2005 | 2006 | 2007 | 2008 |
| Long-term Debt | \$ 3,611 | \$ 27 | \$ 49 | \$ 54 | \$ 58 | \$ -- |
| Capital Leases | 139 | 84 | 55 | -- | -- | -- |
| Operating Leases | 468 | 119 | 158 | 131 | 42 | -- |
| 7.5% Convertible Debentures | 13,100 | -- | -- | -- | 13,100 | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total | \$17,318 | \$230 | \$262 | \$185 | \$13,200 | \$ -- |
| | ===== | ===== | ===== | ===== | ===== | ===== |

Securities Authorized For Issuance Under Equity Compensation Plans

The following table provides information as of July 31, 2003 regarding compensation plans (including individual compensation arrangements) under which equity securities are authorized for issuance.

| Plan Category | Number of Securities To Be Issued Upon Exercise Of Outstanding Options, Warrants and Rights | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | Number Remaining Future Iss Compen (Excludi Reflected |
|--|--|--|--|
| | (a) | (b) | |
| Equity Compensation Plans Approved by security Holders *(FIBR) | 1,263,011 | \$ 92.50 | |
| Equity Compensation Plans not Approved by Security Holders (SNI) | 2,737,847 | \$ 5.27 | 2 |
| Total | 4,000,858 | \$ 32.81 | 2 |

* As adjusted for stock splits.

See the Stock Option Plans note in the financial statements included in this quarterly report for information regarding the material features of the above plans. Each of the above plans provides that the number of shares with respect to which options may be granted, and the number of shares of Common Stock subject to an outstanding option, shall be proportionally adjusted in the event of a subdivision or consolidation of shares or the payment of a stock dividend on Common Stock, and the purchase price per share of outstanding options shall be proportionately revised.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our valuation of inventory and our allowance for uncollectable accounts receivable. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

- o Revenue recognition. Revenue is generally recognized when the products are shipped, all substantial contractual obligations, if any, have been satisfied, and the collections of the resulting receivable is reasonably assured. When title does not pass to the customer at time of shipment, revenue is not recognized until all contractual requirements are met and title has transferred. During this transition period, the amount of the sale and/or installation is shown in deferred revenue.

Revenue from installation is recognized as the services are performed to the extent of the direct costs incurred. To date, installation revenue has not been material. Revenue from service obligations, if any, is deferred and recognized over the life of the contract. Inventory or demonstration equipment shipped to potential customers for field trials is not recorded as revenue. We accrue for warranty costs, sales returns and other allowances at the time of shipment. Although our products contain a software component, the software is not sold separately and we are not contractually obligated to provide software upgrades to our customers.

- o Inventory. Inventory is evaluated on a continual basis and management must make estimates about the future customer demand for our products, taking into account both the economic

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conditions and growth potential of our customers. Reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value and charged to operations in the period in which the facts that give rise to the adjustments become known. A misinterpretation or misunderstanding of these conditions or uncertainty in the future outlook of our industry or the economy, or the failure to estimate correctly, could result in inventory losses in excess of the provisions determined to be appropriate at the time of the balance sheet.

- o Accounts receivable. Accounts receivable balances are evaluated on a continual basis and management regularly reviews the financial stability of individual customers. This analysis involves a judgment of the customers current and projected financial condition and the positive or negative effects of the current and projected industry outlook, as well as that of the economy in general. Allowances are provided for potentially uncollectable accounts based on management's estimate of the collectability and the probability of default of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of their ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known.
- o Intangible assets. We currently have intangible assets that include assets with finite lives, such as our purchased technology. The determination of related estimated useful lives and whether these assets

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are impaired involves judgments based upon short and long-term projections of future performance. We have no goodwill or indefinite life intangible assets. Other intangible assets with finite lives continue to be amortized over their useful lives.

- o Legal contingencies. We are subject to proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to securities, environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for the contingencies is based on a careful analysis of each individual issue with the assistance of outside legal counsel. Our reserves may change in the future due to new developments in each matter or changes in approach such as a change in settlement strategy in dealing with these matters. For more information, see Note H to the consolidated financial statements.
- o Income taxes. We currently have no provisions for income taxes.

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We have carry forward domestic federal net operating losses, which may be available, in part, to reduce future taxable income in the United States. However, due to potential adjustments to the net operating loss carry forwards as provided by the Internal Revenue Code with respect to future ownership changes, future availability of the tax benefits is not assured. In addition, we provided a valuation allowance in full for our deferred tax assets, as it is our opinion that it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Impact of Recent Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 150. "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities in the balance sheets. Previously, many of those financial instruments were classified as equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We expect this pronouncement will not have a material impact on our results of operations and financial condition.

In April 2003, the FASB issued SFAS No. 149, "Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). In particular, it (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in SFAS 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to the language used in FASB Interpretation No. ("FIN") 45, "Guarantor Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others" ("FIN 45") and (4) amends certain other existing pronouncements. SFAS 149 will be effective for contracts entered into or modified after June 30, 2003, except as stated below, and for hedging relationships designated after June 30, 2003. The provisions of SFAS 149 that relate to guidance in SFAS 133 Implementation Issues that have been effective for fiscal quarters which began prior to June 15, 2003, will continue to be applied in accordance with their respective effective dates. In addition, certain provisions relating to forward purchases or sales of when-issued securities or other securities that do not yet exist, will be applied to both existing contracts as well as new contracts entered into after June 30, 2003 We will apply the provision of SFAS 149 on a prospective basis to contracts entered into or modified after June 30, 2003 and expect that this pronouncement will not have a material impact on our results of operations and financial condition.

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities", and interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements", FIN No. 46 explains how to identify variable interest entities and how an enterprise assesses its interests in a variable interest entity to decide whether to consolidate that entity. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. FIN No. 46 is effective immediately for variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. The Interpretation applies in the first fiscal year or interim period

beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. We have adopted FIN No. 46 with no material effect on our financial position or results of operations.

In November 2002, the FASB Emerging Issues Task Force ("EITF") reached a consensus on Issue 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). In the absence of higher level accounting literature, EITF 00-21 governs how to separate and allocate revenue to goods or services or both that are to be delivered in a bundled sales arrangement. EITF 00-21 applies to revenue arrangements entered into after June 30, 2003 and allows for either prospective application or cumulative adjustment upon adoption. We will apply the guidance of EITF 00-21 on a prospective basis and expect that this pronouncement will not have a material impact on our results of operations and financial condition.

Effects of Inflation and Currency Exchange Rates

We believe that the relatively moderate rate of inflation in the United States over the past few years has not had a significant impact on our sales or operating results or on the prices of raw materials. There can be no assurance, however, that inflation will not have a material adverse effect on our operating results in the future.

The majority of our sales and expenses are currently denominated in U.S. dollars and to date our business has not been significantly affected by currency fluctuations. However, we conduct business in several different countries and thus fluctuations in currency exchange rates could cause our products to become relatively more expensive in particular countries, leading to a reduction in sales in that country. In addition, inflation in such countries could increase our expenses. In the future, we may engage in foreign currency denominated sales or pay material amounts of expenses in foreign currencies and, in such event, may experience gains and losses due to currency fluctuations. Our operating results could be adversely affected by such fluctuations.

Other Matters

See Part II, Item 1, "Other Information--Legal Proceedings".

Fluctuations in Revenue and Operating Results

The networking and bandwidth aggregation industry is subject to fluctuation and the declines and increases recently experienced by us are not necessarily indicative of the operating results for any future periods. Our operating results may fluctuate as a result of a number of factors, including the timing of orders from, and shipments to, customers; the timing of new product introductions and the market acceptance of those products; increased competition; changes in manufacturing costs; availability of parts; changes in the mix of product sales; the rate of end user adoption and carrier and private

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network deployment of WAN data, video and audio communication services; factors associated with international operations; and changes in world economic conditions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to financial market risks, including changes in interest rates and foreign currency rates. Our exposure to interest rate risk is the result of our need for periodic additional financing for our large operating losses and capital expenditures associated with establishing and expanding our operations. The interest rate that we will be able to obtain on debt financing will depend on market conditions at that time, and may differ from the rates we have secured on our current debt.

Almost all of our sales have been denominated in U.S. dollars. A portion of our expenses are denominated in currencies other than the U.S. dollar and in the future a larger portion of our sales could also be denominated in non-U.S. currencies. As a result, currency fluctuations between the U.S. dollar and the currencies in which we do business could cause foreign currency translation gains or losses that we would recognize in the period incurred. We cannot predict the effect of exchange rate fluctuations on our future operating results because of the number of currencies involved, the variability of currency exposure and the potential volatility of currency exchange rates. We attempt to minimize our currency exposure risk through working capital management and do not hedge our exposure to translation gains and losses related to foreign currency net asset exposures.

We do not hold or issue derivative, derivative commodity instruments or other financial instruments for trading purposes. Investments held for other than trading purposes do not impose a material market risk.

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We believe that the relatively moderate rate of inflation in the United States over the past few years and the relatively stable interest rates incurred on short-term financing have not had a significant impact on our sales, operating results or prices of raw materials. There can be no assurance, however, that inflation or an upward trend in short-term interest rates will not have a material adverse effect on our operating results in the future should we require debt financing in the future.

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. These disclosure controls and procedures are designed and maintained by or under the supervision of the Company's Chief Executive Officer and Chief Financial Officer, as required by

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the rules of the SEC. The Company's Chief Executive Officer and Chief Financial Officer are responsible for evaluating the effectiveness of the disclosure controls and procedures. Based on their evaluation of the Company's disclosure controls and procedures which took place as of the end of the period covered by this report, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that the Company is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods. During the period covered by this report, there have been no changes in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Changes in Controls and Procedures

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these internal controls after the date of our most recent evaluation.

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PART II OTHER INFORMATION

Item 1: Legal Proceedings

On June 4, 2003, we consummated the exchange transaction and cancelled all outstanding Series A Convertible Preferred Stock and 9.75% Senior Convertible Debentures. The Exchange Agreement provides that the litigation instituted by the former holders of Series A stock be dismissed without prejudice against the Company, its subsidiaries, its current officers and directors, and other defendants who execute an appropriate release, and without prejudice against all other defendants. This dismissal will require court approval, which is in the process of being obtained by counsel for all parties.

In accordance with a settlement agreement reached between us and our former Chairman and Founder, Par Chadha, 566,000 shares of ENI stock were transferred to Mr. Chadha in exchange for mutual releases by the Company and Mr. Chadha and certain of his affiliates. The stock transfer was completed on July 1, 2003 and had a value of \$88 thousand.

In addition, claims in arbitration were filed by two of our former financial officers and employees who worked in our Santa Monica office, which has since been closed, alleging that their resignations in May 2002 were for "good reason" as defined in their employment agreements, all of which were to expire on May 22, 2002. One of the claims has been settled, and we are disputing the other claim. The amount of the disputed claim is approximately \$195 thousand plus attorneys fees.

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We have also been sued by a former officer of our Sorrento subsidiary alleging breach of a consulting agreement we entered into with him in March 2002, following his resignation "for good reason" as defined in his employment agreement. He is seeking acceleration of consulting fees due to him under his consulting agreement in the amount of \$229 thousand. We feel these claims are without merit and are vigorously defending the claims. We have also filed counterclaims. In May 2002, the former officer's motion for summary judgment was denied. Currently, the matter is in discovery.

From time to time, we are involved in various other legal proceedings and claims incidental to the conduct of our business. Although it is impossible to predict the outcome of any outstanding legal proceedings, we believe that such legal proceedings and claims, individually and in the aggregate, are not likely to have a material adverse effect on our financial position, results of operations, or cash flows.

Item 2: Changes in Securities and Use of Proceeds

As part of the exchange of 9.75% Debentures and Series A Preferred Stock for shares of our common stock, we changed our state of incorporation from New Jersey to Delaware. We provided a comparison of shareholders' rights under the law of the states of Delaware and New Jersey in our proxy statement dated April 15, 2003, which is incorporated herein by reference.

Item 3: Defaults Upon Senior Securities

Not Applicable

Item 4: Submission of Matters to a Vote of Security Holders

The special meeting of shareholders of Sorrento Networks Corporation (the "Meeting") scheduled for May 19, 2003 was postponed until May 29, 2003 when a quorum was present.

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The shareholders approved each of the following proposals as listed in the Sorrento Networks Corporation's proxy circular and proxy statement dated April 15, 2003.

- Proposal 01. An amendment to our certificate of incorporation to increase our authorized common stock from 7.5 million to 30 million shares, in order to enable us to effectuate the restructuring transaction, and to enable us to obtain additional financing for working capital.
- Proposal 02. The issuance to the exchanging holders of the Outstanding Debentures and Series A of an aggregate of approximately 8,269,000 shares of our common stock in the restructuring transaction, and Exchange Debentures convertible into approximately 2,067,000 shares of our common stock, assuming the Exchange Debentures are convertible into 17.5% of our outstanding common stock on a diluted basis.

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- Proposal 03. The reincorporation of our company from the State of New Jersey to the State of Delaware, through the merger of our company into a new Delaware corporation, formed solely for the purpose of accomplishing the merger.
- Proposal 04. The approval of our 2003 Equity Incentive Plan.
- Proposal 05. An amendment to our certificate of incorporation to increase our authorized common stock to a total of 150 million shares.

The proxies received by Sorrento Networks Corporation for the Meeting were voted as follows:

| | Shares Voted For | Shares Voted Against | Shares Withhold |
|--------------|------------------|----------------------|-----------------|
| | For | Against | Abstain |
| Proposal 01 | 385,631 | 60,416 | 2,783 |
| Proposal 02. | 414,879 | 31,013 | 2,938 |
| Proposal 03 | 424,689 | 21,179 | 2,962 |
| Proposal 04 | 392,241 | 51,749 | 4,840 |
| Proposal 05 | 318,567 | 125,998 | 4,265 |

Item 5: Other Information

Not Applicable

Item 6: Exhibits and Reports on Form 8-K

(a). Exhibits

1. Consolidated Financial Statements for the Quarter and Six Months Ended July 31, 2003 (included in Part I, Item 1).

2. Exhibits:

- 2.1 Agreement and Plan of Merger with LuxN, Inc. (J).
- 3.1 Certificate of Incorporation of the Registrant (G).
- 3.2 By-Laws of the Registrant (G).
- 3.3 Series D Preferred Stock Certificate of Designation (G).
- 4.1 1988 Stock Option Plan (B).

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- 4.2 Amended and Restated 1997 Incentive and Non-Qualified Stock Option Plan (A).
- 4.3 1997 Directors Stock Option Plan (C).
- 4.4 2000 Stock Incentive Plan (E).
- 4.5 2000 Employee Stock Purchase Plan (D).
- 4.6 2000 Stock Option/Stock Issuance Plan of Sorrento Networks, Inc. (E).
- 4.7 Form of 7.5% Convertible Debenture Due August 2, 2007 (G).
- 4.8 Form of Warrant, expiry date August 2, 2007 (G).
- 4.9 Sorrento Networks Corporation 2003 Equity Incentive Plan (G).
- 5. Opinion of Greenbaum, Rowe, Smith, Ravin, Davis & Himmel LLP.
- 10.1 Agreement dated July 12, 2000 with Richard L. Jacobson (E).
- 10.2 Agreement dated March 1, 2002, with Phillip W. Arneson (F).
- 10.3 Exchange Agreement dated March 6, 2003 (G).
- 10.4 Form of Registration Rights Agreement with Exchanging Holders (G).
- 10.5 Agreement dated May 17, 2002 with Joe R. Armstrong (H).
- 10.6 Agreement dated July 3, 2002 with Richard L. Jacobson (H).
- 10.7 Agreement dated February 1, 2003 with Robert L. Hibbard (H).
- 10.8 First Amendment to Exchange Agreement (I).
- 21. Subsidiaries of the Registrant (H).
- 23.1 Consent of BDO Seidman LLP - filed herewith.

The foregoing are incorporated by reference from the Registrant's filings indicated:

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications of Chief Executive Officer and Principal Accounting Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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- (A) Proxy Statement dated December 1, 1999.
- (B) Proxy Statement dated May 13, 1998.
- (C) Proxy Statement dated November 21, 1997.
- (D) Proxy Statement dated December 11, 2000.
- (E) Form 10-K for the year ended January 31, 2001.
- (F) Form 10-K for the year ended January 31, 2002.
- (G) Proxy Statement filed with the SEC on April 16, 2003.
- (H) Form 10-K for the year ended January 31, 2003.
- (I) Form 8-K dated May 30, 2003.
- (J) Form 8-K/A dated August 25, 2003.

NOTE: Certain previously filed exhibits are no longer being incorporated by reference (and therefore not numerically listed) as the underlying documents have either expired or are no longer material or relevant.

(b). Reports on Form 8-K

| | |
|---------------|--|
| June 02, 2003 | Q1 Results of Operations and Financial Condition |
| June 05, 2003 | Consummation of Capital and Corporate Restructuring Plan |
| June 11, 2003 | Q1 Earnings Conference Call Transcript |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SORRENTO NETWORKS CORPORATION
(REGISTRANT)

September 15, 2003

By: /s/ JOE R. ARMSTRONG

Joe R. Armstrong,

Chief Financial Officer
Principal Accounting Officer

STATEMENT OF DIFFERENCES

The section symbol shall be expressed as.....'SS'