SORRENTO NETWORKS CORP
Form 10-Q
September 14, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended JULY 31, 2001

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)

New Jersey	22-2367234
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

9990 Mesa Rim Road
San Diego, California
92121
(Address of principal executive offices)
(Zip Code)

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

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, $.30 par value per share, Outstanding: 14,229,026 shares at September 12, 2001.

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.

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In Thousands)

	Unaudited July 31, 2001	Ja
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 3,615	
Accounts receivable, net	12,675	
Inventory, net	28,867	
Prepaid expenses and other current assets	1,210	
Investment in marketable securities	25,811	
TOTAL CURRENT ASSETS	72,178	
PROPERTY AND EQUIPMENT, NET	17,956	
OTHER ASSETS		
Purchased technology, net	838	
Other assets	1,920	
Investment in former subsidiary	1,266	
TOTAL OTHER ASSETS	4,024	
TOTAL ASSETS	$ 94,158	
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term debt	$ 1,180	
Current maturities of long term debt	524	
Accounts payable	19,960	
Accrued and other current liabilities	8,067	
TOTAL CURRENT LIABILITIES	29,731	
Long-term debt and capital lease obligations	3,922	

Dividend payable	1,266
TOTAL LIABILITIES	34,919
COMMITMENTS AND CONTINGENCIES	
MINORITY INTEREST	
Preferred stock of subsidiary; 8,954 shares issued and outstanding; subsidiary liquidation preference $48,800	48,800
STOCKHOLDERS' EQUITY	
Preferred stock, $.01 par value; cumulative dividends; liquidation preference $1,353 including accumulated dividends	1
Common stock, $.30 par value; 150,000 shares authorized; 14,238 shares issued and 14,229 shares outstanding at July 31, 2001; 12,608 shares issued and 12,599 shares outstanding at January 31, 2001	4,271
Additional paid-in capital	125,107
Notes receivable from option exercises	(5,034)
Deferred stock compensation	(569)
Accumulated deficit	(134,919)
Accumulated unrealized gain on marketable securities	21,651
Treasury stock, at cost; 9 shares at July 31, 2001 and January 31, 2001	(69)
TOTAL STOCKHOLDERS' EQUITY	10,439
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 94,158

See accompanying notes to consolidated financial statements

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SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In Thousands, except per share amounts)

	Three Months Ended July 31	
	2001	2000
NET SALES	$ 7,998	$ 11,376
COST OF SALES	6,702	7,534

GROSS PROFIT	1,296	3,842
OPERATING EXPENSES		
Selling and marketing	3,836	5,512
Engineering, research and development	3,425	6,465
General and administrative	3,293	5,035
Deferred compensation	205	836
Other operating expenses	93	93
TOTAL OPERATING EXPENSES	10,852	17,941
LOSS FROM OPERATIONS	(9,556)	(14,099
OTHER INCOME (CHARGES)		
Investment income	43	873
Interest expense	(144)	(289
Other income (charges)	(168)	(9
Losses on marketable securities	(1,136)	--
TOTAL OTHER INCOME (CHARGES)	(1,405)	575
LOSS BEFORE INCOME TAXES	(10,961)	(13,524
Provision for Income Taxes	--	--
NET LOSS	$(10,961)	$(13,524
INCOME (LOSS) PER COMMON SHARE:		
PREFERRED STOCK DIVIDENDS	--	579
NET LOSS APPLICABLE TO COMMON SHARES	$(10,961)	$(14,103
BASIC		
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING (IN THOUSANDS)	14,184	11,609
NET LOSS PER COMMON SHARE	$ (0.77)	$ (1.21
DILUTED		
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING (IN THOUSANDS)	14,184	11,609
NET LOSS PER COMMON SHARE	$ (0.77)	$ (1.21
COMPREHENSIVE INCOME AND ITS COMPONENTS CONSIST OF THE FOLLOWING:		
Net loss	$(10,961)	$(13,524
Unrealized gains (losses) from marketable securities:		
Unrealized holding gains (losses) arising during the period	(2,798)	65,969
Reclassification adjustment for losses included in net income	1,136	--

COMPREHENSIVE INCOME (LOSS)	$(12,623)	$ 52,445

See accompanying notes to consolidated financial statements

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In Thousands)

	Six Months Ended July 31	
	2001	200
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss from operations	$(16,729)	$(26,
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,648	2,
Accounts receivable and inventory reserves	5,104	5,
Intangible assets valuation allowances	--	
Losses on marketable securities	1,136	
Deferred and other stock compensation	406	
Changes in assets and liabilities net of effects of business entity divestures:		
Increase in accounts receivable	(100)	(5,
Increase in inventories	(15,444)	(3,
Increase in short-term commercial paper	--	(8,
Decrease in other current assets	255	
Increase (decrease) in accounts payable	11,654	(
Increase (decrease) in accrued and other current liabilities	(1,507)	4,
NET CASH USED IN OPERATING ACTIVITIES	(13,577)	(30,
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(2,596)	(7,
Proceeds from sale of marketable securities	13	
Advances to affiliates, net of repayments	--	
Other assets	(517)	(2,

NET CASH USED IN INVESTING ACTIVITIES	(3,100)	(8,
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term debt, net of repayments	(162)	(
Repayment of long-term debt	(17)	(
Proceeds from preferred stock issued by subsidiary	--	46,
Proceeds from common stock	9,645	
Proceeds from stock option exercises	861	2,
NET CASH PROVIDED BY FINANCING ACTIVITIES	10,327	47,
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(6,350)	7,
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	9,965	13,
CASH AND CASH EQUIVALENTS - END OF PERIOD	$ 3,615	$ 21,

See accompanying notes to consolidated financial statements.

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SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(In Thousands, except share and per share amounts)

Sorrento Networks Corporation (formerly Osicom Technologies, Inc.) (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, Santa Monica, California and Fremont, California. In addition, we have various sales offices located in the United States, Europe and Asia. Our former subsidiary, Entrada Networks is located in San Diego, California. 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 as of July 31, 2001 and January 31, 2001, for the three and six months ended July 31, 2001 and 2000, have 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 generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The January 31, 2001 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. 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 for the year ended January 31, 2001.

The preparation of financial statements in conformity with generally accepted accounting principles 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 differ from these estimates. In the opinion of Management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows as of July 31, 2001 and for the three and six months ended July 31, 2000, have been made. The results of operations for the three and six months ended July 31, 2001 are not necessarily indicative of the operating results for the full year.

On August 31, 2000, we completed a merger of 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. and changed its symbol to ESAN. 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 Entrada for $3,306. After these transactions and Entrada's issuance of shares to outside investors in connection with the merger we owned 48.9% of Entrada Networks. Accordingly, the accompanying financial statements reflect the results of Entrada 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 Entrada 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 Entrada 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 will receive a similar number of Entrada shares. Prior to July 31, 2001 we distributed 29,533 of our Entrada shares upon the exercise of options and as of July 31, 2001 have reserved 1,046,045 shares for future exercises of options and warrants. The cost basis of these reserved shares and related liability to the option and warrant holders is included in the investment in former subsidiary and dividends payable in the accompanying balance sheet. The aggregate distribution of our Entrada shares including the shares reserved for option and warrant holders has been accounted

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for at our original cost of $5,122. In addition we have granted options to purchase 410,000 of our Entrada shares for $3.19 per share (the merger price) to several of our then officers and consultants.

The remaining 1,106,337 Entrada 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. During the quarter ended July 31, 2001, we recorded an impairment allowance of $1,087 to reflect the decline in the market value of our Entrada shares. More information concerning Entrada is available in its public filings with the Securities and Exchange Commission.

NETsilicon, Inc.

On September 15, 1999 NETsilicon, Inc. ("NSI") completed an initial public offering in which we sold 2,000,000 of our shares in NSI and in which our remaining 55.4% interest became non-voting shares until sold to a non-affiliate. Accordingly, the accompanying financial statements reflect the results of operations of NSI through September 14, 1999 at which time our remaining interest is accounted for as an "available for sale security." Under this accounting, the 7.5 million shares of NSI held by us are 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 is included in the computation of comprehensive income.

After our sale in October 2000 of 527,344 of our shares in NSI we own 6,972,656 shares of NSI, or 49.6% as of July 31, 2001. More information concerning NSI is available in its public filings with the Securities and Exchange Commission.

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 Sorrento subsidiary granted by it to its employees. During the quarters ended July 31, 2001 and 2000, and the six months ended July 31, 2001 and 2000 our subsidiary Sorrento Networks "Sorrento" amortized $157, $678, $311 and $678 respectively of the total $2,604 initially recorded for deferred stock compensation.

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 Sorrento subsidiary granted by it to its consultants. During the quarters ended July 31, 2001 and 2000, and the six months ended July 31, 2001 and 2000 Sorrento recorded $48, $158, $95 and $158, respectively, for options granted to consultants.

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)
(In Thousands, except share and per share amounts)

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board finalized Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets". SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that we recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. Upon adoption of SFAS 142, it requires that we reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that we identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS 142 requires us to complete a transitional goodwill impairment test six months from the date of adoption. The Company is also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142.

During the fiscal years ended January 31, 1997 we completed several business combinations which were accounted for using the purchase method. As of July 31, 2001, the net carrying amount of intangible assets is $837 all of which pertain to our Meret Optical business segment. Amortization expense during the quarters ended July 31, 2001 and 2000 was $93 and during the six months ended July 31, 2001 and 2000 was $186. We are currently evaluating the effect, if any, the adoption of SFAS 141 and 142 will have on our financial position and results of operations.

SFAS 133, as amended by SFAS 137 and 138 "Accounting for Derivative Instruments and Hedging Activities," is effective for financial statements with fiscal quarters of all fiscal years beginning after June 15, 2000. The Accounting Standards Executive Committee issued Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," and SOP 98-5, "Reporting on the Costs of Start-up Activities," effective in the current or future periods. The adoption or future adoption of these standards has had or will have no material effects, if any, on our financial position or results of operations.

(In Thousands, except share and per share amounts)

The Financial Accounting Standards Board issued Interpretation ("FIN") No. 44, "Accounting for Certain Transactions involving Stock Compensation," an Interpretation of APB Opinion No. 25. FIN 44 clarifies the application of Opinion No. 25 for (a) the definition of an employee for purposes of applying Opinion No. 25, (b) the criteria for determining whether a plan qualifies as a non-compensatory plan, (c) the accounting consequences of various modifications to the terms of a previously fixed stock option award, and (d) the accounting for an exchange of stock compensation awards in a business combination. FIN 44 is effective July 2, 2000, but certain conclusions cover specific events that occur after either December 15, 1998, or January 12, 2000. The adoption of this standard had no material effect, if any, on our financial position or results of operations.

The Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, Revenue Recognition ("SAB 101") which broadly addresses how companies report revenues in their financial statements effective the fourth fiscal quarter of years beginning after December 31, 1999. The adoption of this policy had no effect on our financial position or results of operations.

BALANCE SHEET DETAIL

Inventories at July 31, 2001 and January 31, 2001 consist of:

	July 31, 2001	January 31, 2001
Raw material	$ 19,582	$ 10,201
Work in process	4,519	4,310
Finished goods	8,533	2,882
	32,634	17,393
Less: Valuation reserve	(3,767)	(2,792)
	$ 28,867	$ 14,601

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. Investments not classified as held to maturity, those for which we have the intent and ability to hold, are classified as available for sale. Our investments in NETsilicon 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 and during the quarter ended July 31, 2001 we recorded an impairment loss of $1,087 against our investment in Entrada. At July 31, 2001 and January 31, 2000 marketable securities were as follows:

(In Thousands, except share and per share amounts)

	Cost	Unrealized Gains	Market Value
July 31, 2001:			
NETsilicon	$ 3,938	$ 21,651	$ 25,589
Entrada	222	-	222
	$ 4,160	$ 21,651	$ 25,811
January 31, 2001:			
NETsilicon	$ 3,938	$ 42,303	$ 46,241
Entrada	1,371	2,646	4,017
	$ 5,309	$ 44,949	$ 50,258

STOCKHOLDERS' EQUITY

We are authorized to issue the following shares of stock:
150,000,000 shares of Common Stock ($.30 par value)
2,000,000 shares of Preferred Stock ($.01 par value) of which the following series have been designated:
2,500 shares of Preferred Stock, Series A 1,000 shares of Preferred Stock, Series B 100,000 shares of Preferred Stock, Series C 3,000 shares of Preferred Stock, Series D 1,000,000 shares of Preferred Stock, Series E

We have outstanding the following shares of preferred stock:

	Shares Outstanding	Par Value	Liquidation Preference
Series D	1,353	$ 1	$ 1,353

Preferred stock dividends during the three and six months ended July 31, 2001 and 2000 consist of:

	Three Months Ended July 31,		Six Months Ended
	2001	2000	2001
Accrued, unpaid dividends (Series A)	$ -	$ 38	$ -
Deemed dividends (Sorrento Series A)	-	541	180
	$ -	$ 579	$ 180

OTHER CAPITAL STOCK TRANSACTIONS

In March, 2001 we completed a private placement of 1,525,995 unregistered shares of our common stock receiving net proceeds of $9,645. In addition the purchasers received three year warrants to acquire an additional 381,499 shares of our common stock at $8.19 per share. In the event we issue shares of our common stock or equity securities convertible into our common stock at a price less than $6.5531 per share the purchasers are entitled to receive additional shares of common stock.

During, 2000, our Sorrento completed a sale of 8,596,333 shares of its Series A Convertible Preferred Stock receiving net proceeds of $46,638 from a group of investors. 1,467,891 shares were purchased by entities in which our immediate past Chairman and CEO, who was an outside director at that time, was a partner or member pursuant to a previously contracted right of participation. In addition, Sorrento paid a finders fee of $1,950 through the issuance by Sorrento of an additional 357,799 shares of its Series A Convertible Preferred Stock to an entity in which our immediate past Chairman and CEO, who was an outside director at that time, was a partner. One of our then outside directors purchased 45,872 shares and a then director of Sorrento purchased 91,744 in this placement.

Each share of Sorrento's Series A Preferred Stock is convertible into one share of Sorrento's common stock at the option of the holder, may vote on an "as converted" basis except for election of directors, and has a liquidation preference of $5.45 per share. The shares are automatically converted into Sorrento's common stock upon an underwritten public offering by Sorrento with an aggregate offering price of at least $50,000. Since Sorrento did not complete a $50,000 public offering by March 1, 2001, the holders of more than 50% of the then outstanding Series A shares may request a redemption at the current liquidation preference of $48.8 million and Sorrento has received such written notices. The requested redemption can only be made from specified categories of funds, and our Sorrento subsidiary cannot legally redeem any of the Series A shares at this time. We have engaged an investment banking firm to assist in structuring an agreement between Sorrento and the Series A shareholders regarding their redemption request. The net proceeds from the issuance of these shares has been classified as a minority interest in the accompanying financial statements. The difference between the net proceeds received on the sale of these shares and their liquidation preference of $48,800 has been recorded as a deemed dividend during the period from issuance to March 31, 2001. During the six months ended July 31, 2001 and the quarter and six months ended July 31, 2000, we recorded a deemed dividend of $180, $541 and $901, respectively, with respect to the Sorrento Series A shares.

We made sales of products to subsidiaries of two of the purchasers of Sorrento's Series A Preferred Stock. During the three and six months ended July 31, 2001 we made sales of $0 and $1,592, respectively, to the subsidiaries of the purchaser of 33.8% of the shares and those customers had outstanding receivables of $1,833 at July 31, 2001 under 180 days terms. During the three and six months ended July 31, 2001 we made sales of $1,108 and $2,292, respectively, to the subsidiaries of the purchaser of 6.2% of the shares and those customers had outstanding receivables of $626 at July 31, 2001.

STOCK OPTION PLANS

We have four stock options plans in effect: 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. At July 31, 2001 there were 4,828,993 shares under option at prices varying from $3.00 to $69.13 per share.

In addition Sorrento adopted its 2000 Stock Option/Stock Issuance Plan under which it has granted options to certain of its employees, directors at prices not less than fair value at the date of grant and generally vest over four years. Eligible individuals may be issued shares of common stock directly, when through immediate purchase of the shares at fair value or as a bonus tied to performance milestones. No stock has been issued under the stock issuance program and at July 31, 2001 there were 17,446,021 Sorrento shares under option at prices varying from $2.00 to $6.85 per share.

The holders of these options may elect to convert all or a portion of their options into options to acquire our stock at a ratio of 3.9 for one. During the six months ended July 31, 2001 we issued options to acquire 5,718 of our common stock exercisable at $7.80 to $21.55 per share upon conversions of Sorrento options.

EARNINGS PER SHARE CALCULATION

The following data show the amounts used in computing basic earnings per share for the three and six months ended July 31, 2001 and 2000.

(In Thousands, except share and per share amounts)

	Three Months Ended July 31, 2001	Three Months Ended July 31, 2000	Six Months End 2001
Net loss	$ (10,961)	$ (13,524)	$ (16,729)
Less: preferred dividends	-	(579)	(180)
Net loss available to common shareholders used in basic EPS	$ (10,961)	$ (14,103)	$ (16,909)
Average number of common shares used in basic EPS	14,183,611	11,608,562	13,740,247

We had a net loss for the three and six months ended July 31, 2001 and 2000. Accordingly, the effect of dilutive securities including convertible preferred stock, vested and nonvested stock options and warrants to acquire

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common stock are not included in the calculation of EPS because their effect would be antidilutive. The following data shows the effect on income and the weighted average number of shares of dilutive potential common stock.

	Three Months Ended July 31, 2001	Three Months Ended July 31, 2000	Six Months 2001
Net loss available to common shareholders used in basic EPS	$ (10,961)	$ (14,103)	$ (16,909)
Preferred stock dividends	-	-	-
Net loss available to common shareholders used in basic EPS	$ (10,961)	$ (14,103)	$ (16,909)
Average number of common shares used in basic EPS	14,183,611	11,608,562	13,740,247

(In Thousands, except share and per share amounts)

Effect of dilutive securities:			
Convertible preferred stock	-	-	-
Stock benefit plans	199,003	2,105,306	239,222
Stock benefit plan of Sorrento	39,230	-	47,820
Warrant exercises	61,486	106,190	31,970
Average number of common shares and dilutive potential common stock used in diluted EPS	14,483,330	13,820,058	14,059,259

The shares issuable upon exercise of options and warrants represents the quarterly average of the shares issuable at exercise net of the shares assumed to have been purchased, at the average market price for the period, with the assumed exercise proceeds. Accordingly, options and warrants to acquire 8,894,558 of our common stock with exercise prices in excess of the average market price during the quarter ended July 31, 2001 are excluded because their effect would be antidilutive.

RELATED PARTY TRANSACTIONS

During the year ended January 31, 2001 we made a 6.6% three year loan in the amount of $300 to an officer in connection with his accepting employment as our Senior Vice President, Legal. This is a full recourse loan and the officer has pledged all his options to acquire our common stock and any options he may receive from any of our subsidiaries as collateral. Accrued unpaid interest on this loan at July 31, 2001 was $6.

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. At times such amounts may exceed the F.D.I.C. limits. We limit the amount of credit exposure with any one financial institution and believe that no significant concentration of credit exists with respect to cash investments. No accounts at a single bank accounted for more than 10% of our current assets.

Although we are directly affected by the economic well being of significant customers listed in the following tables, management does not believe that significant credit risk exist at July 31, 2001. We perform ongoing evaluations of our customers and require letters of credit or other collateral arrangements as appropriate. Accordingly, trade credit losses have not been significant.

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

	July 31, 2001	January 31, 2001
Customer A	14.7%	20.6%
Customer B	11.4	14.1
Customer C	4.9	15.6
Customer D	0.3	2.4
Customer E	10.0	-
Customer F	24.2	12.0
Customer G	14.5	20.5
Customer H	13.7	-
Customer I	13.2	-

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

	Three Months Ended July 31,		Six Months Ended July 31,	
	2001	2000	2001	2000
Customer A	22.4%	- %	13.3%	- %
Customer B	18.2	-	18.5	-
Customer C	13.9	12.8	10.2	6.8
Customer D	10.4	-	4.0	15.2
Customer E	3.0	-	3.1	-
Customer F	-	-	15.9	-
Customer G	-	12.0	7.1	6.4
Customer H	-	-	7.0	-

SUBSEQUENT EVENTS

During August 2001, we completed a private placement of our 9.75% senior convertible debentures receiving net proceeds of $29.7 million. The debentures, due August 2, 2004, have a face value of $32.2 million which is convertible into our common stock at $7.21 per share. At maturity we may elect to redeem the debentures for cash and we have the option of paying the interest on these debentures in shares of our common stock or cash. In addition the purchasers received four year warrants to acquire an additional 3,351,840 shares of our common stock at $7.21 per share. Subject to certain exceptions, if we issue shares of our common stock, equity securities, options or warrants at a price less than $7.21 per share the conversion price and warrant exercise price are subject to adjustment.

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)
(In Thousands, except share and per share amounts)

SEGMENT INFORMATION

	Sorrento Networks	Meret Optical	Entrada Networks	Other	Tota
Three months ended July 31, 2001:					
Net sales to external customers	$ 6,747	$ 1,251	$ -	$ -	$ 7,
Intersegment sales	-	-	-	-	
Total net sales	6,747	1,251	-	-	7,
Cost of goods sold	5,945	757	-	-	6,
Gross profit	802	494	-	-	1,
Operating income (loss) from continuing operations	(8,941)	135	-	(750)	(9,
Depreciation & amortization expense	816	136	-	85	1,
Valuation allowance additions	3,957	75	-	-	4,
Capital asset additions	1,128	7	-	30	1,
Total assets	51,483	7,861	n/a	34,814	94,

	Sorrento Networks	Meret Optical	Entrada Networks	Other	Tota
Three months ended July 31, 2000:					
Net sales to external customers	$ 3,550	$ 1,785	$6,041	$ -	$ 11,
Intersegment sales	-	-	-	-	
Total net sales	3,550	1,785	6,041	-	11,
Cost of goods sold	2,782	1,057	3,695	-	7,
Gross profit	768	728	2,346	-	3,
Operating income (loss) from continuing operations	(12,533)	375	(622)	(1,319)	(14,
Depreciation & amortization expense	833	123	399	1	1,
Valuation allowance additions	686	177	22	-	
Capital asset additions	2,396	29	133	7	2,
Total assets	25,624	8,853	11,893	232,590	278,

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)
(In Thousands, except share and per share amounts)

SEGMENT INFORMATION (continued)

	Sorrento Networks	Meret Optical	Entrada Networks	Other	Tota
Six months ended July 31, 2001:					
Net sales to external customers	$ 19,886	$ 2,609	$ -	$ -	$ 22,
Intersegment sales	-	-	-	-	
Total net sales	19,886	2,609	-	-	22,
Cost of goods sold	14,611	1,659	-	-	16,
Gross profit	5,275	950	-	-	6,
Operating income (loss) from continuing operations	(13,571)	247	-	(1,961)	(15,
Depreciation & amortization expense	1,213	272	-	163	1,
Valuation allowance additions	4,356	247	-	500	5,
Capital asset additions	2,524	11	-	61	2,
Total assets	51,483	7,861	n/a	34,814	94,

	Sorrento Networks	Meret Optical	Entrada Networks	Other	Tota
Six months ended July 31, 2000:					
Net sales to external customers	$ 8,234	$ 3,439	$9,751	$ -	$ 21,
Intersegment sales	-	-	-	-	
Total net sales	8,234	3,439	9,751	-	21,
Cost of goods sold	4,862	1,772	9,093	-	15,
Gross profit	3,372	1,667	658	-	5,
Operating income (loss) from continuing operations	(18,426)	972	(7,593)	(2,159)	(27,
Depreciation & amortization expense	1,232	246	881	2	2,
Valuation allowance additions	748	300	4,753	-	5,
Capital asset additions	4,544	51	184	2,342	7,
Total assets	25,624	8,853	11,893	232,590	278,

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements contained in this Quarterly Report on Form 10-Q, including, without limitation, statements containing the words "believes", "anticipates", "estimates", "expects", and words of similar import constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Readers are referred to the "Other Risk Factors" section of our Annual Report on Form 10-K, as well as the "Financial Risk Management" and "Future Growth Subject to Risks" sections contained therein, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements.

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 for the year ended January 31, 2001.

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".

Entrada Networks

On August 31, 2000, we completed a merger of our Entrada subsidiary with Sync Research, Inc. a Nasdaq listed company. After the merger, our purchase of Sync shares prior to the merger and our purchase of shares for cash from Entrada we owned 48.9% of the merged entity which changed its name to Entrada Networks. Pursuant to our plans adopted prior to the merger, we distributed one-fourth shares of an Entrada share for each of our outstanding shares and reserved a similar number for each unexercised option and warrant to acquire our common stock outstanding on the record date. After the distribution and reserve for options and warrants we own approximately 10.1% of Entrada and account for this remaining interest as an "available for sale security" which is marked to market at the end of each period.

The amounts included in our fiscal 2002 year are not comparable to our fiscal 2000 year due to the inclusion of Entrada Networks only through the August 31, 2000 merger. Additional information regarding the Entrada is available from its various filings with the Securities and Exchange Commission which are available online at www.freeedgar.com and www.sec.gov or from the Securities and Exchange Commission.

Results of Operations/Comparison of the Quarters and Six Months Ended July 31, 2001 and 2000

Net sales. Our consolidated net sales were $8.0 million for the quarter ended July 31, 2001 compared to $11.4 million for the three months ended July 31, 2000, a decrease of 29.8%. This decrease in net sales reflects an increase of $3.1 million at our subsidiary Sorrento Networks ("Sorrento") and a decrease of $534,000 at Meret Optical Communications ("Meret"). The remaining decline was related to Entrada Networks. During the six months ended July 31, 2001 our net sales increased to $22.5 million from $21.4 million for the comparable six months ended July 31, 2000, an increase of 5.1%. This increase in net sales reflects a $11.7 million increase at Sorrento, and an $860,000 decrease at Meret. The remaining decline was related to Entrada.

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. Consolidated gross profit decreased to $1.3 million for the quarter ended July 31, 2001 from $3.8 million for the comparable quarter last year. This decrease reflects a $34,000 increase at Sorrento offset by $234,000 decrease at Meret. The remaining decline was related to Entrada. Consolidated gross profit increased to $6.2 million, or by 8.7%, for the six months ended July 31, 2001 from $5.7 million for the six months ended July 31, 2000. This increase reflects a $1.9 million increase at Sorrento, partially offset by a $747,000 decrease at Meret and $658,000 for Entrada.

Selling and marketing. Selling and marketing expenses consist primarily of employee compensation and related costs, commissions to sales representatives, tradeshow expenses, facilities costs, and travel expenses. We will continue to manage our expenditures for sales and marketing in relation with the expansion of our domestic and

international sales channels and the establishment of strategic relationships. Our consolidated selling and marketing expenses decreased to $3.8 million, or 47.5% of net sales, for quarter ended July 31, 2001 from $5.5 million, or 48.2% of net sales for the comparable quarter last year. Approximately $400,000 of this decrease was related to Sorrento. The remaining decrease was related to Entrada. Our selling and marketing expenses decreased to $8.1 million, or 36.0% of net sales, during the six months ended July 31, 2001 from $9.2 million, or 43.0% of net sales, for the comparable six month period last year. Sorrento's selling expenses increased by $1.3 million for the six months ended July 31, 2001 from the comparable six month period last year which was offset by the decrease related to Entrada.

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 expect research and development costs to increase as our sales increase. Our consolidated engineering, research and development expenses decreased to $3.4 million, or 42.5% of net sales, for the quarter ended July 31, 2001 from $6.5 million, or 57.0% of net sales, for the comparable period last year. Sorrento accounted for $1.8 million of this decrease. The remaining decrease was related to Entrada. During the six months ended July 31, 2001, our consolidated engineering, research and development expenses decreased to $6.7 million, or 29.8% of net sales, from $12.4 million, or 57.9% of net sales, for the comparable six month period last year. Sorrento's engineering, research and development expenses decreased $2.8 million for the six months ended July 31, 2001 from the comparable six month period last year and the remaining decrease was related to Entrada.

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. Our consolidated general and administrative expenses decreased to $3.3 million, or 41.3% of net sales, for the quarter ended July 31, 2001 from $5.0 million, or 43.9 % of net sales, for the comparable quarter ended last year. Approximately $900,000 of this decrease was related to Sorrento. The remaining decrease related to Entrada. Our consolidated general and administrative expenses decreased to $6.0 million, or 26.7% of net sales, for the six months ended July 31, 2001 from $8.2 million, or 38.3% of net sales, for the comparable period last year. Sorrento accounted for $1.2 million of this decrease and the remaining decrease primarily related to Entrada.

Other operating expenses. Other operating expenses for the quarters and six months ended July 31, 2001 and 2000 include $93,000 and $186,000, respectively, of amortization of purchased technology related to acquisitions included in Meret. During the six months ended July 31, 2000, approximately $2.1 million of these costs were attributable to the closure of one of Entrada's facilities and valuation reserves recorded against distributor receivables and capitalized software costs of Entrada.

Other income (charges). Other income (charges) decreased to $1.4 million charges for the quarter ended July 31, 2001 from $575,000 income for the comparable period last year. Investment income declined by $830,000 during the quarter ended July 31, 2001 from the comparable period last year due to reduced investments of our cash surplus cash in short-term investments as well as reduced interest received on customer financing receivables. Our interest expense decreased by $190,000 for the quarter ended July 31, 2001 from the comparable quarter last year due to reductions in our short-term borrowings. Other charges increased by $159,000 during the quarter ended July 31, 2001 from the comparable period last year primarily as the result of foreign currency exchanges. Losses on marketable securities during the quarter ended July 31, 2001 include a $1.1 million impairment allowance on our available for sale investment in Entrada and realized losses on sales of Entrada shares. During the six months ended July 31, 2001 other income (charges) decreased to $1.4 million charges from $845,000 million income for the comparable six months last year. The decrease reflects a decrease in investment income of $1.2 million related to reduced investments of surplus cash in short term investments as well as reduced interest received on customer financing receivables. Our interest expense decreased by $178,000 for the six months ended July 31, 2001 from the comparable six months last year due to reduced short-term borrowings. Other charges increased by $113,000 during the six months ended July 31, 2001 from the comparable period last year primarily as the result of foreign currency exchanges.

Income taxes. There was no provision for income taxes for quarters and six months ended July 31, 2001 and 2000. 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. However, due to potential adjustments to the net operating loss carry forwards

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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 assets will not be realized.

Sorrento Networks

Net sales. Net sales increased 91.4% to $6.7 million for the three months ended July 31, 2001 from $3.6 million for the comparable quarter last year. During the three months ended July 31, 2001, we shipped product to fourteen customers of which four customers represented over 75% of our net sales. During the quarter ended July 31, 2000, we shipped product to five customers of which two customers represented over 75% of our net sales. Net sales increased by 142.7% to $19.9 million for the six months ended July 31, 2001 from $8.2 million for the comparable period last year. During the six months ended July 31, 2001, we shipped product to sixteen customers of which six customers represented over 75% of our net sales. During the six months ended July 31, 2000, we shipped product to eleven customers of which four customers represented over 75% of our net sales. Sales to our international customers increased to 57.1% of our net sales during the quarter ended July 31, 2001 from 38.5% during the comparable quarter last year. For the six months ended July 31, 2001 sales to international customers increased to 45.5% of our net sales from 24.7% during the comparable period last year. 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.

Gross profit. Gross profit increased by 4.4% to $802,000 for the quarter ended July 31, 2001 from $768,000 for the comparable quarter last year. Our gross margin decreased to 12.0% of net sales for the quarter ended July 31, 2001 from 21.3% of net sales for the comparable quarter last year. Gross profit for the six months ended July 31, 2001 increased by 55.9% to $5.3 million from $3.4 million for the comparable period last year. Our gross margin for the six months ended July 31, 2001 decreased to 26.6% of net sales from 41.5% for the comparable period last year. The decline in gross margin for the quarter and six months ended July 31, 2001 results from changes in our product mix, increases in our obsolescence reserve and increases in manufacturing costs.

Selling and marketing. Selling and marketing expenses decreased to $3.7 million, or 55.2% of net sales, for the quarter ended July 31, 2001 from $4.1 million, or 113.9% of net sales for the comparable quarter last year. For the six month period ended July 31, 2001 selling and marketing expenses increased to $7.9 million, or 39.7% of net sales from $6.6 million, or 80.5% of net sales. The decrease in sales and marketing expenses for the three months ended July 31, 2000 is primarily the result of decreases in trade show participation, advertising and promotion and recruitment. The increase in sales and marketing expenses for the six months ended July 31, 2001 is primarily the result of increased operating expenses related to opening three foreign sales offices located in Beijing, Singapore and the Netherlands and increased field service expenses. We increased our sales and marketing personnel to 76 at July 31, 2001 from 57 at July 31, 2000. We are continually evaluating our resource requirements and will plan accordingly for any additions necessary to expand our domestic and international sales force and marketing efforts.

Engineering, research and development. Engineering, research and development expenses decreased to $3.3 million, or 49.3% of net sales, for the quarter ended July 31, 2001 from $5.1 million, or 141.7% of net sales, for the comparable quarter last year. For the six months ended July 31, 2001 engineering, research and development expenses decreased to $6.6 million, or 33.2% of net sales from $9.4 million, or 114.6% of net sales. The decreases were primarily due to the completion and conversion of an existing project into production and reduced project material and consulting expenses. The decrease is also the result of decreased relocation and travel expenses. We increased our research and development personnel to 95 at July 31, 2001 from 88 at July 31, 2000. We expect our research and development expenses to increase in future periods as sales increase to support our efforts in our continued development of end-to-end optical networking solutions for the metropolitan market.

General and administrative. General and administrative expenses decreased to $2.5 million, or 37.3% of net sales, for the quarter ended July 31, 2001 from

$3.4 million, or 94.4% of net sales, for the comparable quarter last year. For the six months ended July 31, 2001 general and administrative expenses decreased to $4.0 million, or 20.1% of net sales from $5.2 million, or 63.4% of net sales. During the three and six month periods, our legal and professional expenses decreased in comparison to last year where substantially higher expenses were incurred in anticipation of a public offering. This decrease was partially offset by increases to our bad debt allowance as well as

increased personnel and personnel related expenses incurred to build our infrastructure needed to support our planned growth. We have increased our general and administrative personnel to 29 at July 31, 2001 from 24 at July 31, 2000.

Deferred and other stock compensation. Deferred and other stock compensation for the quarter and six months ended July 31, 2001 includes $157,000 and $311,000 of amortization of deferred stock compensation and $48,000 and $95,000 of amortization of the value of stock options granted to consultants, respectively. 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 is being amortized on an accelerated basis over the vesting period of the options.

Meret Optical Communications

Net sales. Net sales for Meret decreased to $1.3 million, or by 27.8%, for the quarter ended July 31, 2001 from $1.8 million for the for the comparable quarter last year. During the six months ended July 31, 2001 net sales decreased to $2.6 million, or by 23.5%, from $3.4 million for the comparable six months last year. The decline in net sales results from the decrease in product demand for the legacy product family.

Gross Profit. Gross profit decreased to $494,000, or by 32.1%, for the quarter ended July 31, 2001 from $728,000 for the comparable quarter last year. Meret's gross margins decreased to 38.0% for the quarter ended July 31, 2001 from 40.4% for the comparable quarter last year. During the six months ended July 31, 2001 Meret's gross profit decreased to $950,000, or by 44.1%, from $1.7 million for the six months ended July 31, 2000. Meret's gross margins decreased to 36.5% for the six months ended July 31, 2000 from 50.0% for the six months ended July 31, 2000. The decrease in gross margin reflects a shift in Meret's product mix towards shipments of lower margin products.

Selling and Marketing. Selling and marketing expenses increased to $122,000 or 9.4% of net sales, for the quarter ended July 31, 2001 from $105,000, or 5.8% of net sales, for the comparable period last year. For the six months ended July 31, 2001, selling and marketing expenses decreased to $220,000, or 8.5% of net sales, from $285,000, or 8.3% of net sales, for the six months ended July 31, 2000. The decrease results primarily from a decline in external sales commissions directly related to the decrease in net sales from the comparable period last year.

Engineering, Research and Development. Engineering, research and development expenses increased to $88,000 or 6.8% of net sales, for the quarter ended July 31, 2001 from $59,000 or 3.3% of net sales for the comparable quarter last year.

During the six months ended July 31, 2001 engineering expenses increased to $169,000 or 6.5% of net sales, from $87,000 for 2.6% of net sales for the comparable six months last year. The increase is attributable to expenditures to update existing products.

General and Administrative. General and administrative expenses decreased to $54,000 or 4.2% of net sales for the quarter ended July 31, 2001 from $96,000 or 5.3% of net sales for the comparable quarter last year. The decrease is primarily attributable to reductions in allowances for bad debts. During the six months ended July 31, 2001, general and administrative expenses decreased slightly to $127,000 from $138,000 for the comparable six months last year.

Other operating expenses. Other operating expenses of $93,000 and $186,000 for the quarter and six months ended July 31, 2001 remained unchanged compared to the comparable quarter and six months last year. These costs represent the amortization of purchased technology related to prior acquisitions.

Liquidity and Capital Resources

We finance our operations through a combination of debt and equity financing. At July 31, 2001, our working capital was $42.5 million including $3.6 million in cash and cash equivalents.

The amounts included in our statement of cash flows for the six months ended July 31, 2001 are not comparable to our six months ended July 31, 2000 amounts due to the inclusion of Entrada for only the six months ended July 31, 2000. Readers should refer to Entrada's quarterly reports on Form 10-Q for information concerning Entrada.

Our operating activities used cash flows of $13.6 million during the six months ended July 31, 2001. During the six months ended July 31, 2000 our operating activities used cash flows of $31.0 million. The decreases in cash flows used by operations results primarily from the decrease in our net loss and increases in accounts payable partially offset by increases in inventory and decreases in accrued and other current liabilities.

Our standard payment terms range from net 30 to net 90 days. Receivables from international customers have frequently taken longer to collect. For some of the Sorrento customers payment is required within 180 days from the date of shipment.

Our investing activities during the six months ended July 31, 2001 used cash flows of $3.1 million. We purchased property and equipment of $2.6 million and $517,000 in other assets. During the six months ended July 31, 2000 the investing activities used cash flows of $9.0 million. This consisted primarily of $7.1 million in purchases of capital equipment, and $2.0 million invested in a Sorrento customer. We expect our investments in property and equipment will increase as sales increase.

Our financing activities during the six months ended July 31, 2001 provided cash flows of $10.3 million which consisted of $9.6 million in net proceeds from a private placement for issuance of our common stock and $861,000 in proceeds from option and warrant exercises offset by repayments of short and long term debt.

During the six months ended July 31, 2000 the financing activities provided cash flows of $47.8 million which consisted of $46.6 million in net proceeds from a private placement by Sorrento of its convertible preferred stock and $2.3 million in proceeds from option and warrant exercises offset by repayments of short and long term debt.

We have a line of credit which totals $8.0 million. Outstanding borrowings against this line of credit was $1.2 million at July 31, 2001. Our credit line is collateralized by accounts receivable, inventory and equipment.

During March 2000, our Sorrento subsidiary completed a private placement of 8,596,333 shares of its Series A Convertible Preferred Stock to a group of investors receiving net proceeds of approximately $46.6 million. Each share of our Sorrento subsidiary's Series A Preferred Stock is convertible into one share of its common stock at the option of the holder, may vote on an "as converted" basis except for election of directors, and has a liquidation preference of $5.45 per share. The shares are automatically converted into Sorrento's common stock upon an underwritten public offering by Sorrento with an aggregate offering price of at least $50 million. Since our Sorrento subsidiary did not complete a $50 million public offering by March 1, 2001, the holders of more than 50% of the then outstanding Series A shares may request to be redeemed at the shares then adjusted liquidation preference. Our Sorrento subsidiary has received notice from the holders of more than 50% of its Series A Preferred Stock requesting that Sorrento redeem the Series A Preferred Stock which has a liquidation preference of $48.8 million. The requested redemption can only be made from specified categories of funds, and our Sorrento subsidiary cannot legally redeem any of the Series A Preferred Stock at this time. We have engaged an investment banking firm to assist in structuring an agreement between our Sorrento subsidiary and the Series A Preferred Shareholders regarding their redemption request.

During August 200l, we completed a private placement of our 9.75% senior convertible debentures receiving net proceeds of $29.7 million. The debentures, due August 2, 2004, have a face value of $32.2 million which is convertible into our common stock at $7.21 per share. At maturity we may elect to redeem the debentures for cash and we have the option of paying the interest on these debentures in shares of our common stock or cash. In addition the purchasers received four year warrants to acquire an additional 3,351,840 shares of our common stock at $7.21 per share. Subject to certain exceptions, if we issue shares of our common stock, equity securities, options or warrants at a price less than $7.21 per share the conversion price and warrant exercise price are subject to adjustment.

We anticipate that our available working capital, together with additional financings including a line of credit at our Sorrento subsidiary, will be sufficient to meet our presently anticipated capital requirements for the next year. Nonetheless, our future capital requirements may vary materially from those now planned including the need for additional working capital to accommodate our future 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.

Impact of Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board finalized Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets". SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that we recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. Upon adoption of SFAS 142, it requires that we reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that we identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS 142 requires us to complete a transi uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. These risks and uncertainties are described in the following section. 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.

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. Additionally, the interest rates charged by our present lenders adjust on the basis of the lenders' prime rate.

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.

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.

PART II
OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

On September 10, 2001, holders of outstanding Series A Preferred Stock of our Sorrento subsidiary obtained a preliminary injunction prohibiting it from issuing further shares of its Series A Preferred Stock or incurring any additional debt without the consent of the holders of a majority of the currently outstanding shares of such Series A Preferred Stock. We are requesting such consent from the holders of these shares. Our management does not believe that the preliminary injunction will prevent us from making capital contribution to our Sorrento subsidiary.

From time to time, we are involved in various 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 effect on our financial position or results of operations or cash flows.

ITEM 2: CHANGES IN SECURITIES AND USE OF PROCEEDS

On March 26, 2001 we issued 1,525,995 of our common stock at $6.5531 per share to a group of three private institutional investors, receiving $9,645,292 in net proceeds to be used for working capital purposes. There were no underwriters in the transaction; however, we paid of fee of $300,000 to a placement agent. In addition the purchasers received three year warrants to acquire an additional 381,499 shares of our common stock at $8.19 per share. In the event we issue shares of our common stock or equity securities convertible into our common stock at a price less than $6.5531 per share the purchasers are entitled to receive additional shares of common stock in order to reduce their effective purchase price to such lower amount.

This sale was made without general solicitation or advertising and no underwriters received fees in connection with this security sale. The purchasers were accredited and sophisticated investors with access to all relevant information necessary. The shares were issued pursuant to exemptions from registration under Rule 506 of Regulation D and Section 4(2) of the Securities Act of 1933 as a transaction not involving any public offering. We have filed a Registration Statement on Form S-3 covering the resale of these shares.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

Not Applicable

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not Applicable

ITEM 5: OTHER INFORMATION

Not Applicable

ITEM 6: EXHIBITS AND REPORTS ON FORM 8-K

A. Exhibits

20 Consolidated Financial Statements for the Quarter Ended July 31, 2001 (included in Part I, Item 1)

B. Reports on Form 8-K

June 1, 2001	Fiscal 2002 First Quarter Results
August 3, 2001	Convertible Debentures Placement

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)

By: /s/ Joe R. Armstrong   Date: September 14, 2001

Joe R. Armstrong,
Chief Financial Officer
Principal Accounting Officer