SORRENTO NETWORKS CORP
Form 10-Q
December 17, 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 OCTOBER 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: 13,989,037 shares at December 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

	OCTOBER 31, 2001 (Unaudited)	JANUARY 31, 2001
	(In thousands)	
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 13,329	$ 9,965
Restricted cash	10,314	--
Accounts receivable, net	10,691	16,000
Inventory, net	19,576	14,601
Prepaid expenses and other current assets	1,629	813
Investment in marketable securities	20,464	50,258
TOTAL CURRENT ASSETS	76,003	91,637
PROPERTY AND EQUIPMENT, NET	18,106	16,600
OTHER ASSETS		
Purchased technology, net	745	1,023
Other assets	2,465	2,556
Investment in former subsidiary	1,061	1,307
TOTAL OTHER ASSETS	4,271	4,886
TOTAL ASSETS	$ 98,380	$ 113,123
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term debt	$ 1,239	$ 1,342
Current maturities of long term debt	32	422
Accounts payable	10,061	8,382
Accrued and other current liabilities	8,344	9,498
TOTAL CURRENT LIABILITIES	19,676	19,644
Long-term debt and capital lease obligations	3,938	3,819
Debentures payable	4,963	--
Dividend payable	1,061	1,307
TOTAL LIABILITIES	29,638	24,770
COMMITMENTS AND CONTINGENCIES		

MINORITY INTEREST		
Preferred stock of subsidiary; 8,954 shares issued and outstanding; subsidiary liquidation preference $48,800	48,800	48,620
STOCKHOLDERS' EQUITY		
Preferred stock, $.01 par value; cumulative dividends; liquidation preference $1,353 including accumulated dividends	1	1
Common stock, $.30 par value; 16,667 shares authorized; 14,505 shares issued and 14,496 shares outstanding at October 31, 2001; 12,608 shares issued and 12,599 shares outstanding at January 31, 2001	4,351	3,782
Additional paid-in capital	152,826	114,994
Receivable from option exercises	(2,334)	(5,034)
Deferred stock compensation	(412)	(880)
Accumulated deficit	(150,843)	(118,010)
Accumulated unrealized gain on marketable securities	16,422	44,949
Treasury stock, at cost; 9 shares and 9 shares at October 31, 2001 and January 31, 2001, respectively	(69)	(69)
TOTAL STOCKHOLDERS' EQUITY	19,942	39,733
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 98,380	$ 113,123

See accompanying notes to consolidated financial statements.

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	THREE MONTHS ENDED OCTOBER 31		NINE MONTHS ENDED OCTOBER 31	
	2001	2000	2001	2000
	(In thousands, except per share amounts)			
NET SALES	$ 10,066	$ 10,849	$ 32,561	$ 32,273
COST OF SALES	8,745	7,340	25,015	23,067
GROSS PROFIT	1,321	3,509	7,546	9,206
OPERATING EXPENSES				
Selling and marketing	4,099	4,335	12,248	13,561
Engineering, research and development	3,511	5,707	10,237	18,093
General and administrative	3,361	4,186	9,404	12,386
Deferred compensation	203	400	609	1,236
Other operating expenses	2,793	93	2,979	2,348
TOTAL OPERATING EXPENSES	13,967	14,721	35,477	47,624

LOSS FROM OPERATIONS	(12,646)	(11,212)	(27,931)	(38,418)
OTHER INCOME (CHARGES)				
Investment income	186	494	329	1,855
Interest expense	(3,500)	(234)	(3,834)	(746)
Other income (charges)	83	--	(34)	(4)
Gains (losses) on marketable securities	(47)	4,049	(1,183)	4,049
TOTAL OTHER INCOME (CHARGES)	(3,278)	4,309	(4,722)	5,154
LOSS BEFORE INCOME TAXES	(15,924)	(6,903)	(32,653)	(33,264)
Provision for Income Taxes	--	--	--	--
NET LOSS	$(15,924)	$ (6,903)	$(32,653)	$ (33,264)
INCOME (LOSS) PER COMMON SHARE:				
PREFERRED STOCK DIVIDENDS	--	579	180	1,555
NET LOSS APPLICABLE TO COMMON SHARES	$(15,924)	$ (7,482)	$(32,833)	$ (34,819)
BASIC				
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING (IN THOUSANDS)	14,316	11,845	13,891	11,658
NET LOSS PER COMMON SHARE	$ (1.11)	$ (0.63)	$ (2.36)	$ (2.99)
DILUTED				
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING (IN THOUSANDS)	14,316	11,845	13,891	11,658
NET LOSS PER COMMON SHARE	$ (1.11)	$ (0.63)	$ (2.36)	$ (2.99)
COMPREHENSIVE INCOME AND ITS COMPONENTS CONSIST OF THE FOLLOWING:				
Net loss	$(15,924)	$ (6,903)	$(32,653)	$ (33,264)
Unrealized gains (losses) from marketable securities:				
Unrealized holding losses arising during the period	(5,276)	(100,082)	(29,710)	(66,623)
Reclassification adjustment for (gains) losses included in net income	47	--	1,183	(4,049)
COMPREHENSIVE INCOME (LOSS)	$(21,153)	$(106,985)	$(61,180)	$(103,936)

See accompanying notes to consolidated financial statements.

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	NINE MONTHS ENDED OCTOBER 31	
	2001	2000
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from operations	$(32,653)	$(33,264)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,910	3,345
Accounts receivable, option receivables and inventory reserves	8,201	5,416
Expense paid through issuances of securities	516	--
(Gains) losses on marketable securities	1,183	(4,049)
Non-cash interest on debentures	2,466	--
Deferred and other stock compensation	609	1,236
Changes in assets and liabilities net of effects of business entity divestures:		
Increase in restricted cash	(10,314)	--
Decrease (increase) in accounts receivable	3,921	(12,127)
Increase in inventories	(8,587)	(6,732)
(Increase) decrease in other current assets	(335)	491
Increase in accounts payable	1,716	1,061
Increase (decrease) in accrued and other current liabilities	(1,603)	5,987
NET CASH USED IN OPERATING ACTIVITIES	(32,970)	(38,636)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(3,138)	(12,473)
Cash received from sale of marketable securities	82	4,219
Other receivables	(285)	808
Other assets	(603)	(343)
Expenditures for investments	--	(6,929)
Cash of former subsidiary	--	(6,961)
NET CASH USED IN INVESTING ACTIVITIES	(3,944)	(21,679)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term debt, net of repayments	(103)	(211)
Proceeds from long-term debt	167	2,417
Repayment of long-term debt	(26)	(402)
Proceeds from debentures	29,749	--
Proceeds from preferred stock issued by subsidiary	--	46,638
Proceeds from common stock issued by former subsidiary	--	7,851
Proceeds from common stock	9,630	--
Proceeds from stock option exercises	861	3,246
NET CASH PROVIDED BY FINANCING ACTIVITIES	40,278	59,539
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,364	(776)
CASH AND CASH EQUIVALENTS -- BEGINNING OF PERIOD	9,965	13,511
CASH AND CASH EQUIVALENTS -- END OF PERIOD	$ 13,329	$ 12,735

See accompanying notes to consolidated financial statements.

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 Irvine, 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 October 31, 2001 and January 31, 2001, for the three and nine months ended October 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 October 31, 2001 and for the three and nine months ended October 31, 2000, have been made. The results of operations for the three and nine months ended October 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 October 31, 2001 we distributed 29,533 of our Entrada shares upon the exercise of options and as of October 31, 2001 have reserved 877,218 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 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 695,478 Entrada shares owned by us, which includes 193,714 shares attributable to eligible options which lapsed unexercised, 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. In July 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 October 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 October 31, 2001 and 2000, and the nine months ended October 31, 2001 and 2000, our subsidiary Sorrento Networks ('Sorrento') amortized $157, $303, $468 and $981 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 October 31, 2001 and 2000, and the nine months ended October 31, 2001 and 2000 Sorrento recorded $46, $97, $141 and $255, respectively, for options granted to consultants.

RECENT ACCOUNTING PRONOUNCEMENTS

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ('SFAS') No. 144, 'Accounting for the Impairment or Disposal of Long-Lived Assets' effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. Restatements of previously issued annual financial statements is not permitted, however, comparative financial information for earlier periods shall reflect required reclassifications in presentation. SFAS 144 requires long-lived assets of continuing and discontinued operations be measured at the lesser of carrying amount or fair value less estimated selling costs. The assets and liabilities of discontinued operations shall be presented separately in the asset and liability sections of the balance rather than shown as net realizable value. We do not believe the adoption of SFAS 144 will have a material effect on our financial position or results of operations.

In August 2001, the Financial Accounting Standards Board issued SFAS 143, 'Accounting for Asset Retirement Obligations' effective for fiscal years beginning after June 15, 2002. SFAS 143 requires the recognition of the fair value of liabilities for asset retirement obligations to be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. We do not believe the adoption of SFAS 143 will have a material effect, if any, on our financial position or results of operations.

In June 2001, the Financial Accounting Standards Board finalized SFAS 141, 'Business Combinations', and SFAS 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 nine months from the date of adoption. We are 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 October 31, 2001, the net carrying amount of intangible assets is $745 all of which pertain to our Meret Optical business segment. Amortization expense during the quarters ended October 31, 2001 and 2000 was $93 and during the nine months ended October 31, 2001 and 2000 was $279. 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.

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 October 31, 2001 and January 31, 2001 consist of:

	OCTOBER 31, 2001	JANUARY 31, 2001
Raw material.................................	$12,926	$10,201
Work in process..............................	5,053	4,310
Finished goods...............................	8,304	2,882
	26,283	17,393
Less: Valuation reserve......................	(6,707)	(2,792)
	$19,576	$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. During the quarter ended October 31, 2001 we incurred losses of $47 on the sale of 579,686 shares of Entrada. During the nine months ended October 31, 2001 we incurred losses of $96 on sales of 630,486 shares of Entrada. At October 31, 2001 and January 31, 2000 marketable securities were as follows:

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (CONTINUED)
(In Thousands, except share and per share amounts)

	COST	UNREALIZED GAINS	MARKET VALUE
October 31, 2001:			
NETsilicon	$3,938	$16,422	$20,360
Entrada	104	--	104
	$4,042	$16,422	$20,464
January 31, 2001:			
NETsilicon	$3,938	$42,303	$46,241
Entrada	1,371	2,646	4,017
	$5,309	$44,949	$50,258

Debentures -- During August 2001, we completed a private placement of our 9.75% convertible debentures receiving net proceeds of $29,749. The debentures, due August 2, 2004, have a face value of $32,200 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. 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 and the placement agent received five year warrants to acquire 111,651 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 or at a discount to the then market price the conversion price and warrant exercise price are subject to adjustment.

In accordance with Emerging Issues Task Force ('EITF') No. 00-27 we have 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 results 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 will be amortized as additional interest expense over the period the debentures are outstanding. Interest expense during the three and nine months ended October 31, 2001 of $3,249 included the stated 9.75% interest of $783 which is paid in common stock, 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 $2,263. We issued 267,399 shares of our common stock in payment of $516 interest. At October 31, 2001 debentures payable consists of:

Face Value	$ 32,200
Issuance costs	(2,451)
Value of warrants and deemed beneficial	

Conversion feature	(27,252)
Debenture book value at issuance	2,497
Accumulated amortization of Issuance costs	203
Value of warrants and deemed beneficial conversion feature	2,263
	$ 4,963

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (CONTINUED)
(In Thousands, except share and per share amounts)

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

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

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 nine months ended October 31, 2001 and 2000 consist of:

(In Thousands, except share and per share amounts)

	THREE MONTHS ENDED OCTOBER 31, 2001	THREE MONTHS ENDED OCTOBER 31, 2000	NINE MONTHS ENDED OCTOBER 31, 2001	NINE MONTHS ENDED OCTOBER 31, 2000
Accrued, unpaid dividends (Series A).....	$ --	$ 38	$ --	$ 113
Deemed dividends (Sorrento Series A).....	--	541	180	1,442
	$ --	$579	$180	$1,555

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. If we issue shares of our common stock or equity securities convertible into our common stock at a price less than $6.5531 per share for an aggregate purchase price of $10,000, the purchasers are entitled to receive additional shares of common stock. If we issue common stock or equivalents at a price less than the warrant exercise price the warrant exercise price is subject to adjustment. During October 2001 the warrant exercise price was reduced to $1.93 per share.

During 2000, our Sorrento subsidiary ('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 shares in this placement. One of our present outside directors, who was not a director at that time, purchased 183,486 shares in this placement. In addition, he is a director of Liberty Media Corporation which owns an 11% economic interest representing a 37% voting interest in UGC. The purchaser of 3,027,523 shares in this placement is an indirect subsidiary of UGC. Liberty Media also holds convertible debt in this Series A holder which debt it has agreed to exchange for shares in UGC.

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 nine months ended October 31, 2001 and the quarter and nine months ended October 31, 2000, we recorded a deemed dividend of $180, $541 and $1,442, respectively, with respect to the Sorrento Series A shares.

We made sales of products to affiliates of two of the purchasers of Sorrento's Series A Preferred Stock. During the three and nine months ended October 31, 2001 we made sales of $292 and $1,884, respectively, to affiliates of the purchaser of 33.8% of the shares and these customers had outstanding receivables of $818 at October 31, 2001 under 180 days terms. One of our present outside directors is also a director of Liberty Media which is shareholder of the parent of these customers and is debt holder of a subsidiary of these purchasers as more fully described above. During the three and nine months ended October 31, 2001 we made sales of $4 and $2,296, respectively, to the subsidiaries of the purchaser of 6.2% of the shares and those customers had outstanding receivables of $0 at October 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 October 31, 2001 there were 4,408,962 shares under option at prices varying from $2.93 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 October 31, 2001 there were 16,143,381 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 nine months ended October 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 nine months ended October 31, 2001 and 2000.

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (CONTINUED)
(In Thousands, except share and per share amounts)

	THREE MONTHS ENDED OCTOBER 31,		NINE MONTHS ENDED OCTOBER 31,	
	2001	2000	2001	20
Net loss	$ (15,924)	$ (6,903)	$ (32,653)	$ (3
Less: preferred dividends	--	(579)	(180)	(
Net loss available to common shareholders used in basic EPS	$ (15,924)	$ (7,482)	$ (32,833)	$ (3
Average number of common shares used in basic EPS	14,316,221	11,844,816	13,891,207	11,65

We had a net loss for the three and nine months ended October 31, 2001 and 2000. Accordingly, the effect of dilutive securities including convertible preferred stock, vested and nonvested stock options and warrants to acquire 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 OCTOBER 31,		NINE MONTHS ENDED OCTOBER 31,	
	2001	2000	2001	20
Net loss available to common shareholders used in basic EPS	$ (15,924)	$ (7,482)	$ (32,833)	$ (3
Interest on convertible debt (net of tax)	3,249	--	--	
Net loss available to common shareholders used in diluted EPS	$ (12,675)	$ (7,482)	$ (32,833)	$ (3
Average number of common shares used in basic EPS	14,316,221	11,844,816	13,891,207	11,65
Effect of dilutive securities:				
Convertible preferred stock	--	31,623	--	1
Stock benefit plans	1,275	1,574,748	159,906	1,95
Stock benefit plan of Sorrento	--	--	31,880	
Warrants	33,472	87,522	32,470	10

(In Thousands, except share and per share amounts)

Convertible debentures............	4,368,934	--	1,456,311	
Average number of common shares and dilutive potential common stock used in diluted EPS......................	18,719,902	13,538,709	15,571,774	13,73

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 12,465,211 of our common stock with exercise prices in excess of the average market price during the quarter ended October 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 October 31, 2001 was $11.

During June 2000, we entered into various agreements with our former CEO and Chairman which, among other matters, provides for payments of $250 per year for three years of consulting services and loans by us for the exercise of previously granted options to acquire 1,178,500 options

at prices varying from $7.03 to $49.25 per share. As the members of our Board of Directors at the time of his resignation ceased to represent more than 50% of the Board in October 2000, all payments for consulting services were accelerated and no future consulting services are required. During October 2000, he exercised 71,112 options, applying the $500 accelerated payment to the exercise. In addition, he exercised 507,388 options for which we are contractually obligated to loan the $5,034 due on the exercise. During September 2001, he notified us that he does not have any obligations under the agreements. We have notified him that we do not agree with his interpretation of his repayment obligations under the terms of his agreements.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Our former CEO and Chairman returned the 507,388 shares to us for cancellation and we cancelled the receivable due from him and restored the original option agreements. The required non-cash expense as a result of the rescission equal to the difference between the amount of the loan receivable and the market value of the returned shares was recorded as a reserve of $2,700 against the receivable during the quarter ended October 31, 2001 and is included in other operating expenses in the accompanying income statement. This rescission agreement did not resolve any underlying dispute as to the option loan repayment obligations.

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 October 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:

	OCTOBER 31, 2001	JANUARY 31, 2001
Customer A	26.9%	20.6%
Customer B	5.5	14.1
Customer C	--	15.6
Customer D	0.3	2.4
Customer E	10.0	--
Customer F	1.5	12.0
Customer G	8.1	20.5
Customer H	13.0	--

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

	THREE MONTHS ENDED OCTOBER 31,		NINE MONTHS ENDED OCTOBER 31,	
	2001	2000	2001	2000
Customer A	32.5%	19.8%	19.3%	12.9%
Customer B	7.8	--	15.2	2.3
Customer C	--	9.0	7.1	14.8
Customer D	13.2	14.4	6.9	17.8
Customer E	--	--	2.1	--
Customer F	3.5	--	12.1	6.8
Customer G	2.9	10.9	5.8	10.0
Customer H	16.3	--	5.0	--

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	TOTAL
Three months ended October 31, 2001:					
Net sales to external customers...........	$ 8,707	$1,359	$ --	$ --	$ 10,0
Intersegment sales........................	--	--	--	--	
Total net sales.......................	8,707	1,359	--	--	10,0
Cost of goods sold........................	7,959	786	--	--	8,7
Gross profit..........................	748	573	--	--	1,3
Operating income (loss) from operations...	(8,831)	170	--	(3,985)	(12,6
Depreciation & amortization expense.......	101	135	--	26	2
Valuation allowance additions.............	2,613	82	--	2,700	5,3
Capital asset additions...................	312	5	--	--	3
Total assets..............................	46,470	7,733	n/a	44,177	98,3
Three months ended October 31, 2000:					
Net sales to external customers...........	$ 7,157	$1,551	$ 2,141	$ --	$ 10,8
Intersegment sales........................	--	--	--	--	
Total net sales.......................	7,157	1,551	2,141	--	10,8
Cost of goods sold........................	4,951	1,017	1,372	--	7,3
Gross profit..........................	2,206	534	769	--	3,5
Operating income (loss) from continuing operations............................	(8,139)	31	(266)	(2,838)	(11,2
Depreciation & amortization expense.......	578	126	143	137	9
Valuation allowance additions.............	(397)	4	8	--	(3
Capital asset additions...................	1,889	78	260	5,449	7,6
Total assets..............................	26,200	9,114	n/a	134,221	169,5
Nine Months ended October 31, 2001:					
Net sales to external customers...........	$28,593	$3,968	$ --	$ --	$ 32,5
Intersegment sales........................	--	--	--	--	
Total net sales.......................	28,593	3,968	--	--	32,5
Cost of goods sold........................	22,570	2,445	--	--	25,0
Gross profit..........................	6,023	1,523	--	--	7,5
Operating income (loss) from continuing operations............................	(22,401)	417	--	(5,947)	(27,9
Depreciation & amortization expense.......	1,314	407	--	189	1,9
Valuation allowance additions.............	4,672	329	--	3,200	8,2
Capital asset additions...................	3,061	16	--	61	3,1
Total assets..............................	46,470	7,733	n/a	44,177	98,3

Nine months ended October 31, 2000:					
Net sales to external customers	$15,392	$4,989	$11,892	$ --	$ 32,2
Intersegment sales	--	--	--	--	
Total net sales	15,392	4,989	11,892	--	32,2
Cost of goods sold	9,813	2,789	10,465	--	23,0
Gross profit	5,579	2,200	1,427	--	9,2

(table continued on next page)

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (CONTINUED)
(In Thousands, except share and per share amounts)

(table continued from previous page)

	SORRENTO NETWORKS	MERET OPTICAL	ENTRADA NETWORKS	OTHER	TOTAL
Operating income (loss) from continuing operations	(26,565)	1,003	(7,859)	(4,997)	(38,4
Depreciation & amortization expense	1,810	372	1,024	139	3,3
Valuation allowance additions	351	304	4,761	--	5,4
Capital asset additions	6,433	129	444	5,467	12,4
Total assets	26,200	9,114	n/a	134,221	169,5

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 6.3% 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 NINE MONTHS ENDED OCTOBER 31, 2001 AND 2000

Net sales. Our consolidated net sales were $10.1 million for the quarter ended October 31, 2001 compared to $10.8 million for the three months ended October 31, 2000, a decrease of 6.5%. This decrease in net sales reflects an increase of $1.6 million at our subsidiary Sorrento Networks ('Sorrento') and a decrease of $192,000 at Meret Optical Communications ('Meret'). The remaining decline was related to Entrada Networks. During the nine months ended October 31, 2001 our net sales increased to $32.6 million from $32.3 million for the comparable nine months ended October 31, 2000. This increase in net sales reflects a $13.2 million increase at Sorrento, and an $1.0 million 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 October 31, 2001 from $3.5 million for the comparable quarter last year. Sorrento's gross profit decreased by $1.5 million however this decrease includes an increase in the valuation allowance recorded against inventory at Sorrento of $2.4 million. Gross profit increased by $39,000 for Meret during the quarter ended October 31, 2001 from the comparable quarter last year. The remaining decline was related to Entrada. Consolidated gross profit decreased to $7.5 million, or by 18.5%, for the nine months ended October 31, 2001 from $9.2 million for the nine months ended October 31, 2000. This decrease reflects a $2.4 million increase at Sorrento exclusive of the $2.0 million valuation allowance against inventory at Sorrento during the nine months ended

October 31, 2001. Gross profit decreased by $700,000 for Meret for the nine months ended October 31, 2001 from the comparable nine months last year. The remaining decline was related to 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 $4.1 million, or 40.6% of net sales, for quarter ended October 31, 2001 from $4.3 million, or 39.8% of net sales for the comparable quarter last year. Selling expenses for Sorrento and Meret increased by approximately $110,000 and $83,000 respectively during the quarter ended October 31, 2001 from the comparable quarter last year, offset by the decrease related to Entrada. Our selling and marketing expenses decreased to $12.2 million, or 37.4% of net sales, during the nine months ended October 31, 2001 from $13.6 million, or 42.1% of net sales, for the comparable nine month period last year. Sorrento's selling expenses increased by $1.5 million for the nine months ended October 31, 2001 and Meret remained relatively unchanged from the comparable nine month period last year. These increases were 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 will continue to manage our research and development costs in relation to the changes in our sales volumes. Our consolidated engineering, research and development expenses decreased to $3.5 million, or 34.7% of net sales, for the quarter ended October 31, 2001 from $5.7 million, or 52.8% of net sales, for the comparable period last year. Sorrento accounted for $1.8 million of this decrease and the remaining decrease was related to Entrada. During the nine months ended October 31, 2001, our consolidated engineering, research and development expenses decreased to $10.2 million, or 31.3% of net sales, from $18.1 million, or 56.0% of net sales, for the comparable nine month period last year. Sorrento's engineering, research and development expenses decreased by $4.6 million for the nine months ended October 31, 2001 from the comparable nine month period last year. 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 $3.4 million, or 33.7% of net sales, for the quarter ended October 31, 2001 from $4.2 million, or 38.9% of net sales, for the comparable quarter last year. During the quarter, Sorrento reflected an increase of approximately $1.1 million while Meret had a decrease of approximately $221,000 from the comparable quarter last year. We had a decrease of approximately $1.6 million in our corporate headquarters expenses relating primarily to decreases in legal, financial advisor and professional fees, employee compensation and relocation costs. The remaining decrease related to Entrada. Our consolidated general and administrative expenses decreased to $9.4 million, or 28.8% of net sales, for the nine months ended October 31, 2001 from $12.4 million, or 38.4% of net sales, for the comparable period last year. Sorrento expenses remained relatively unchanged while Meret and corporate headquarters accounted for $230,000 and $3.0 million, respectively, of the decrease with the remaining decrease related to Entrada.

Other operating expenses. Other operating expenses for the quarter and nine months ended October 31, 2001 and 2000 include $93,000 and $279,000, respectively, of amortization of purchased technology related to acquisitions included in Meret. During the quarter and nine months ended October 31, 2001 we recorded a $2.7 million valuation allowance against option receivables from our former CEO and Chairman. During the nine months ended October 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 $3.3 million charges for the quarter ended October 31, 2001 from $4.3 million income for the comparable period last year. Investment income declined by $308,000 during the quarter ended October 31, 2001 from the comparable period last year due to reduced investments of our cash surplus in short-term investments, lower interest rates as well as reduced interest received on customer financing receivables. The increase of $3.3 million in interest expense for the quarter ended October 31, 2001 from the comparable quarter last year is primarily due to the interest incurred on our convertible debentures. The $3.2 million of interest on these debentures included the stated 9.75% interest of $783,000 which is paid in common stock, amortization of issuance costs of $203,000, and amortization of the fair value of the warrants issued to the purchasers and placement agent and the deemed beneficial conversion feature of $2.3 million. Other charges increased by $83,000 during the quarter ended October 31, 2001 from the comparable period last year resulting primarily from favorable gains on foreign currency exchanges. We incurred losses of $47,000 on the sale of 579,686 shares of Entrada during the quarter ended October 31, 2001. During the nine months ended October 31, 2001 other income (charges) decreased to $4.7 million charges from $5.1 million income for the comparable nine months last year. The decrease reflects a $1.5 million reduction of investment income resulting from reduced investments of surplus cash in short term investments, lower interest rates as well as reduced interest received on customer financing receivables. Our interest expense increased by $3.1 million for the nine months ended October 31, 2001 from the comparable nine months last year due to the interest incurred on our newly issued convertible debentures which was partially offset by a decline in our short term borrowings. Other charges increased by $30,000 during the nine months ended October 31, 2001 from the comparable period last year primarily as the result of foreign currency exchanges. Gains on marketable securities decreased by $5.2 million for the nine months ended October 31, 2001 from the comparable nine months last year. Approximately $4.0 million of this decrease relates to the gain on our sale of NSI shares during the comparable nine month period last year. The remaining $1.2 million decrease is results from an impairment allowance of $1.1 million on our available for sale investment in Entrada and $100,000 in realized losses on the sale of 630,486 shares of Entrada.

Income taxes. There was no provision for income taxes for quarters and nine months ended October 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 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 20.8% to $8.7 million for the three months ended October 31, 2001 from $7.2 million for the comparable quarter last year. During the three months ended October 31, 2001, we shipped product to fourteen customers of which four customers represented 79.6% of our net sales. During the quarter ended October 31, 2000, we shipped product to eight customers of which five customers represented 92.0% of our net sales. Net sales increased by 85.7% to $28.6 million for the nine months ended October 31, 2001 from $15.4 million for the comparable period last year. During the nine months ended October 31, 2001, we shipped product to eighteen customers of which four customers represented over 59.7% of our net sales. During the nine months ended October 31, 2000, we shipped product to twelve customers of which four customers represented 77.7% of our net sales. Sales to our international customers decreased to 14.8% of our net sales during the quarter ended October 31, 2001 from 30.2% during the comparable quarter last year. For the nine months ended October 31, 2001 sales to international customers increased to 35.9% of our net sales from 27.3% 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 decreased by 66% to $748,000 for the quarter ended October 31, 2001 from $2.2 million for the comparable quarter last year. This decrease includes a $2.4 million reserve recorded against Sorrento's inventory. Our gross margin decreased to 8.6% of net sales for the quarter ended October 31, 2001 from 30.8% of net sales for the comparable quarter last year. Absent the inventory valuation reserve our gross margin on sales during the quarter ended October 31, 2001 would have been significantly higher. Gross profit for the nine months ended October 31, 2001 increased by 7.1% to $6.0 million from $5.6 million for the comparable period last year. Our gross margin for the nine months ended October 31, 2001 decreased to 21.1% of net sales from 36.2% for the comparable period last year. The decline in gross margin for the quarter and nine months ended October 31, 2001 is the result of a $2.0 million inventory valuation allowance and changes in our product mix.

Selling and marketing. Selling and marketing expenses increased to $4.0 million, or 46.0% of net sales, for the quarter ended October 31, 2001 from $3.8 million, or 53.5% of net sales for the comparable quarter last year. For the nine month period ended October 31, 2001 selling and marketing expenses increased to $11.9 million, or 41.6% of net sales from $10.4 million, or 67.5% of net sales. The increase in sales and marketing expenses for the three months ended October 31, 2001 is primarily the result of increases in advertising and promotional expenses. The increase in sales and marketing expenses for the nine months ended October 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 and promotional expenses. We increased our sales and marketing personnel to 71 at October 31, 2001, from 53 at October 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 $3.4 million, or 39.1% of net sales, for the quarter ended October 31, 2001 from $5.2 million, or 73.2% of net sales, for the comparable quarter last year. For the nine months ended October 31, 2001 engineering, research and development expenses decreased to $10.0 million, or 35.0% of net sales from $14.6 million, or 94.8% of net sales. The decreases were primarily due to the completion of existing projects and reduced payroll and payroll related costs, consulting and travel expenses. We decreased our research and development personnel to 83 at October 31, 2001 from 96 at October 31, 2000.

General and administrative. General and administrative expenses increased to $2.0 million, or 23.0% of net sales, for the quarter ended October 31, 2001 from $858,000, or 12.0% of net sales, for the comparable quarter last year. For the nine months ended October 31, 2001 general and administrative expenses increased to $6.0 million, or 21.0% of net sales from $5.9 million, or 38.3% of net sales. During the three and nine 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 offset by increases to our bad debt allowance, purchase cancellation fees and costs associated with our personnel reductions. We have decreased our general and administrative personnel to 23 at October 31, 2001 from 24 at October 31, 2000.

Deferred and other stock compensation. Deferred and other stock compensation for the quarter and nine months ended October 31, 2001 includes $157,000 and $468,000 of amortization of deferred stock compensation and $46,000 and $141,000 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 $1.4 million, or by 12.5%, for the quarter ended October 31, 2001 from $1.6 million for the comparable quarter last year. During the nine months ended October 31, 2001 net sales decreased to $4.0 million, or by 20.0%, from $5.0 million for the

comparable nine months last year. The decline in net sales results from decreased in product demand for the legacy product family.

Gross Profit. Gross profit increased to $573,000, or by 7.3%, for the quarter ended October 31, 2001 from $534,000 for the comparable quarter last year. Meret's gross margins increased to 41.0% for the quarter ended October 31, 2001 from 33.4% for the comparable quarter last year. During the nine months ended October 31, 2001 Meret's gross profit decreased to $1.5 million, or by 31.8%, from $2.2 million for the nine months ended October 31, 2000. Meret's gross margins decreased to 37.5% for the nine months ended October 31, 2001 from 44.0% for the nine months ended October 31, 2000. The comparative changes in gross margin resulted from sales volume fluctuations and shifts in Meret's product mix.

Selling and Marketing. Selling and marketing expenses increased to $145,000 or 10.4% of net sales, for the quarter ended October 31, 2001 from $62,000, or 3.9% of net sales, for the comparable period last year. The increase during the quarter ended October 31, 2001 compared to the same three month period last year resulted from higher internal commissions due to increases in commissionable sales, severance costs related to personnel reduction, and increases in commissions to external sales representatives. For the nine months ended October 31, 2001, selling and marketing expenses increased slightly to $365,000, or 9.1% of net sales, from $347,000, or 6.9% of net sales, for the nine months ended October 31, 2000. The increase results primarily from severance costs related to personnel reductions.

Engineering, Research and Development. Engineering, research and development expenses increased to $86,000 or 6.1% of net sales, for the quarter ended October 31, 2001 from $47,000 or 2.9% of net sales for the comparable quarter last year. During the nine months ended October 31, 2001 engineering expenses increased to $255,000 or 6.4% of net sales, from $134,000 for 2.7% of net sales for the comparable nine months last year. The increase for both the three and nine months ended October 31, 2001 relate to the addition of three engineers to support our development of our new coarse wavelength division multiplexing products and the enhancement of existing products.

General and Administrative. General and administrative expenses decreased to $79,000 or 5.6% of net sales for the quarter ended October 31, 2001 from $300,000 or 18.8% of net sales for the comparable quarter last year. During the nine months ended October 31, 2001, general and administrative expenses decreased to $208,000 or 5.2% of net sales from $438,000 or 8.8% of net sales for the comparable nine months last year. The decreases for the three and nine months ended October 31, 2001 results from reductions in bad debt allowances and bank fees.

Other operating expenses. Other operating expenses of $93,000 and $279,000 for the quarter and nine months ended October 31, 2001 remained unchanged compared to the comparable quarter and nine 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 October 31, 2001, our working capital was $56.3 million including $13.3 million in cash and cash equivalents as well as $10.3 million of restricted cash from our August 2001 debenture placement which was released to us subsequent to October 31, 2001.

The amounts included in our statement of cash flows for the nine months ended October 31, 2001 are not comparable to our nine months ended October 31, 2000 amounts due to the inclusion of Entrada for only the seven months ended August 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 $33.0 million during the nine months ended October 31, 2001. During the nine months ended October 31, 2000 our operating activities used cash flows of $38.6 million. The decreases in cash flows used by operations results primarily from the temporary increase in restricted cash of $10.3 million, decreases in our accounts receivable,

increases in accounts payable partially offset by increases in inventory and other current assets as well as 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 nine months ended October 31, 2001 used cash flows of $3.9 million. We purchased property and equipment of $3.1 million and other assets of $603,000, other receivables increased by $285,000 and we received $82,000 proceeds from the sale of shares of Entrada. During the nine months ended October 31, 2000 the investing activities used cash flows of $21.7 million including $7.0 million in cash balances at Entrada on August 31, 2000 when it ceased to be a subsidiary. We purchased capital equipment $12.5 million, invested $3.3 million in Entrada and $3.2 million in a Sorrento customer. During the nine months ended October 31, 2000, we received $4.2 million from the sale of a portion of our shares in NSI and $808 from the purchasers of our discontinued operations.

Our financing activities during the nine months ended October 31, 2001 provided cash flows of $40.3 million which consisted of $29.7 million in net proceeds from the private placement of our 9.75% convertible debentures, $9.6 million in proceeds from issuance of common stock, $861,000 in proceeds from option and warrant exercises offset by repayments of short and long term debt. During the nine months ended October 31, 2000 the financing activities provided cash flows of $59.5 million which consisted of $46.6 million in net proceeds from a private placement by Sorrento of its convertible preferred stock, $7.9 million in net proceeds from a private placement by Entrada of it's common stock, $3.2 million from option and warrant exercises and $2.4 million in proceeds from long-term debt offset by repayments of short and long term debt.

We have a line of credit of $8.0 million. Outstanding borrowings against this line of credit was $1.2 million at October 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 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 or at a discount to the then market price 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 October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ('SFAS') No. 144, 'Accounting for the Impairment or Disposal of Long-Lived Assets' effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. Restatements of previously issued annual financial statements is not permitted, however, comparative financial information for earlier periods shall reflect required reclassifications in presentation. SFAS 144 requires long-lived assets of continuing and discontinued operations be measured at the lesser of carrying amount or fair value less estimated selling costs. The assets and liabilities of discontinued operations shall be presented separately in the asset and liability sections of the balance rather than shown as net realizable value. We do not believe the adoption of SFAS 144 will have a material effect on our financial position or results of operations.

In August 2001, the Financial Accounting Standards Board issued SFAS 143, 'Accounting for Asset Retirement Obligations' effective for fiscal years beginning after June 15, 2002. SFAS 143 requires the recognition of the fair value of liabilities for asset retirement obligations to be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. We do not believe the adoption of SFAS 143 will have a material effect, if any, on our financial position or results of operations.

In June 2001, the Financial Accounting Standards Board finalized SFAS 141, 'Business Combinations', and SFAS 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 nine 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 October 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 October 31, 2001 and 2000 was $93 and during

the nine months ended October 31, 2001 and 2000 was $279. 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.

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.

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

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. One of our present outside directors, who was not a director at that time, owns 2% of the Series A Preferred stock and he is a director of the majority shareholder of the holder of 33.8% of the Series A Preferred Stock. 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.

On September 10, 2001, holders of a portion of the 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. Subsequently,

the Delaware Supreme Court accepted our appeal of the preliminary injunction ruling. The appeal has been briefed and oral argument is currently scheduled to take place on January 8, 2002. Neither the preliminary injunction nor the original Series A documents prevent us from making capital contributions to, or buying the common stock of Sorrento in the best business judgment of our board of directors.

On October 19, 2001, an amended complaint was filed in the injunction action, adding as named defendants, the Company, our Meret subsidiary, certain present and former officers and directors of the Company and our subsidiaries as well as our investment bankers. The amended complaint also added, among other things, claims for fraud, securities fraud, breach of fiduciary duty, conspiracy, and intentional interference with contract as well as requesting the appointment of a receiver for our Sorrento subsidiary all which are based on alleged wrongs committed in connection with or since the Series A placement. Our Sorrento subsidiary and the original individual defendants have all answered this amended complaint denying all allegations of wrongdoing. The new defendants have all moved to dismiss the amended complaint. Management believes the allegations contained in the amended complaint are without merit. The Company and all other defendants intend to vigorously litigate this matter.

On December 14, 2001, plaintiffs filed motions to sequester the common stock of our Sorrento subsidiary owned by Meret and the Sorrento Series A preferred stock that we own, as an alternative method of obtaining jurisdiction over us and Meret in the Delaware litigation. Management believes that these motions are without merit and intends vigorously to contest them.

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

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,' '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: our ability to successfully develop, sell and market our optical networking and other products; our expectations concerning factors affecting the markets for our products, such as demand for increased bandwidth; the scope and duration of the economic slowdown currently being experienced by many of our existing and prospective customers; our ability to compete successfully with companies who are much larger than we are and who have much greater financial resources at their disposal; our ability, or failure, to complete strategic alliances and strategic opportunities such as sales or spin-offs of subsidiaries or business units on terms favorable to us for reasons either within or outside our control; our ability successfully to finance our current and future needs for working capital; changed market conditions, new business opportunities or other factors that might affect our decisions as to the best interest of our shareholders; our ability to resolve a dispute with our former CEO and Chairman with respect to his option exercise loan obligations; the impact of recent terrorist activities and potential activities as described more fully below; and other risks detailed from time to time in our reports filed with the Securities and Exchange Commission.

Our business depends upon the free flow of products and services through the channels of commerce. Recently, in response to terrorists' activities and threats aimed at the United States, transportation, mail, financial and other services have been slowed or stopped altogether. Further delays or stoppages in transportation, mail, financial or other services could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may experience an increase in operating costs, such as costs for transportation, insurance and security as a result of the activities and potential activities. We may also experience delays in receiving payments from payers that have been affected by the terrorist activities and potential activities. Our customers and potential customers may delay or cancel orders for our products. The U.S. and global economy in general is being adversely affected by the terrorist activities and potential activities and any economic downturn could adversely impact our results of operations, impair our ability to raise capital or otherwise adversely affect our ability to grow our business.

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. These risks and uncertainties are described above and in our report on Form 10-K for the year ended January 31, 2001. 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 a portion of the 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. Subsequently, the Delaware Supreme Court accepted our appeal of the preliminary injunction ruling. The appeal has been briefed and oral argument is currently scheduled to take place on January 8, 2002. Neither the preliminary injunction nor the original Series A documents prevent us from making capital contributions to, or buying the common stock of Sorrento in the best business judgment of our board of directors.

On October 19, 2001, an amended complaint was filed in the injunction action, adding as named defendants, the Company, our Meret subsidiary, certain present and former officers and directors of the Company and our subsidiaries as well as our investment bankers. The amended complaint also added, among other things, claims for fraud, securities fraud, breach of fiduciary duty, conspiracy, and intentional interference with contract as well as requesting the appointment of a receiver for our Sorrento subsidiary all which are based on alleged wrongs committed in connection with or since the Series A placement. Our Sorrento subsidiary and the original individual defendants have all answered this amended complaint denying all allegations of wrongdoing. The new defendants have all moved to dismiss the amended complaint. Management believes the allegations contained in the amended complaint are without merit. The Company and all other defendants intend to vigorously litigate this matter.

On December 14, 2001, plaintiffs filed motions to sequester the common stock of our Sorrento subsidiary owned by Meret and the Sorrento Series A preferred stock that we own, as an alternative method of obtaining jurisdiction over us and Meret in the Delaware litigation. Management believes that these motions are without merit and intends vigorously to contest them.

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 August 2, 2001 we issued $32,200,000 of our 9.75% convertible debentures to a group of eleven private institutional investors, receiving $29,700,000 in net proceeds to be used for working capital purposes. The debentures, due August 2, 2004, are 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 in shares of our common stock. There were no underwriters in the transaction; however, we paid of fee of $2,093,000 to a placement agent. 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 and the placement agent received a five year warrant to acquire 111,651 shares of our common stock at $7.21 per share. Subject to certain exceptions, if we issue shares of our common stock, equity securities or warrants at a price less than $7.21 per share the conversion price and warrant exercise price are subject to adjustment.

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 October 31, 2001 (included in Part I, Item 1)

B. Reports on Form 8-K

August 3, 2001	Convertible Debentures Placement
September 5, 2001	Sorrento Networks, Inc. (our Sorrento subsidiary) legal matters

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)

Date: December 17, 2001

By: /s/ JOE R. ARMSTRONG
....
JOE R. ARMSTRONG,
CHIEF FINANCIAL OFFICER
PRINCIPAL ACCOUNTING OFFICER