

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORP  
Form 10-K  
May 16, 2002

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended JANUARY 31, 2002

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  
(State or other jurisdiction of incorporation or  
organization)

22-2367234  
(IRS Employer Identification Number)

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

92121  
(Zip Code)

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

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, Par Value \$0.30  
Title of each class

Nasdaq  
Name of exchange on which registered

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 by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S is not contained herein, and will not be contained, to the best of Registrant's knowledge, in a definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this

# Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Form 10-K. \_\_\_\_\_

The Registrant's revenues for its most recent fiscal year were \$40,827,000

The aggregate market value of voting stock based upon the bid and ask price held by non-affiliates of the Registrant on April 30, 2002 was \$33,244,301.

Number of shares outstanding of the Registrant's only class of common stock as of April 30, 2002 (the latest practicable date):14,534,410.

## DOCUMENTS INCORPORATED BY REFERENCE:

None.

## PART I

### Item 1. Business

#### Introduction

This Annual Report on Form 10-K may contain forward-looking statements that involve risks and uncertainties. Such statements include, but are not limited to, statements containing the words "believes," "anticipates," "expects," "estimates" and words of similar import. Our actual results could differ materially from any forward-looking statements, which reflect, management's opinions only as of the date of this report, as a result of such risks and uncertainties. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements. Readers should carefully review the risk factors set forth below in "Factors That May Affect Future Results" and in other documents the company files from time to time with the Securities and Exchange Commission, including its quarterly reports on Form 10-Q.

We are a leading supplier of end-to-end, intelligent optical networking solutions for metro and regional applications world-wide. Our solutions enable communication service providers to offer broadband networking services over optical fibers for metro and regional applications. Our technologies permit telecommunications service providers to increase fiber capacity and fiber bandwidth utilization, reduce network costs and network complexity over scaleable and efficient networking platforms. Our optical networking systems support a wide variety of protocols, mixed speeds of traffic and accommodate changing traffic patterns directly over optical networks.

Our dense wavelength division multiplexing (DWDM) platform can be used in both metropolitan and regional network applications. DWDM technology allows many optical signals to be transmitted simultaneously on the same optical fiber by using different wavelengths of light to distinguish the signals. This technology increases optical network capacity and flexibility. Our comprehensive suite of optical networking interfaces and optical access multiplexers allow us to also address broadband applications in the optical access market including data center fail-over recovery, storage area networking (SAN) and internet connectivity applications. Our introduction of a coarse wavelength division multiplexing (CWDM) product is a lower cost, entry level that can be used for

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

enterprise customer access that complements our DWDM product line.

We have also developed all-optical wavelength routing switch technology that, when commercialized, will further increase the functionality of our end-to-end all-optical networking solution. Our optical network element management platforms permit management of end-to-end optical networks. We currently have an installed base with over 20 communications service providers and system integrators worldwide, including AT&T Broadband Network Solutions, Deutsche Telekom, Belgacom, United Pan-Europe Communications, Cox Communications, El Paso Global Networks, and INRANGE Technologies. According to Ryan, Hankin & Kent, a telecommunications industry research group, we garnered about 4% of the global metropolitan DWDM system market in calendar 2001 by selling our GigaMux<sup>®</sup> optical transport systems and EPC<sup>™</sup> access multiplexers.

An important development in 2001 was the significant downturn in both the general economic environment and the telecommunications industry. These adverse market conditions affected our operations and required us to undertake a number of initiatives, including workforce reductions and other cost reduction measures, that have substantially reduced our fixed costs and, we believe, enhanced our ability to respond to the new economic and industry environment.

On January 17, 2001, we changed our name to Sorrento Networks Corporation from Osicom Technologies, Inc., in recognition of our corporate focus on the business of our flagship optical networking subsidiary, Sorrento Networks, Inc.

### Understanding Our Market

Definitions of technical terms used throughout this document can be found at the end of this Item 1.

### Rapid Growth in Bandwidth Demand

Fueled by the growth of the Internet, the volume of data traffic transmitted across telecommunications networks now exceeds voice traffic. The growth of data traffic is attributable to increased Internet usage, increased access speeds

1

and greater use of bandwidth intensive applications. According to Ryan, Hankin & Kent, Internet traffic is projected to increase at a rate exceeding 40% per year for the next five years.

### Migration of Network Infrastructure

Traditional copper-based and SONET/SDH based telecommunications infrastructures were originally designed for voice traffic. These infrastructures do not scale effectively to provide the bandwidth needed to support the growth in high-speed data traffic. In addition, these infrastructures need network-wide upgrades in order to accommodate growing traffic thus resulting in long delays for provisioning new services. DWDM and

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

CWDM technologies are more flexible, more efficient and more scalable networking alternatives for meeting the growing demand for bandwidth and new broadband services. Multi-wavelength optical (DWDM) networks for long-haul applications were the first to be deployed, and optical solutions specifically designed to address the challenges faced by metropolitan markets have significantly lagged in deployment. Accordingly, metro networks are considered to be traffic bottlenecks in the fast and efficient transmission of data. Significantly, recent developments in technology are permitting metropolitan optical networking vendors to address regional applications, which prior to 2000 were only addressable by long haul networking products.

### Enhanced Competition in the Service Provider Market

Worldwide deregulation in the telecommunications industry has led to an increase in the number of service providers seeking to address the growing demand for bandwidth. In the U.S. and internationally, traditional service providers such as Incumbent Local Exchange Carriers (ILECs), IXCs and PTTs are seeing new entrants in the broadband networking market seeking to capitalize on the growing demand for bandwidth. A number of competitors to these incumbents are building new data-centric networks to address the present bandwidth bottlenecks in the metropolitan markets, including utilities and cable television companies (MSOs) which are upgrading their current networks and are leveraging existing investments in fiber optic infrastructure to deliver high-speed data services in both the local and regional markets. This enhanced competition in the service provider market is driving increased capital expenditures on network infrastructure focused on delivering scalable high-speed data services in a cost efficient manner.

### Network Topography

The following describes each of the network segments within the optical network hierarchy:

- o Long-haul networks are high capacity networks that connect service providers and carry voice and data across large geographic regions typically spanning distances up to 4,000 kilometers. Long-haul networks are relatively simple networks, built around the SONET/SDH time domain multiplexing hierarchy and are primarily designed only to satisfy carriers' long-haul network capacity requirements.
- o Metropolitan core (metro-core) networks connect the central offices of service providers in a metropolitan area and facilitate the transport and switching of traffic within extended metropolitan areas and between the network edge and long-haul networks. Metropolitan core networks are typically implemented in ring configurations and reach ring circumferences up to 300 kilometers. In order to efficiently use the optical network, sub-rate multiplexing devices aggregate traffic into wavelengths carrying higher speed aggregate bit rates across telecommunications networks. Regional networks typically transport voice and data traffic between cities across distances of 200 to 600 kilometers or more.
- o Access networks connect enterprises or traffic aggregation nodes in multiple locations throughout metropolitan areas to service providers' central offices or connect different end-user locations to each other. In order to efficiently use the optical network, optical access devices aggregate traffic from end users into wavelengths for transport across telecommunications networks. Because access networks must support the varying demands of end users, these networks tend to support multiple services and bit rates.

#### Metropolitan area optical network opportunity

While optical technologies are being deployed in long-haul networks to relieve capacity constraints, these solutions are not specifically designed to address the issues inherent in metropolitan and regional optical networks. Data is normally mapped into the voice multiplexing hierarchy for transport over the long-haul network. Metropolitan optical networks are characterized by varying traffic patterns and protocols, topologies and end-user requirements, making them more complex and difficult to manage than long haul networks. As a result, service providers have only recently begun to exploit the benefits of optical technologies in metropolitan optical networks.

The optical networking market has seen a substantial downturn in 2001 from 2000 levels. The metro DWDM market, which was expected to increase, has also experienced a slowdown in recent months as capital spending has declined throughout the telecommunications industry. While Sorrento Networks believes that the metro WDM world-wide market will grow significantly in the years to come, such growth is not likely to occur until capital spending resumes in the markets we serve, and we are unable to assess at present when this might take place. According to industry analysts, including RHK (Ryan, Hankin and Kent) and others, the metro WDM market in 2001 was about \$1.2 billion worldwide and is expected to grow to \$3.6 billion by 2005.

#### Regional optical network opportunity

In addition to the metropolitan market, recent engineering enhancements have permitted the use of metropolitan optical (DWDM) networking platforms in regional optical networking applications. This development opens up the opportunity to address a portion of the substantial long haul market. In some regions, e.g., in Europe, regional solutions apply to the majority of the networks installed. Industry researchers recently started looking at reclassifying the regional market opportunity, although statistical data for this market are not expected until next year.

#### Specific challenges facing metropolitan optical networks

Service providers face numerous specific challenges in addressing metropolitan and regional optical networks:

- o Scalability Limitations. Originally constructed for voice traffic, the current (SONET/SDH) network infrastructure does not allow for the network efficiencies necessary to address the shift to a predominantly data-driven network. Due to its inherent lack of scalability, the current network infrastructure may require service providers to undertake the expensive and tedious process of replacing network equipment or overlaying new layers of similar equipment in response to changes or increases in bandwidth demand. Alternative approaches to WDM are being developed by other vendors to address the scalability of the SONET/SDH networks. These nonstandard solutions are called next generation SONET/SDH and can minimize the wasted bandwidth of legacy SONET/SDH. These solutions, however, are not able to accommodate the

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

need for large amounts of bandwidth.

- o Need to Support Multiple Protocols. Metropolitan optical networks are characterized by a wide variety of protocols. The inability to support multiple protocols and services from a single platform further increases the cost and complexity of the metropolitan networks. Alternative approaches to WDM are being developed by other vendors to address the requirement for support of multiple services. These nonstandard solutions are called multiservice provisioning platforms. These solutions generally carry out protocol conversions and are much more complex than WDM solutions.
- o Market Downturn. Virtually all telecom related market segments have suffered a decline in demand in the current economic downturn. What was once viewed as only a long-haul decline in market demand has now affected the regional and metropolitan networks as both enterprise and carrier business have cut back capital spending. While we expect that demand in the regional and metropolitan markets will be strong in future periods, there are no assurances that capital spending will resume within this sector in the near term.
- o Several Stages of Conversion. Present solutions require several conversions to transport data through a metropolitan network. In the access networks, aggregation of traffic often requires protocol conversions into a common protocol before optical transmission. In the central office, data is often demultiplexed and

3

converted into electrical signals for regeneration, switching or further aggregation into higher capacity links and then reconverted into optical signals for transmission in the metro-core network.

- o Inefficient Bandwidth Utilization. Within metropolitan optical networks, service providers must cater to end-users with varying access speeds. Current optical access solutions do not make efficient use of scarce wavelength resources. Service providers must assign a full wavelength to each signal, whether or not the end-user requires the full bandwidth potential of each wavelength.
- o Difficulty of Network Management. Multiple protocols and service, coupled with the lack of standards that exist in metropolitan optical networks, make network management functions, such as performance monitoring and configuration, exceedingly difficult. Lack of a robust network management platform further adds to the cost and complexity of metropolitan optical networks.
- o Need for New, Enhanced Service Offerings to Generate New Revenue Opportunities. Broadband network service providers are searching for next-generation solutions that will enable them to generate additional sources of revenue by offering new or enhanced services to their customers. Current solutions typically require the service provider to deploy equipment that is specifically designed for a particular

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

service and transmission rate. Next-generation solutions must be able to offer enhanced features, wavelength provisioning and bandwidth-on-demand features, that end-users will increasingly request from service providers.

### Our Solution

Our solutions feature products designed to specifically address the shortcomings of legacy SONET/SDH networks and to facilitate offering new services throughout metropolitan and regional optical networks. We enable our customers to meet the rapidly growing demand for bandwidth by offering end-to-end metropolitan and regional optical networking solutions for the aggregation, transport and management of traffic. Our current products, including our GigaMux'r' DWDM transport system, with our EPC'TM' sub-rate multiplexing modules, our JumpStart'TM' CWDM transport system as well network management product line that includes GigaView, TeraManager'TM' and TeraConfigurator'TM'. are specifically designed to meet the unique requirements of the metropolitan and regional markets. We have also developed a prototype all-optical wavelength routing switch, called TeraMatrix'TM', that will complement our current products when market conditions permit us to put it into production,

Our end-to-end metropolitan optical networking solution offers numerous benefits, including:

Cost Effective Entry-Level Access Solution. Our Jumpstart CWDM platform allows low cost multiplexing of up to four wavelengths carrying a mix of protocols and signals for access applications.

Scalable Architecture. We have created a delayed or flat optical networking solution that simultaneously transmits voice, data, and video over optimized fiber channels. The modular architecture of our solution enables service providers to incrementally expand capacity, as their bandwidth needs increase. This simple, scaleable, and functional solution solves short and long-term service provider problems, which enhances their ability to reduce costs and offer value-added services. For example, a service provider can begin deployment with a single channel and later expand to multiple channels providing up to 640Gbps of transmission capacity without interrupting existing traffic.

Protocol and Signal Transparency. Our suite of solutions transports a mix of protocols and signals, including SONET/SDH, ATM, IP, Gigabit Ethernet, Fibre Channel and ESCON in their native formats over numerous wavelengths in the same fiber. This "transparency" brings in operational simplicity in that the service provider can offer networking connectivity without having to worry about protocol conversions. This is particularly important in metropolitan areas where multiple protocols are utilized and data transmission rates change often. The transparency of our solution eliminates the unnecessary opto-electro-optical conversions as well as several layers of equipment that would otherwise be required in the transport and switching of traffic, thus reducing network complexity and signal latency.

Efficient and Cost Effective Bandwidth Utilization. Our EPC'TM', optical access sub-rate multiplexer

aggregates traffic, of varied rates utilizing a wavelength per direction of transmission, from businesses and network points of presence for transport throughout optical networks. This sub-rate aggregation allows better utilization of wavelengths and lowers capital expenditures of telecom service providers by reducing investments in excess network capacity. Our GigaMux'r' optical transport product utilizes DWDM technology to provide ring and linear optical multi-wavelength connections over new and existing fibers and to enable traffic to travel throughout metropolitan and regional optical networks without opto-electro-optical conversion at every node.

Manageability. The design of our end-to-end optical networking solution will allow service providers to perform network management from a single platform with our TeraManager'TM' product. This intelligent optical network management software platform provides fault, configuration, performance, and security management utilizing an easy-to-use graphical user interface that allows "point and click" network provisioning and monitoring.

Regional optical transport. Our solution permits service providers to expand beyond the confines of metropolitan networks using the same platform for metropolitan and regional applications. Regional networks can now be built using the lower cost solutions developed for the metropolitan environment.

#### Sorrento Strategy

Our objective is to become a leading supplier of end-to-end, intelligent optical networking solutions for metro and regional applications world-wide. The key elements of our strategy are to:

Enhance and complete our end-to-end metropolitan/regional optical networking solution

We intend to continue to enhance our existing family of metropolitan and regional optical networking products and to introduce new products that increase the functionality of our end-to-end optical solution. We introduced TeraManager'TM' and TeraConfigurator'TM' in our management solution portfolio in fiscal 2002. We also introduced JumpStart'TM', our CWDM solution, in fiscal year 2002. We have also completed the development of a prototype all-optical wavelength routing switch, the TeraMatrix'TM', which will enable service providers to dynamically reassign bandwidth in response to changing network traffic patterns.

The combination of our GigaMux'r' optical transport products, with the EPC'TM' sub-rate multiplexer, the JumpStart'TM' CWDM, and TeraManager'TM', our carrier class network management product, creates an intelligent all-optical transport solution. When released at a future date, our TeraMatrix'TM' switching product will provide more efficient use of bandwidth, require less network equipment and allow for greater scalability.

Leverage our engineering leadership

We intend to leverage our engineering expertise in the areas of optical, mechanical, electrical and network management design to continue to provide



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

leading end-to-end metropolitan and regional optical networking systems and to expand our market share. We believe we were the first company to commercially ship a metropolitan optical networking product using DWDM technology. As of January 31, 2002, we had a skilled team of 67 engineers that continually focus on developing products for the metropolitan and regional optical transport market. We believe that our technological leadership has been the key to our success and will enable us to rapidly develop new product offerings and end-to-end optical solutions for the metropolitan and regional markets.

Allow our customers to leverage their fiber assets by offering revenue-generating services

The majority of our existing customers and targeted customers have a large amount of fiber assets in the metropolitan and regional network infrastructure. We intend to continue to develop and provide solutions that will enable our customers to leverage their existing fiber infrastructure to deliver revenue-generating services, while reducing their overall network costs. In addition, we believe our existing customer base provides us with an advantage when competing for new customers. We intend to continue to work closely with our customers and invest in sales and marketing resources to maintain our high level of customer service and remain responsive to our customers' changing needs.

5

Aggressively pursue expense reduction initiatives

The Company plans to aggressively pursue cost reduction initiatives to bring its expenses in line with current and future anticipated revenues. Such reductions may affect the size of our workforce, and may require decreasing our operating expenses and capital spending. During fiscal 2001, we effected three such initiatives, and anticipate the need for another cost reduction initiative in the near future.

Maintain our sales, service and support organizations worldwide

We intend to continue to market our products worldwide. We currently have sales, service and support teams in North America, Europe and Asia. This global presence has helped us to position our products into the Asia-Pacific market with shipments in the fourth quarter of fiscal year 2002. We believe that sales, service and support efforts on a customer-by-customer basis are most effective due to the technical evaluation and significant investments that are made by our customers.

Products

Our family of optical networking systems is designed to provide our customers with end-to-end solutions for the metropolitan and regional optical networking markets. Our transport, access, switching and network management systems include the following products, some of which are still in development.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### GigaMux'r' - DWDM Optical Transport

Our GigaMux'r' optical transport product utilizes DWDM technology to expand the capacity of new and existing fibers and enable traffic to travel throughout metropolitan optical networks without O-E-O conversions at each intermediate node. Our GigaMux'r' features wavelength translation, wavelength multiplexing, optical amplification, optical add-drop multiplexing, protection switching and performance monitoring. The scalable and modular architecture of our GigaMux'r' product enables service providers to easily and cost-effectively expand their existing networks as bandwidth requirements increase. GigaMux'r' can simultaneously transport multiple protocols bi-directionally over one or more fibers, which reduces the cost and complexity of the network.

Our GigaMux'r' product is Network Equipment Building Standards, or NEBS, level III certified. As of January 31, 2002, we have shipped our GigaMux'r' product to over 20 direct carrier customers or resellers worldwide. Our GigaMux'r' product includes the following key features:

- o Scalability: the system can grow from 1 to 64 protected channels (640 Gbps/fiber) without a major upgrade or service interruption.
- o Protocol transparency: the system can aggregate and transport SONET/SDH (OC-3/STM-1 through OC-192/STM-64 carrying voice, IP or ATM traffic), ESCON, Fibre Channel, Fast Ethernet, Gigabit Ethernet and video.
- o Modular protection: the system's modular protection system allows redundancy to be implemented at any point in the network.
- o Add/drop channels: the system is equipped with add/drop modules that allow specific channels to be added or dropped while all other channels pass through. Our filter subsystem can add or drop from single channels to larger wavelength bands.
- o Reach: Up to 600 kilometers with optical amplifiers and up to 1000 km with the addition of dispersion compensation.

### EPC'TM' - Sub-Rate Access Multiplexer

Electric Photonic Concentrator, or EPC'TM', is our sub-rate access multiplexer product that aggregates a wide variety of traffic from businesses and network points of presence for high-speed transport throughout optical

networks. The traffic is aggregated and effectively shares a wavelength per direction of transmission and can be ported directly into the DWDM stage of our GigaMux'r'. EPC'TM' is designed to lower the cost and increase the efficiency of bandwidth delivery within optical networks.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Our EPC'TM' products include the following key features:

- o Support for asynchronous or synchronous (SONET/SDH) time division multiplexing of data
- o Provisionable bit rates and protocol and overhead transparency

JumpStart'TM' - CWDM Transport

JumpStart is our entry level solution for multiplexing up to 4 bi-directional data channels using coarse wavelength division multiplexing technology on a single fiber. The product is very compact and can be stacked to provide additional capacity - 4 channels per fiber.

TeraManager'TM' - Element Management System

TeraManager'TM' is our TL1-based intelligent element management software platform that provides fault, configuration, performance and security management for all the Sorrento networks products and for networks built with such products. Service providers can operate our network management platform through an easy-to-use graphical user interface, which gives users a complete network view and enables "point and click" provisioning and monitoring.

Our TeraManager'TM' product will includes the following features:

- o Fault, configuration, security and performance management
- o Carrier class performance
- o Interface with higher layer operation support systems

TeraMatrix'TM' - Optical Switching

We have completed development of a fully functioning prototype of TeraMatrix'TM', a MEMS-based, all-optical wavelength routing switch, that enables dynamic, real-time wavelength provisioning. TeraMatrix'TM' is designed to utilize advanced optical technology to create an all-optical switching product requiring significantly less space in the service provider's central office than do competing solutions.

Commercial release of TeraMatrix'TM' is on hold, given the existing downturn in telecom spending and the uncertain market demand for an all optical metro/regional switch.

Meret Optical Communications

Our other optical networking subsidiary, Meret Communications, Inc., doing business as Meret Optical Communications, also markets our new CWDM product, as well as feature-rich video transport and switching, RF transmission, and RF synthesis products.

Customers

Our target customer base includes wholesale and retail broadband service providers, such as inter-exchange carriers, local and foreign telephone companies, the telecom affiliates of utility companies (utilicoms), cable television service providers, system integrators and distributors.

Our customers generally fit the following customer profiles:

- o Wholesale Network Providers - these customers provide wavelength and broadband services to communication service providers and include

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

- telecommunication carriers, cable companies and utilicomms.
- o Managed Services Providers - these customers provide wavelength and broadband services to enterprises and include telecommunication carriers, cable companies, utilicomms and Internet Service Providers.

7

- o System Integrators - companies that specialize in providing turnkey networking solutions for enterprise networks and applications such as data-center connectivity and storage area networks.
- o Major Enterprises - major enterprise customers are generally large organizations with complex networking needs, usually spanning multiple locations and difficult types of network requirements. Enterprise customers include industrial corporations, government agencies, and utilities.
- o Small and Medium Businesses - these customers have a need for networks as well as connection to the Internet and/or to their business partners. However, they generally have limited resources. Therefore, we provide product through systems integrators or Value Added Resellers.

During fiscal 2002 the majority of our sales were to relatively few customers, and we expect this customer concentration to continue for the foreseeable future. For fiscal 2002, we shipped our optical networking products to a total of 17 customers worldwide. Three customers, AT&T Broadband, Cox Communications and Deutsche Telekom each represented more than 10% of our net sales for fiscal 2002 and two customers each accounted for more than 10% of our net sales during fiscal 2001.

### Key Relationships

We have entered into long-term agreements with some of our customers and strategic allies, including:

#### AT&T Broadband Network Solutions

In February 2000, we entered into a strategic alliance agreement with AT&T Broadband. Under the terms of this agreement, we and AT&T Broadband Network Solutions agreed to negotiate in good faith concerning the implementation of a number of joint sales and marketing initiatives. AT&T Broadband also agreed to help introduce our technology to individuals at other AT&T divisions and to provide feedback concerning our products' performance. The initial term of this agreement expired in February 2002 and was automatically renewed for an additional one-year term. Similar automatic renewals will occur in each succeeding February. Either we or AT&T Broadband may terminate the agreement for any reason upon ninety days notice. In addition, we concurrently entered into an equipment purchase agreement. We started shipping our products to AT&T Broadband in the second quarter of fiscal year 2001.

#### INRANGE Technologies

In March 2000, we entered into a strategic alliance agreement with INRANGE. Under the terms of the agreement, INRANGE will act as an exclusive worldwide

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

distributor of our optical networking products for storage networks of enterprise customers. INRANGE has agreed to offer our wave division multiplexing (WDM) and dense wave division multiplexing, or DWDM products, including GigaMux'r', as part of family of virtual storage networking products. In addition, INRANGE must purchase minimum amounts of our products in order to retain exclusive worldwide rights for offering our products in the enterprise storage networking market. These products will facilitate the creation of virtual storage networks by reducing the costs of sending information over long distances. The initial term of this agreement expires in March 2005 and will be automatically renewed for additional two-year terms. INRANGE has agreed to purchase targeted minimum amounts of products from us. We have a right to terminate this agreement with sixty days prior written notice to INRANGE in the event INRANGE fails to purchase the applicable targeted minimum amounts of products. In fiscal year 2002, INRANGE did not meet its minimum purchase commitment under this agreement. In addition, General Signals Holding Company, the parent company of INRANGE, purchased 550,459 of our Sorrento subsidiary's series A convertible preferred shares in March 2000. We started shipping our products to INRANGE in the second quarter of fiscal year 2001.

### United Pan-Europe Communications

In March 2000, we entered into a strategic alliance agreement and an equipment purchase agreement with United Pan-Europe Communications, N.V., or UPC. Under the terms of these agreements, United Pan-Europe Communications has agreed to make Sorrento a supplier for optical networking products in networks deployed throughout Europe. These agreements also contemplate our working together with United Pan-Europe Communications on joint sales and marketing initiatives. The likelihood of any large scale deployments by UPC given its current operating environment is questionable, and the future benefit to the Company from this relationship is uncertain. The initial terms of these agreements expire in March 2003 and will be automatically renewed for additional

one-year periods unless either we or United Pan-Europe Communications provide notice at least 90 days prior to the expiration of the then-current term of the intent to terminate the agreements. In addition, UnitedGlobalCom, Inc., parent to United Pan-Europe Communications, purchased 3,027,523 of our Sorrento subsidiary's series A convertible preferred shares in March 2000, through an affiliated entity. We started shipping our products to UPC in the second quarter of fiscal year 2001.

### Looking Glass Networks

In August 2001, we entered into an equipment purchase agreement with Looking Glass Networks, or LGN. Under the terms of this agreement, LGN agreed to purchase metro DWDM optical networking equipment from Sorrento as the primary supplier. LGN also agreed to receive early adopter access to new and emerging Sorrento technologies, and to serve as a beta tester for new and emerging equipment and to provide feedback concerning our products' performance. The initial term of this agreement expires in August 2004 and will be automatically renewed for additional one-year terms. Either LGN or Sorrento may terminate the agreement at the end of the initial or any renewal term upon ninety days notice. We started shipping our products to LGN in the third quarter of fiscal year

2002.

#### TeraBeam

In June 2000, we entered into a development, purchase and strategic partnership agreement with TeraBeam. Under the terms of this agreement, the customer has agreed to make commercially reasonable efforts to purchase target quantities of our products but is not contractually committed to purchase these target quantities. The initial term of this agreement is 48 months from the date of the first commercial shipment of our products to the customer. At the end of the initial term, the agreement will automatically renew for four successive one year terms. Either we or the customer may terminate the agreement for any reason upon 180 days prior written notice as to the initial term or 90 days prior written notice as to any renewal term. In addition, either we or this customer may terminate the agreement at any time subject to customary termination provisions. Commercial shipments under this agreement have not as yet begun, and the future benefit to the Company from this relationship is uncertain.

#### Sales and Marketing

Our sales effort is currently focused on North America, Europe and Asia. As of January 31, 2002 our sales and marketing organization included 55 employees, including account managers, sales engineers and support personnel. In North America, Europe and Asia, we sell our products through our direct sales force as well as through system integrators. Our international direct sales force is located in France, Belgium, Germany, Spain, Singapore and China.

In support of our worldwide selling efforts, our marketing team targets potential customers through in-depth market analysis. Our marketing objectives include building market awareness and acceptance of our products as well as expanding our customer base. Our customer acquisition strategy has focused on targeting customers who are aggressively building network infrastructure and are looking to leverage existing fiber assets to generate additional revenue from broadband services. This focus has led to strategic supply agreements with several MSOs, utilities, and to a lesser extent CLECs. We also plan to target incumbent carriers as they expand the development of their metropolitan and regional fiber networks. Marketing personnel coordinate our participation in trade shows, seminars and industry events and conduct media relation's activities with trade and general business publications. We participate in many industry organizations responsible for developing standards that are used in optical networks.

#### Customer Service and Support

Our customer service and support team provide a critical component of our customer satisfaction initiative. This team provides support to our customers allowing them to successfully design and implement their optical networks. All services can be customized to meet the needs our customers. Our staff is experienced, and has the equipment necessary to support both installation and problem resolution. A variety of installation service packages supports the implementation from start up to upgrades and maintenance. Specialists are available 7 days a week, 24 hours a day. We offer a Technical Assistance Center as well as field services support. Multiple technical support service agreements allow our customers to define the level of support they require. Our customer service and support team

provides installation, maintenance and training programs addressing the product, installation and maintenance processes and can be delivered at the customer location or at our training facility.

We currently provide service and support to our international customers on a direct basis and are establishing service and support agreements throughout the world. To date revenues from service and support agreements have not been material. We intend to continue to develop our internal team to meet the needs of our customers and will utilize strategic partners to allow us to provide greater value when appropriate.

We provide a total service solution. Our hardware products are warranted against defects for a period of 12 to 36 months dependent on purchase agreements, including technical support and parts repair/replacement. We also offer support contracts for a fee to our customer base, thereby allowing our customers to select a service plan tailored to their own particular needs.

#### Research and Development

We have assembled a team of highly skilled engineers with extensive experience in the fields of optical, mechanical, electrical and network management design. We believe that our success in introducing DWDM optical technology for use in the metropolitan and regional markets was a result of our strength in research and development. As of January 31, 2002, 67 employees were engaged in research and development efforts. Our research and development efforts are focused on new product development as well as enhancing performance and reliability of our existing products. We believe that our research and development efforts are key in maintaining technical competitiveness, delivering innovative products, and addressing the needs of the regional and metropolitan market.

Our engineering, research and development expenses were \$13.7 million, \$23.9 million, and \$11.7 million for the years ended January 31, 2002, January 31, 2001 and January 31, 2000, respectively. The Company plans to continue to make substantial investments in research and development for both new product development and enhancement of existing products.

#### Manufacturing and Quality

We outsource the manufacturing of our products. We design our products and perform system integration, quality control, final testing and configuration at our San Diego, California and Fremont, California locations. Our San Diego facility is ISO-9002 certified and we have begun the process of becoming ISO9000/2000. By meeting such standards, we assure our customers that we meet internationally recognized standards for quality, customer care and sound management practices. We believe that outsourcing our manufacturing allows us to conserve working capital, flexibly respond to changes in market demand and more quickly deliver products to our customers.

We currently purchase products from our contract manufacturers and other suppliers on a purchase order basis. We generally do not enter long-term contracts with our contract manufacturers or suppliers, and they are not obligated to perform services for us for any specific period or at any specified price, except as may be provided in a particular purchase order. We purchase a limited number of key components used in the manufacturing of our products from a limited number of suppliers and some of our components are purchased exclusively from a single supplier on a purchase order basis.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### Patent, Trademarks and Licenses

We currently hold approximately 20 patents and have several patent applications pending. Although we attempt to protect our intellectual property rights through patents, trademarks, and copyrights, maintaining certain technology as trade secrets and other measures, we cannot assure that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. We cannot assure that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or intend to do business in the future. We also have licensed and

10

may in the future license technologies from other companies on a non-exclusive basis. For example, our CWDM product incorporates technology purchased from Entrada Networks, Inc., a former affiliate of the Company, that we then enhanced to complete a commercially feasible product.

We believe that the future success of our business will depend on our ability to translate the technological expertise and innovation of our personnel into new and enhanced products. We cannot assure that the steps taken by us will prevent misappropriation of our technology. In the future, we may take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could harm our business and operating results.

As is common in our industry, we have from time to time received notification from other companies of intellectual property rights held by those companies upon which our products may infringe. Any claim or litigation, with or without merit, could be costly, time consuming and could result in a diversion of management's attention, which could harm our business. If we were found to be infringing on the intellectual property rights of any third party, we could be subject to liabilities for such infringement, which could be material, and could be required to seek licenses from other companies or to refrain from using, manufacturing or selling certain products or using certain processes. Although holders of patents and other intellectual property rights often offer licenses to their patent or other intellectual property rights, no assurance can be given that licenses would be offered, that the terms of any offered license would be acceptable to us or that failure to obtain a license would not cause our operating results to suffer.

### Working Capital Practices

We have historically maintained high levels of inventories to meet output



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

requirements of our customers and to ensure an uninterrupted flow of inputs from suppliers. It is not our standard policy to grant customers the right to return merchandise that performs according to specifications. Typical payment terms require payment within thirty days from the date of shipment, however, for one customer we extend a 180 day payment term.

We perform ongoing credit evaluations of each customer's financial condition and extend unsecured credit related to the sales of various products. From time to time we receive financial instruments such as letters of credit for payments for international customers. At January 31, 2002, accounts receivable due from Cox Communications, Deutsche Telekom, iNOC and UPC accounted for 13.9%, 24.7%, 20.0%, and 19.8% of net receivables.

### Our Backlog

At January 31, 2002 the Company had minimal backlog. Our backlog consists of orders confirmed with a purchase order for products to be shipped within twelve months to customers with approved credit status. We do not believe that backlog, as of any particular date, should be used as an indication of sales for any future period for two reasons. First, orders are increasingly being booked and shipped in a short period of time and therefore are never calculated in the backlog amount at the end of any particular quarter. Second, customers have and can change delivery schedules or cancel orders without a significant penalty.

### Competition

The market for optical networking equipment is extremely competitive and subject to rapid technological change. We expect competition to intensify in the future. Our primary competitors in the DWDM market include vendors of optical networking and infrastructure equipment such as Nortel Networks, CIENA Corporation, ONI Systems, Cisco Systems, Lucent Technologies, and Sycamore Networks, as well as private companies that have been or will be focusing on our target markets. Our primary competitors for our CWDM products include Adva, Controlware, ONI Systems, LuxN and others. Many of our competitors have significantly greater financial resources and are able to devote these greater resources to the development, promotion, sales and support of their products. In addition, many of our competitors have more extensive customer relationships than we do, including relationships with our potential customers. We believe each of our competitors has optical networking products in various stages of development.

11

We believe the principal competitive factors in the optical networking market are:

- o product performance, features, functionality and reliability;
- o price/performance characteristics;
- o timeliness of new product introductions;

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

- o relationships with existing customers; and
- o service, support and financing.

We believe we compete favorably with our competitors with respect to most of these factors.

The competitors for Meret's legacy products include Pesa, Artel, RGB Spectrum, Utah Scientific, and many other companies.

Increased competition may result from further price reductions, reduced gross margins and loss of market share, any of which could materially and adversely affect our business, operating results and financial condition. There can be no assurance that we will be able to compete successfully against current and future competitors, or that competitive factors will not have a material adverse effect on our business, operating results and financial condition.

### Environmental Compliance

We are required to file environmental compliance reports with the Federal Food and Drug Administration regarding the emissions levels of our laser-based products, which are used in fiber optics communications. All of our products comply with required safety level standards.

### Employees

As of January 31, 2002, we had 217 employees of which 67 were in research and development, 55 in sales and marketing, and the remainder in manufacturing and in general and administrative functions. Of the 67 employees in research and development 28 have masters degrees and 23 have doctorate degrees. We also employ a number of part-time and temporary personnel from time to time in various departments. Our future success will depend in part on our ability to attract, retain and motivate highly qualified technical and management personnel, for whom competition is intense. None of our employees are covered by a collective bargaining agreement and we believe that our relations with our employees are good.

### Forward-Looking Statements - Cautionary Statement

All statements other than statements of historical fact contained in this Form 10-K, 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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

finance our current and future needs for working capital; changed market conditions, new business opportunities or other factors that might affect our

12

decisions as to the best interest of our shareholders; and other risks detailed from time to time in our reports filed with the Securities and Exchange Commission.

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

### Factors That May Affect Future Results

In connection with the safe harbor contained in the Private Securities Reform Act of 1995 we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Any such statement is qualified by reference to the following cautionary statements:

We will need additional funds to support operations in the future in order to continue to enhance and expand our product offerings and to penetrate additional market share in the regional and metropolitan marketplace. If we are unable to obtain new investment, we will have to reduce or cease operations, or attempt to sell some or all of our operations or to merge with another entity.

The further development of our products as well as the expansion of manufacturing capabilities or the establishment of additional sales, marketing and distribution capabilities will require the commitment of substantial funds. Our existing working capital will not be sufficient to meet these expansion plans. Potential sources of additional funds include public or private offerings of debt or equity securities, bank lines of credit or extensions of existing arrangements by us or our Sorrento subsidiary. Additional financing may not be available on terms favorable to us, or at all. Insufficient funds may require us to delay, scale back or eliminate certain product development programs, or attempt to merge with another entity or otherwise reduce or cease operations. We also expect that, as a result of the slowdown in capital spending in the telecom industry, we will need to reduce our expenses in the near future to bring them in line with reduced revenues in order to conserve our working capital. Moreover, without adequate financing, potential customers who otherwise would select our products to purchase may decide to buy from other vendors who they perceive to have greater financial stability.

The Series A Preferred Stock issued by our Sorrento Networks, Inc. subsidiary ("SNI"), and a preliminary injunction obtained by some of the holders of that

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

stock, could have a material adverse effect on our ability to raise the capital that we need.

Certain holders of SNI's Series A preferred stock obtained a preliminary injunction in September 2001 from the Delaware Court of Chancery, which was affirmed by the Delaware Supreme Court in January 2002. The injunction prohibits SNI from issuing additional shares of Series A preferred stock and from incurring debt without the consent of the holders of a majority of the outstanding shares of Series A preferred stock. The Court of Chancery will decide whether to make this injunction permanent at a trial that is not currently scheduled. We cannot predict the outcome of that trial. The injunction against SNI, our principal operating subsidiary, issuing Series A preferred stock, makes it very difficult to fund SNI as its business operations require. The Company, however, does have the right to make such capital contributions to SNI to fund its operations as the Board may deem necessary. Capital contributions do not increase the Company's ownership interest in SNI, but rather increases the basis of our ownership interest. The Board has authorized capital contributions to be made when necessary to fund the SNI operations, but there can be no assurance that the Board will continue to authorize such contributions in the future should other funding methods continue to be unavailable.

13

The redemption rights of the Series A preferred stock of our Sorrento subsidiary, Sorrento Networks, Inc., or SNI, could have a negative impact on the Company's business.

In April 2001, the holders of the Series A preferred stock exercised their right to ask SNI to redeem their shares for approximately \$49 million in cash. Such request can only be paid from lawfully available funds of which SNI has none available and would normally be generated from operating profits of the business. SNI does not foresee any such profits in the near future. As a result, the Company is in negotiations with the Holders of Series A Stock to allow them to convert their Series A Stock to either the Company's common shares, preferred shares or a combination of both. While negotiations have been under way for a significant period of time, the Company has not reached an agreement with the Series A Holders and there is no assurance that it will do so in the future. Such uncertainty could impact the business negatively on both a short term and long term basis.

We have a history of losses and expect to incur future losses.

We have incurred operating losses during the years ended January 31, 2002, 2001 and 2000 of \$37.2 million, \$50.4 million and \$10.0 million, respectively, and as of January 31, 2002, we had an accumulated deficit of \$161.3 million. We expect to continue to incur losses in the future. If we do not become profitable, the value of our stock will decrease. We have large expenses in the areas of sales and marketing, research and development, manufacturing, and general and administrative expenses that are not covered by our current sales volume and resulting gross margin. Currently, the majority of revenues are from shipments of our optical networking product lines. In order for us to become profitable, we will need to generate and sustain higher revenue while maintaining reasonable expense levels.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Our history of losses and future losses could impact our ability to finance our business, cause defaults under obligations to our Holders of Senior Debentures and risk our ability to continue operating.

The Company has incurred significant losses and may incur significant losses in the future. Such losses could cause our equity balance to fall below necessary levels to be in compliance with our Senior Convertible Debenture agreements and impact the Company's ability to finance its future operations. In addition, deficient equity could violate minimum listing requirements for our publicly traded stock on Nasdaq and could cause significant decline in shareholder value and stock price.

Your percentage of ownership and voting power, and the price of our common stock may decrease because we may issue a substantial number of shares of common stock, or securities convertible or exercisable into our common stock.

We have the authority to issue up to 150 million shares of our common stock and 2 million shares of our preferred stock without shareholder approval. We may also issue options and warrants to purchase shares of our common stock. These future issuances could be at values substantially below the price paid for our common stock by current stockholders. We may conduct additional future offerings of our common stock, preferred stock, or other securities with rights to convert the securities into shares of our common stock, which may result in a decrease in the value, or market price of our common stock. Further, the issuance of preferred stock could have the effect of delaying, deferring or preventing a change of ownership without further vote or action by the stockholders and may adversely affect the voting and other rights of holders of common stock.

Provisions of our charter documents and New Jersey law may have anti-takeover effects that could prevent a change in control, which could negatively affect the market price for our stock.

Provisions of New Jersey law and our amended and restated certificate of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders.

Our industry is highly competitive, and we may not have the resources required to compete successfully.

The market for optical networking equipment is extremely competitive. We expect competition to intensify in the future. Our primary sources of competition include vendors of optical networking and infrastructure equipment such as CIENA Corporation, Cisco Systems, Lucent Technologies, Nortel Networks, ONI Systems, Sycamore Networks, and ADVA AG Optical Networking as well as private companies that have been or will be focusing on our target markets. The competitors for Meret's legacy products include Pesa, Artel, RGB Spectrum, Utah Scientific, and many other companies. We may also face competition from a number of other companies that have announced plans for new products to address the same network problems that our products address. Many of our current and potential competitors have significantly greater sales and marketing, technical, manufacturing, financial and other resources than we do. Our competitors also may have more extensive customer relationships than us, including relationships

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

with our current and potential customers. If we are unable to compete successfully against our current and future competitors, we could experience pricing pressures, reduced gross margins and order cancellations, any one of which could seriously harm our business.

Our business may be seriously harmed if the market for optical networking products in metropolitan and regional areas does not develop as we expect.

Our current and future product offerings are focused on the needs of providers that service regional and metropolitan areas. The market for optical networking products in regional and metropolitan areas is not yet mature, and we cannot be certain that a feasible market for our products will develop or be sustainable. In addition, the market has suffered a cutback in capital spending from both enterprise and carrier customers as a result of poor economic conditions. If this market does not develop, or develops more slowly than we expect or continues to be impacted by the reduction in capital spending, our business may be seriously harmed. Furthermore, the optical networking industry is subject to rapid technological change, and newer technology or products developed by others could render our products less competitive or obsolete. In developing our products, we have made, and will continue to make, assumptions about the optical networking standards that our customers and competitors may adopt.

If the standards adopted are different from those which we have chosen to support, market acceptance of our product would be significantly reduced and our business will be seriously harmed.

Our future growth depends on our ability to attract new customers, and on our customers' ability to sell additional services to their own customers.

Most of our potential customers evaluate optical networking products for deployment in large telecommunications systems that they are installing. There is only a relatively limited number of potential customers for our products. If we are not selected by a potential customer, our revenues and ability to grow our business may be seriously harmed. Similarly, our growth depends on our customers' success in selling communications services based on our products and complementary products from others. Our success will depend on our ability to effectively anticipate and adapt to customer requirements and offer products and services that meet customer demands. Any failure of our current or prospective customers to purchase products from us for any reason, including a downturn in their business, would seriously harm our ability to grow our business.

If we fail to establish and successfully maintain strategic alliances, long-term contracts and relationships with distributors and system integrators, our ability to grow and be profitable may be seriously harmed.

Strategic alliances and long-term contracts are an important part of our effort to expand our sales opportunities and technological capabilities. To date, we have entered into strategic alliances with AT&T Broadband, United Pan-Europe Communications, INRANGE, Looking Glass, and Terabeam. In addition we have a long-term contract with Cox Communications. We cannot be certain that our existing alliances and long-term contracts will not be cancelled or that we will be able to enter additional strategic alliances on terms that are favorable to us. Our agreements to date with our strategic allies are non-exclusive, and we anticipate that future agreements will also be on a non-exclusive basis. These agreements are generally short term, have no minimum financial commitments on either side and can be cancelled without significant financial consequence. In addition, we cannot be certain that our existing and any future strategic alliances will be successful. As we expand internationally, we will increasingly depend upon distributors and system integrators. Our ability to grow and be profitable may be seriously harmed if we fail to establish and maintain strategic alliances, long-term contracts and relationships with distributors and

system integrators.

15

We rely on a small number of customers for most of our revenues and any loss, cancellation, reduction or delay in sales to, or collections from, any single customer could seriously harm our business.

Our customer base is highly concentrated. Historically, orders from a relatively limited number of customers accounted for most of our net sales. During the year ended January 31, 2002, five customers accounted for 61.9% of net sales and in fiscal year 2001, five customers accounted for 44.4% of our net sales. We expect that, for the foreseeable future, sales to a limited number of customers will continue to account for a high percentage of our net sales. We currently do not have any long-term purchase commitments with any of our customers, and we are subject to the varying purchase cycles of our customers. Our concentrated customer base significantly increases the credit risks associated with slow payments or non-payments by our customers. The loss or delay of orders or slow or non-payment from, any of our largest customers could adversely impact our business.

Our backlog at any point may not be a good indicator of expected revenues.

Our backlog at the beginning of each quarter typically is not sufficient to achieve expected sales for the quarter. To achieve our sales objective, we are dependent upon obtaining orders during each quarter for shipment during that quarter. Furthermore, our agreements with our customers typically provide that they may change delivery schedules and cancel orders within specified time frames typically 30 days or more prior to the scheduled shipment date, without significant penalty. Our customers have in the past built, and may in the future build significant inventory in order to facilitate more rapid deployment of anticipated major projects or for other reasons. Decisions by such customers to reduce their inventory levels have led and could lead to reductions in purchases from us. These reductions, in turn, have and could cause fluctuations in our operating results and have had and could have caused an adverse effect on our business, financial condition and results of operations in periods in which the inventory is reduced.

Our operating results are likely to fluctuate significantly and may fail to meet or exceed the expectations of securities analysts or investors, causing our stock price to decline.

Our revenues and operating results will vary significantly from quarter to quarter and year to year due to a number of factors, many of which are outside of our control and any of which may cause our stock price to fluctuate. Some of the factors that may affect us include changes in market demand for our optical networking products, the cost and availability of components used in our products, the timing and amount of customer orders, the length and unpredictability of the sales and deployment cycles of our products, the timing of new product introductions and enhancements by our competitors and ourselves, changes in our pricing or the pricing of our competitors, our ability to attain and maintain production volumes and quality levels of our products, and general economic conditions as well as those specific to the telecommunications and related industries.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

If we are unable to comply with regulations affecting our customers' industries, our revenues may be seriously harmed.

Our customers are involved in industries that are subject to extensive regulation by domestic and foreign governments. If we fail to conform our products to these regulatory requirements, we could lose sales and our business could be seriously harmed. Additionally, any failure of our products to comply with relevant regulations could delay their introduction and require costly and time-consuming engineering changes.

The time that our customers and potential customers require for testing and qualification before purchasing our products can be long and variable, and may require us to invest significant resources without any assurances of sales, which may cause our results of operations to be unpredictable.

Before purchasing our products, potential customers typically undertake a lengthy evaluation, testing and product qualification process. In addition, potential customers often require time-consuming field trials of our products. Our sales effort requires the effective demonstration of the benefits of our products to, and significant training of, potential customers. In addition, even after deciding to purchase our products, our customers may take several years to deploy our products. The timing of deployment depends on many factors, including the sophistication of a customer and the complexity and size of a customer's networks. Our sales cycle, which is the period from the time a sales lead is

16

generated until the recognition of revenue, can often be longer than one year. The length and variability of our sales cycle is influenced by a variety of factors beyond our control, including our customers' buildout and deployment schedules, our customers' access to product purchase financing, our customers' needs for functional demonstration and field trials, and the manufacturing lead time for our products. Because our sales cycles are long and variable and may require us to invest significant resources without any assurances of sales, our results of operations may be unpredictable.

The GigaMux'r', EPC'TM', TeraManager'TM' and JumpStart'TM' are our only currently available significant products, and if they are not commercially successful, our revenue will not grow and we may not achieve profitability.

If our customers and potential customers do not adopt, purchase and successfully deploy our GigaMux'r',EPC'TM', TeraManager and JumpStart products in large numbers, our revenue may not grow and our business, financial condition and results of operations will be seriously harmed. Since the market for our products is relatively new, future demand for our products is uncertain and will depend on the speed of adoption of optical networking, in general, and optical equipment in metro and regional networks, in particular.

If we are not able to develop and commercialize new or enhanced products, our operating results and competitive position will be seriously harmed.

Our growth depends on our ability to successfully fund and develop new and enhanced products. The development of new or enhanced products is a costly,



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

complex and uncertain process that requires us to anticipate accurately future technological and market trends. Our next generation of transport and network management products, as well as our TeraMatrix<sup>TM</sup> line of wavelength switching products, are currently under development. We cannot be sure whether these or other new products will be successfully developed and introduced to the market on a timely basis, or at all. We will need to complete each of the following steps to successfully commercialize these and any other new products, complete product development, qualify and establish component suppliers, validate manufacturing methods, conduct extensive quality assurance and reliability testing, complete software validation, and demonstrate systems interoperability.

Each of these steps presents serious risks of failure, rework or delay, any one of which could adversely affect the rate at which we are able to introduce and market our products. If we do not develop these products in a timely manner, our competitive position and financial condition could be adversely affected.

In addition, as we introduce new or enhanced products, we must also manage the transition from older products to newer products. If we fail to do so, we may disrupt customer ordering patterns or may not be able to ensure that adequate supplies of new products can be delivered to meet anticipated customer demand. Any failure to effectively manage this transition may cause us to lose current and prospective customers.

If our products do not interoperate with our customers' networks, installations will be delayed or cancelled or our products could be returned.

Many of our customers require that we design products to interoperate with their existing networks, each of which may have different specifications and utilize a variety of protocols. Our customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our products must interoperate with all of the products within these networks as well as future products in order to meet our customers' requirements. If we are required to modify our product design to be compatible with our customers' systems to achieve a sale, it may result in a longer sales cycle, increased research and development expense and reduced margins on our products. If our products do not interoperate with those of our customers' networks, installations could be delayed, orders for our products could be cancelled or our products could be returned, any of which could seriously harm our business.

Our products may have errors or defects that we find only after deployment, which could seriously harm our relationship with our customers and our reputation.

Our customers may discover errors or defects in our products, and our products may not operate as expected. If we are unable to fix errors or other problems that may be identified on a timely basis, we could experience losses of or

delays in revenues and loss of market share, loss of customers, failure to

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

attract new customers or achieve market acceptance, diversion of engineering resources, increased service and warranty costs, and legal actions by our customers. Any failure of our current or planned products to operate as expected could delay or prevent their adoption and seriously harm our relationship with our customers and our reputation.

We depend upon contract manufacturers and any disruption in these relationships may cause us to fail to meet the demands of our customers and damage our customer relationships.

We use contract manufacturers to manufacture and assemble our products in accordance with our specifications. We currently have three U.S.-based contract manufacturers. We do not have long-term contracts with any of them, and none of them is obligated to perform services for us for any specific period or at any specified price, except as may be provided in a particular purchase order. We may not be able to effectively manage our relationships with these manufacturers and they may not meet our future requirements for timely delivery or provide us with the quality of products that we and our customers require.

Each of our contract manufacturers also builds products for other companies. We cannot be certain that they will always have sufficient quantities of inventory available to fill our orders, or that they will allocate their internal resources to fill these orders on a timely basis. Qualifying a new contract manufacturer and commencing volume production is expensive and time consuming and could result in a significant interruption in the supply of our products. If we are required to change contract manufacturers, we may suffer delays that could lead to the loss of revenue and damage our customer relationships.

We rely on a limited number of suppliers and single suppliers for some of our components, and our sales and operating results may be seriously harmed if our supply of any of these components is disrupted.

We and our contract manufacturers currently purchase several key components of our products from single and limited sources. We purchase each of these components on a purchase order basis and have no long-term contracts for these components. In the event of a disruption in supply or if we receive an unexpectedly high level of purchase orders, we may not be able to develop an alternate source in a timely manner or at favorable prices. Any of these events could hurt our ability to deliver our products to our customers and negatively affect our operating margins. In addition, our reliance on our suppliers exposes us to potential supplier production difficulties or quality variations. Any such disruption in supply would seriously affect our present and future sales.

We expect the average selling prices of our products to decline, which may reduce gross margins and revenue.

Our industry has experienced significant erosion of average product selling prices. We anticipate that the average selling prices of our products will decline in response to competitive pressures, increased sales discounts, new product introductions by our competitors or other factors. If we are unable to achieve sufficient cost reductions and increases in sales volumes, the decline in average selling prices will reduce our gross margins and revenue.

If we are unable to hire or retain highly skilled personnel, we may not be able to operate our business successfully.

Our future success depends upon the continued services of our key management, sales and marketing, and engineering personnel, many of whom have significant industry experience and relationships. Many of our personnel could be difficult to replace. We do not have "key person" life insurance policies

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

covering any of our personnel. The loss of the services of any of our key personnel could delay the development and introduction of, and negatively impact our ability to sell, our products. Competition for highly skilled personnel is intense in our industry, and we may not be able to attract and retain qualified personnel, which could seriously harm our business.

If we become subject to unfair hiring claims, we could incur substantial costs in defending ourselves.

Companies in our industry whose employees accept positions with competitors frequently claim that their competitors have engaged in unfair hiring practices. We cannot assure you that we will not receive claims of this kind in the future as we seek to hire qualified personnel or that those claims will not result in material litigation. We could incur substantial costs in defending ourselves or our employees against such claims, regardless of their merits. In

18

addition, defending ourselves from such claims could divert the attention of our management away from our operations.

We may be unable to protect our intellectual property, which could limit our ability to compete.

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and control access to, and distribution of, our software, documentation and other proprietary information. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If competitors gain access to our technology, our ability to compete could be harmed.

We could become subject to litigation regarding intellectual property rights, which could seriously harm our business and require us to incur significant costs.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We may be a party to litigation in the future to protect our intellectual property or as a result of an allegation that we infringe upon others' intellectual property rights. Any parties asserting that our products infringe upon their proprietary rights would force us to defend ourselves and possibly our customers or manufacturers against the alleged infringement. These claims and any resulting lawsuits, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights. Additionally, any claims and lawsuits, regardless of their merits, would likely be time-consuming and expensive to resolve and would divert management time and attention.

Any claims of infringement on the intellectual property rights of others

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

could also force us to do one or more of the following: stop selling, incorporating or using our products that use the challenged intellectual property, obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, which may not be available to us on reasonable terms, or at all, or redesign those products that use such technology. If we are forced to take any of the foregoing actions, our business may be seriously harmed. However, the Company intends to vigorously protect its intellectual property against all material challenges.

If necessary licenses of third-party technology are not available to us or are very expensive, our products could become obsolete.

We have been and may be required to license technology from third parties to develop new products or product enhancements. We cannot assure you that third-party licenses will be available to us on commercially reasonable terms, if at all. If we are required to obtain any third-party licenses to develop new products and product enhancements, we could be required to obtain substitute technology, which could result in lower performance or greater cost, either of which could seriously harm the competitiveness of our products.

We are subject to various risks associated with international sales and operations.

Our international operations are subject to a number of risks, including changes in foreign government regulations and telecommunications standards, import and export license requirements, tariffs, taxes and other trade barriers, fluctuations in currency exchange rates, difficulty in collecting accounts receivable, the burden of complying with a wide variety of foreign laws, treaties and technical standards, difficulty in staffing and managing foreign operations, and political and economic instability.

The majority of our sales and expenses have been denominated in U.S. dollars. However, in the future a larger portion of our sales and expenses may 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 do not currently engage in foreign exchange hedging transactions to manage our foreign currency exposure.

If we do not effectively manage our growth, we may not be able to successfully expand our business.

Our business has experienced wide fluctuations in sales volume from quarter to quarter, and which place a significant strain on our management systems and resources. Our ability to successfully offer our products and implement our business plan in a rapidly evolving market requires an effective planning and management process. We will need to continue to improve our financial, managerial and manufacturing processes and reporting systems, and will need to

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

continue to expand, train and manage our workforce worldwide. If we fail to effectively manage our growth and address the above requirements, our ability to pursue business opportunities and expand our business could be harmed.

### Definitions

As used in this Annual Report on Form 10-K, the following terms have the meanings indicated:

"ATM" means Asynchronous Transfer Mode, which is a type of networking technology based on transferring data in cells or packets of a fixed size. The small, constant cell size allows ATM equipment to transmit video, audio, and data over the same network, and assure that no single type of data overtakes the line. Current implementations of ATM support data transfer rates of 25 to 2.48 Gbps.

"Backbone" means a main segment of a network carrying large amounts of traffic. Individual metro and interoffice rings are attached to the backbone.

"Bandwidth" means the capacity to move information down a communications channel. Bandwidth is defined by the highest data rates that can be transmitted by that channel and is commonly measured in bits per second (bps). For example, Ethernet has a 10 Mbps bandwidth and OC-192 has 10 gigabits per second bandwidth.

"Bridge" means a device that connects two or more networks of the same access method (Ethernet to Ethernet or Token Ring to Token Ring) by making simple forward/don't forward decisions on each data packet received from any of the networks to which it is connected.

"Broadband" means technologies or networks that have the ability to transmit high data rates.

"CLEC" means a Competitive Local Exchange Carrier.

"Concentrator" means the connection point, more sophisticated than a hub, incorporating different types of cable connections, back-up power supply, data-gathering capability for management purposes and possibly even bridge and router features as well.

"CWDM" means Coarse Wavelength Division Multiplexing, which is a sophisticated optoelectronics technology that uses multiple wavelengths of light spaced at least 400 Ghz apart to increase the number of video, data or voice channels of information that can be sent on a single optical fiber in a transmission system.

"DWDM" means Dense Wavelength Division Multiplexing, which is a sophisticated optoelectronics technology that uses multiple wavelengths of light very efficiently to greatly increase the number of video, data or voice channels of information that can be sent on a single optical fiber in a transmission system.

"ESCON" - Enterprise System Connectivity - means a protocol for 200 Mbps signal transmission speed over fiber optic cable.

"Ethernet" means a 10 Mbps speed network that runs over thick coaxial cable (10BASE5), thin coaxial cable (10BASE2), twisted-pair (10BASE-T), and fiber-optic cable. It is the most widely used LAN technology and the most popular form of Ethernet is 10BASE-T. Ethernet is a network specification that was developed at Xerox Corp's Palo Alto Research Center, and made into a network standard by Digital, Intel, and Xerox.

"Fast Ethernet" means a 100 Mbps speed network that runs over thick coaxial, twisted-pair, and fiber-optic cable. Fast Ethernet is 10 times faster than

Ethernet.

"FDDI" means a Fiber Distributed Data Interface and is a fiber optic network that supports transmission speeds up to 100 Mbps.

20

"Fibre Channel" means a serial data transfer architecture standard conceived for new mass storage devices and other peripheral devices that require very high bandwidth connections. Bit rates for Fibre channel are either 1.06 Gbps or 2.1 Gbps.

"Gigabit Ethernet" means a 1000 Mbps speed network that runs fiber-optic cable for wide area network connections.

"HDTV" means high definition television, which is a new type of television that provides much better resolution than current television. HDTV is slowly being implemented into the broadcast networks.

"Hub" means a central connection device to which many network tributaries are connected.

"ILEC" means Incumbent Local Exchange Carrier and is a telephone company that provides local services and does not offer long distance services. All the regional operating companies after the break-up of AT&T became ILECs.

"ISDN" means an Integrated Services Digital Network and is an all-digital communications network that provides a wide range of services on a switched basis. Voice, data and video can be simultaneously transmitted on one line from a source.

"ISO" means International Standards Organization. Founded in 1946, ISO is an international organization composed of national standards bodies from over 75 countries. ISO has defined a number of important computer standards, the most significant of which is perhaps is OSI (Open Systems Interconnection), a standardized architecture for designing networks.

"ISP" means an Internet Service Provider.

"ITU" means International Telecommunications Union, which is an intergovernmental organization through which private and public organizations develop telecommunications. The ITU was founded in 1865 and became a United Nations agency in 1947 and it is responsible for adopting international tax treaties, regulations and standards governing telecommunications.

"IXC" means an inter-exchange carrier, a long distance telephone company or a carrier that specializes in connecting central offices of local service providers. This carrier typically does not offer services to end users. AT&T, MCI and Sprint are IXCs. A carrier that provides the backbone of competitive local exchange carriers can also be considered as an IXC. Therefore, an IXC can provide service in both metropolitan and in long haul networks.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

"LAN" means a Local Area Network and is a high-speed communications system designed to link computers for the purpose of sharing files, programs and various devices such as printers and high-speed modems within a small geographic area such as a workgroup, department or single floor of a multi-story building. LANs may include dedicated computers or file servers that provide a centralized source of shared files and programs.

"MSO" means a Multiple Service Operator which is typically a cable TV operator that offers multiple services such as video, voice and data.

"Multiplexing" means a process that combines a number of lower speed data transmissions into one high-speed data transmission by splitting that total available bandwidth into narrower bands (frequency division) or by allotting a common channel to several different transmitting devices one at a time in sequence (time division). The opposite function of separating the data channels into their original format is called demultiplexing.

"OC-1, OC-3, OC-12, OC-48, OC-192" means the SONET bit rates of 51.85Mbps, 155 Mbps, 622 Mbps, 2.5 Gbps and 10Gbps transmission speeds for signals over fiber optic cables. The number in the end of the term corresponds to the equivalent multiple of OC-1 capacity (e.g., OC-192 means equivalent to 192 times OC-1)

"OEMs" means original equipment manufacturers.

"Opto-Electro-Optical" means Optical-Electrical-Optical which describes the conversion of optical signals to electric and back to optical. Typically, devices performing this function in the electrical domain and the signals need to be converted back to optical for transmission over optical fibers.

"Packet" means the "envelope" in which the network software places a message being sent from one station to another station in a network. One of the key features of a packet is that it contains the destination address in addition to the data.

"POTS" means "plain old telephone service" which refers to the standard telephone service over copper lines that most homes use. In contrast, telephone services based on high-speed, digital communications lines, such as ISDN and FDDI, are not POTS. The main distinction between POTS and non-POTS services is speed and bandwidth. POTS is generally restricted to about 52Kbps.

"Protocol" means a standard developed by international standards bodies, individual equipment vendors, and ad hoc groups of interested parties to define how to implement a group of services in one or more layers of the OSI model. The Open Systems Interconnect ("OSI") reference model was developed by the ISO to define all the services a LAN should provide. Ethernet and Token Ring, for example, are both protocols that define different ways to provide the services called for in the Physical and Data Link Layers of the OSI model.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

"PTT" means Postal, Telephone and Telegraph, and refers to a generic telephone company outside the United States. Typically, a PTT is state owned and can operate both local and long distance services.

"RBOC" means a Regional Bell Operating Company.

"Router" means a network translator that reads network-addressing information within packets to provide greater selectivity in directing traffic over multiple network segments. It is a more complex inter-networking device.

"SDH" means Synchronous Digital Hierarchy which is transmission protocol for high speed transmission over fiber optic cable published in 1988 by the Consultative Committee for International Telegraph and Telephony. It a hierarchy similar to SONET but in this case the lowest bit rate channel is STM-1 (155 Mbps).

"SONET" means a transmission protocol for high-speed transmission over fiber optic cable, which was introduced by Bell Communications in 1984 and quickly accepted by American National Standards Institute.

"Switch" means a device that allows the network operator to vary and select connections between network nodes at very high speeds.

"T-1" means a dedicated phone connection supporting data rates of 1.544 Mbps. A T-1 line actually consists of 24 individual channels, each of which supports 64Kbps and can be configured to carry voice or data traffic. T-1 lines are sometimes referred to as DS-1 lines.

"TCP/IP" means Transmission Control Protocol/Internet Protocol, which is a suite of protocols used for communications between two or more devices.

"TDM" means time division multiplexing which is a multiplexing process that combines a number of lower speed data transmissions into one high-speed data transmission by allotting a common channel to several different transmitting devices one at a time in sequence.

"Token Ring" means a 4 Mbps or 16 Mbps speed network that uses different technology than Ethernet to co-ordinate the transmission of data among nodes.

"WAN" means a Wide Area Network and is a communications network that connects geographically dispersed users. Typically, a WAN consists of two or more LANs. The largest WAN in existence is the Internet.

### Item 2. Properties.

We recently moved our headquarters to the San Diego, California facility that we own consisting of approximately 36,000 square feet used for offices, research and development and manufacturing. We also own a 47,000 square foot facility in San Diego, California adjacent to our headquarters that is used for offices, manufacturing and customer support.

We occupy an additional 16,860 square feet used for office, research and development and manufacturing activities under lease as detailed below:

Location	Square Footage	Facility Type	Expiration
Santa Monica, California	6,000	Office	April 30,
Fremont, California	5,000	Office/Manufacturing	July 31, 2



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

San Diego, California	3,000	Office/R&D/Manufacturing	n/a - mont
Richardson, Texas	2,860	Office	September

22

We have two sales office located in the United States (San Diego and Richardson), three sales offices located in Europe (The Netherlands, Belgium and Germany) and two sales office located in Asia (China and Singapore) totaling approximately 14,000 square feet. All such offices are leased for varying terms.

We believe that suitable additional space will be available to us, when needed, on commercially reasonable terms. See Note E to the Consolidated Financial Statements contained in Part II herein for terms and amounts of mortgages on the facility we own.

### Item 3. 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 from the Delaware Court of Chancery 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. On January 23, 2002, the Delaware Supreme Court affirmed the granting of the preliminary injunction.

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 claims 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.

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 also believes that these motions are without merit.

Currently, hearings on all pending motions have been taken off calendar at the request of all parties, pending the resolution of ongoing settlement discussions between the Company and the plaintiffs. While the Company is encouraged at the progress of these negotiations, there can be no assurance

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

that a settlement will be reached.

During June 2000, we entered into various agreements with Par Chadha, our former CEO and Chairman, which, among other matters, provides for payments of \$250,000 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, Mr. Chadha exercised 71,112 options, applying the \$500,000 accelerated payment to the exercise. In addition, he exercised 507,388 options for which we are contractually obligated to loan the \$5,034,000 due on the exercise. During September 2001, Mr. Chadha 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 the agreements.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Mr. Chadha returned the 507,388 shares to us for cancellation and we cancelled the receivable due from him and restored the original option agreements. This rescission agreement did not resolve any underlying dispute as to the option loan repayment obligations. We anticipate this dispute will be resolved through binding arbitration. Should

23

Mr. Chadha prevail in the arbitration, the Company may be required to issue him 1,178,500 shares of the Company's stock for no consideration.

In April 2002, our former Chairman and CEO, Dr. Xin Cheng, filed a claim in arbitration seeking, among other things, payment of \$500,000 and acceleration of the vesting of options pursuant to alleged contractual obligations of our Sorrento subsidiary. The Company is disputing these claims.

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

#### Item 4. Submission of Matters to a Vote of Security Holders

Our Annual Meeting of Stockholders was held on February 21, 2002. During the Annual Meeting, the stockholders elected our nominees to the Company's Board of Directors to serve for the term of one year or until their successors have been elected and qualified with each nominee receiving no less than of the total votes cast for the election of directors.

In addition, the stockholders approved the following proposals:

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

	Votes For -----	Votes Against -----	Abstention -----
Ratification of the appointment of BDO Seidman, LLP as auditors	11,111,316	629,573	10,731

24

PART II

Item 5. Market for Company's Common Equity and Related Stockholder Matters.

Our common stock traded on the Nasdaq Small Cap Market under the symbol FIBR since 1994. On December 16, 1998, we commenced trading on the Nasdaq National Market System under the same symbol.

The following table sets forth the high and low closing bid prices for our common stock in the over-the-counter market from February 1, 2000 to January 31, 2002, based upon information obtained from Nasdaq. Quotations represent inter-dealer prices; they do not include retail markups, markdowns, or commissions; and, they may not represent actual transactions.

Fiscal 2000-2001 -----	High ----
Quarter from February 1, 2000 to April 30, 2000	\$144.88
Quarter from May 1, 2000 to July 31, 2000	\$86.00
Quarter from August 1, 2000 to October 31, 2000	\$74.50
Quarter from November 1, 2000 to January 31, 2001	\$40.88

# Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Fiscal 2001-2002  
-----

Quarter from February 1, 2001 to April 30, 2001	\$25.50
Quarter from May 1, 2001 to July 31, 2001	\$16.19
Quarter from August 1, 2001 to October 31, 2001	\$8.02
Quarter from November 1, 2001 to January 31, 2002	\$5.06

On April 30, 2002, the average of the high and low bid quotation for our common stock was \$2.15 per share. There is no assurance that a market in our common stock will continue.

As of April 30, 2002 (the latest practicable date) there were 795 shareholders of record, including brokerage firms and nominees, of our common stock.

We have never paid any cash dividends on our common stock. The present policy of the Board of Directors is to retain all available funds to finance the planned level of operations. In light of the anticipated cash needs of our business, it is not anticipated that any cash dividends will be paid to the holders of our common or preferred stock in the foreseeable future.

## Item 6. Selected Financial Data

The following table sets forth selected consolidated financial data with respect to our five most recent fiscal years ended January 31. The selected consolidated statement of operations data set forth below for each of our three most recent fiscal years, and the selected consolidated balance sheet data set forth at January 31, 2002 and 2001, are derived from our consolidated financial statements which have been audited by BDO Seidman, LLP, independent certified public accountants, as indicated in their report which is included elsewhere in this annual report. The selected consolidated statement of operations data set forth below for each of the two fiscal years ended January 31, 1999 and 1998, and the consolidated balance sheet data set forth below at January 31, 2000, 1999 and 1998 are derived from our audited consolidated financial statements not included in this annual report. The selected consolidated financial data should be read in conjunction with our consolidated financial statements, and the notes thereto including Note A which discusses our significant acquisitions, dispositions and discontinued operations, included elsewhere in this annual report, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7.

	Fiscal Year Ended January 31,			
	2002	2001	2000	1999
	----	----	----	----

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### Statement of Operations Data:

Net sales	\$ 40,827	\$ 44,641	\$ 68,372	\$ 58
Net income (loss) from continuing operations	\$ (43,136)	\$ (41,905)	\$ 2,410	\$ (11)
Net income (loss) per share from continuing operations:				
Basic	\$ (3.10)	\$ (3.71)	\$ 0.17	\$ (
Diluted	\$ (4.36)	\$ (3.71)	\$ 0.15	\$ (
 Balance Sheet Data:				
Cash and cash equivalents	\$ 14,243	\$ 9,965	\$ 13,511	\$ 3
Working capital	5,839	71,993	189,486	11
Total assets	90,339	113,123	223,265	66
Total debt (including short-term debt)	72,122	24,770	20,727	27
Stockholders' equity	18,217	39,733	202,538	38

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Certain statements contained in this Annual Report on Form 10-K, 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 this Annual Report on Form 10-K, as well as the "Financial Risk Management" and "Future Growth Subject to Risks" sections contained herein, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements.

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 to our shareholders' 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 9.2% of Entrada common shares outstanding as of January 31, 2002, and account for this remaining interest as an "available for sale security" which is marked to market at the end of each period. Additional information regarding Entrada is available from its various filings with the Securities and Exchange Commission which are available online at [www.freeedgar.com](http://www.freeedgar.com) and [www.sec.gov](http://www.sec.gov) or from the Securities and Exchange Commission.

#### NETsilicon or NSI

The results of NSI were included in our consolidated results only through September 15, 1999. Additional information regarding NSI is available from its various filings with the Securities and Exchange Commission which

are available online at [www.freeedgar.com](http://www.freeedgar.com) and [www.sec.gov](http://www.sec.gov) or from the Securities and Exchange Commission. See "Results of Operations: Comparison of the Years Ended January 31, 2000 and January 31, 1999."

Results of Operations: Comparison of the Years Ended January 31, 2002 and January 31, 2001.

Net sales. Our consolidated net sales decreased \$3.8 million or 8.5% to \$40.8 million for fiscal 2002 when compared to net sales of \$44.6 million for fiscal 2001. Net sales for our Sorrento Networks Inc., the Company's primary operating subsidiary, increased \$9.6 million or 36% to \$36.0 million for fiscal 2002 as compared to net sales of \$26.4 million in fiscal 2001. Net sales for Meret Optical segment decreased \$1.5 million or 23.8% in fiscal 2002 to \$4.8 million as compared to net sales of \$6.3 million in fiscal year 2001. Entrada Networks, an operating subsidiary which the Company spun-off in August 2000, had a revenues of \$11.9 million in fiscal 2001 whereas no revenues were reported for Entrada Networks in fiscal year 2002.

Gross profit. Cost of sales consists principally of the costs of components, subcontract assembly from outside manufacturers, and in-house system integration, quality control, final testing and configuration costs. Gross margin percent on a consolidated basis decreased to 22.8% for fiscal 2002 from 29.5% in fiscal 2001. Consolidated gross profit was \$9.3 million, a decrease of 29.2% for fiscal 2002 from \$13.2 million for fiscal 2001. Gross margin percent and gross profit were impacted negatively by increases in inventory reserves and sales that were made at lower gross profit than the prior year. Gross profit for our Sorrento subsidiary decreased to \$7.7 million in fiscal 2002, as compared to \$9.1 million in fiscal 2001, a decrease of 16.2%. An increase in inventory reserves accounts for \$3.7 million of the decrease in gross profit. The gross profit of our Meret Optical segment decreased by \$941,000 from the prior fiscal year and was primarily the result of the revenue volume decrease. The remaining change in gross profit related to Entrada Networks.

Selling and marketing. Selling and marketing expenses consist primarily of employee compensation and related costs, commissions to sales representatives, tradeshow expenses and travel expenses. We 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. We expect sales commissions to increase as our sales volume increases since many of our sales personnel earn a portion of their total compensation from commissions based on sales volume. Our consolidated selling and marketing expenses decreased to \$16.2 million, or 39.6% of net sales, for fiscal 2002 from \$17.2 million, or 38.5% of net sales for fiscal 2001.

Engineering, research and development. Engineering, research and development expenses consist primarily of compensation related costs for engineering personnel, facilities costs, and materials used in the design, development and support of our technologies. All research and development costs are expensed as incurred. We continue to manage our research and development

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

costs in relation to the changes in our sales volume and available capital resources in our development efforts to enhance existing products and introduce new products to our product offering. Our consolidated engineering, research and development expenses decreased to \$13.7 million, or 33.4% of net sales, for fiscal 2002 from \$23.9 million, or 53.6% of net sales, for fiscal 2001. The decrease can primarily be attributed to decreases in product development material and personnel related costs.

General and administrative. General and administrative expenses consist primarily of employee compensation and related costs, legal and accounting fees, public company costs, and allocable occupancy costs. Consolidated general and administrative expenses decreased to \$12.7 million, or 31.3% of net sales, for fiscal 2002 from \$18.1 million, or 40.6% of net sales, for fiscal 2001. The decrease in general and administrative expenses can be attributed to reductions in investment banking, professional fees and personnel related costs.

Other operating expenses. Other operating expenses for both fiscal 2002 and 2001 included approximately \$400,000 of amortization of purchased technology related to acquisitions included in Meret. During the fiscal year ended January 31, 2002, we recorded a \$2.7 million valuation allowance against option receivables from our former CEO and Chairman. During the fiscal year ended January 31, 2001, 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.

27

Other income (charges). Other income (charges) from continuing operations decreased to \$6.0 million charges for fiscal 2002 from \$8.5 million income for fiscal 2001. Investment income declined by \$6.9 million during the fiscal year ended January 31, 2002 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 \$2.4 million in interest expense for the fiscal year ended January 31, 2002 from the prior fiscal year is primarily due to the interest incurred on our newly issued convertible debentures which was partially offset by a decline in our short term borrowings. The \$1.9 million of interest on these debentures included the stated 9.75% interest of \$1,309,000 which is paid in common stock, amortization of issuance costs of \$82,000, and amortization of the fair value of the warrants issued to the purchasers and placement agent and the deemed beneficial conversion feature of \$911,000. Other charges increased by \$99,000 during the fiscal year ended January 31, 2002 from the prior fiscal year resulting primarily from favorable gains on foreign currency exchanges. Gains on marketable securities decreased by \$5.1 million for the fiscal year ended January 31, 2002 from the prior fiscal year. Approximately \$4.0 million of this decrease relates to the gain on our sale of NSI shares during the prior fiscal year. The remaining \$1.1 million decrease results from an impairment allowance of \$178,000 on our available for sale investment in Entrada and \$1,020,000 in realized losses on the sale of 1,051,000 shares of Entrada.

Income taxes. There was no provision for income taxes for fiscal years 2002 and 2001. We have carry forwards of domestic federal net operating losses, which may be available, in part, to reduce future taxable income in the United

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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 to \$36.0 million, or 36.1%, for fiscal 2002 from \$26.5 million for fiscal 2001. The increase in net sales was primarily due to an increase in the number of deployments of systems to both new and existing customers. In fiscal 2002, eleven customers accounted for 94.3% of our net sales compared with seven customers which accounted for 91.1% in fiscal 2001. In addition to the number of new customer and existing customer orders achieved in fiscal year 2002, we continued to increase its product offering by enhancements to existing products and the introduction of new products which also contributed to the increase in net sales in fiscal year 2002. We plan to continue to enhance our existing product line and develop new products to increase sales. Our ability to achieve this goal will depend on continued sales and available working capital that can be allocated to our development efforts.

**Gross profit.** Gross profit was \$7.7 million for fiscal 2002, a decrease of 16.2% from \$9.1 million for fiscal 2001. Gross margin decreased to 21.2% of net sales for fiscal 2002 from 34.3% for fiscal 2001. The gross margin percentage decrease resulted from the shipment of lower margin products to multiple customers with long-term purchase commitments or strategic alliance agreements in fiscal 2002 as well as an increase in the valuation allowance recorded against inventory of \$4.0 million.

**Selling and marketing.** Sales and marketing expenses increased to \$15.7 million, or 43.7% of net sales, for fiscal 2002 from \$14.0 million, or 52.8% of net sales, for fiscal 2001. The increase in sales and marketing expenses resulted from increased travel expenses, trade show participation, and advertising expenses. The number of sales and marketing personnel decreased to 38 at January 31, 2002 from 65 at January 31, 2001.

**Engineering, research and development.** Engineering, research and development expenses decreased to \$13.2 million, or 36.7% of net sales, for fiscal 2002 from \$20.4 million, or 77.0% of net sales, for fiscal 2001. The decrease in engineering, research and development expenses was the result of decreased expenditures associated with the decrease in engineering personnel and decreases in employee relocation and recruiting expenses and reduction in material related development expenses. The number of engineering personnel decreased to 67 at January 31, 2002 from 91 at January 31, 2001.

**General and administrative.** General and administrative expenses decreased to \$6.9 million, or 19.0% of net sales, for fiscal 2002 from \$9.0 million, or 34.0% of net sales, for fiscal 2001. The decrease in general and



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

administrative expenses reflects the reduction of executive and administrative personnel and lower operating expenses. The number of general and administrative personnel decreased to 15 at January 31, 2002 from 32 at January 31, 2001.

Deferred and other stock compensation. Deferred and other stock compensation for the fiscal year ended January 31, 2002 includes \$812,000 of amortization of deferred stock compensation resulting from the value of stock options granted to consultants compared to \$1.9 million for the prior fiscal year. In connection with the grants of stock options with exercise prices determined to be below the fair value of our 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 decreased to \$4.8 million, or 23.8%, for fiscal 2002 from \$6.3 million for fiscal 2001. The decrease in net sales was primarily due to changes in product demand in the RF Synthesis product family. The majority of this decrease was recognized in the fourth quarter of this year.

Gross profit. Gross profit decreased to \$1.7 million, or 34.6%, for fiscal 2002 from \$2.6 million for fiscal 2001. Gross margin as a percentage of net sales decreased to 34.8% for fiscal 2002 compared to 41.6% for the comparable period last year. The decrease in the gross margin percentage from the prior year resulted from the reduction in RF Synthesis sales which generates a higher gross margin.

Selling and marketing. Sales and marketing expenses remained basically unchanged at \$435,000, or 9.0% of net sales, for fiscal 2002, compared to \$437,000, or 6.9% of net sales, for fiscal 2001. Major expense changes by category within the sales and marketing function included an increase in commissions to external sales representatives that was offset by reduced personnel costs as a result of reductions in the sales force.

Engineering, research and development. Meret incurred engineering expenses during fiscal 2002 of \$417,000, or 8.7% of net sales compared to \$177,000, or 2.8% for the comparable period last year. The increase for the fiscal year ended January 31, 2002 relates 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 \$200,000, or 4.2% of net sales during fiscal 2002 from \$595,000, or 9.4% of net sales for the comparable period last year. The decrease in general and administrative expenses during fiscal 2002 resulted from reductions in bad debt allowances and bank fees.

### Results of Operations: Comparison of the Years Ended January 31, 2001 and January 31, 2000

Net sales. Our consolidated net sales from continuing operations decreased to \$44.6 million, or by 34.8%, for fiscal 2001 from \$68.4 million for fiscal 2000. Net sales for our Sorrento Networks segment increased by \$14.0 million for fiscal 2001 from fiscal 2000. Net sales for Meret Optical segment decreased by approximately \$682,000 in fiscal 2001 from the same comparable period last year. The remaining change was related to NSI and 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. Gross profit decreased to \$13.2 million, or by 58.5%, for fiscal 2001 from \$31.8

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

million for fiscal 2000. Gross profit for our Sorrento Networks segment increased to \$9.1 million or 28.2% in fiscal 2001 and, our Meret Optical segment decreased by \$242,000. The remaining change was related to NSI and Entrada. Gross margin decreased to 29.5% for fiscal 2001 from 46.5% for fiscal 2000. The decrease in our gross margin during fiscal 2001, resulted from a change in the customer mix for our Sorrento subsidiary. During fiscal 2000, high margin products were being shipped to a single customer. During fiscal 2001, products were being shipped to multiple customers at a lower margin than last year.

29

**Selling and marketing.** Selling and marketing expenses consist primarily of employee compensation and related costs, commissions to sales representatives, tradeshow expenses and travel expenses. We intend to increase expenditures for sales and marketing including the recruitment of additional sales and marketing personnel, the expansion of our domestic and international distribution channels and the establishment of strategic relationships. In addition, we expect sales commissions to increase as we increase our sales volume. Our consolidated selling and marketing expenses increased to \$17.2 million, or 38.5% of net sales, for fiscal 2001 from \$16.9 million, or 24.7% of net sales for fiscal 2000.

**Engineering, research and development.** Engineering, research and development expenses consist primarily of compensation related costs for engineering personnel, facilities costs, and materials used in the design, development and support of our technologies. All research and development costs are expensed as incurred. We expect research and development costs to increase substantially as we continue to develop our technologies and future products. Our consolidated engineering, research and development expenses increased to \$23.9 million, or 53.6% of net sales, for fiscal 2001 from \$11.7 million, or 17.1% of net sales, for fiscal 2000.

**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. Increases in general and administrative expenses are planned as we strengthen our infrastructure to provide sufficient administrative support for the growth of our businesses. Consolidated general and administrative expenses increased to \$18.1 million, or 40.6% of net sales, for fiscal 2001 from \$12.8 million, or 18.7% of net sales, for fiscal 2000.

**Other operating expenses.** Other operating expenses for both fiscal 2001 and 2000 include approximately \$400,000 of amortization of purchased technology related to acquisitions included in Meret. During the fiscal year ended January 31, 2001, 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.

**Other income (charges).** Other net income (charges) from continuing operations decreased to \$8.5 million income for fiscal 2001 from \$12.4 million income for fiscal 2000. During fiscal 2001, we had recognized gains of \$3.7 million on the sales of shares from our investment with one of Sorrento's customers. We also recognized \$1.4 million and \$330,000 in interest income and dividend income

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

respectively. In addition, we had a recognized gain of \$3.9 million related to the sale of a portion of our investment in NETsilicon. These gains were offset by interest expense incurred on borrowings from our lines of credit, short term borrowing facilities and long term debt. During the fiscal year ended January 31, 2000, we recognized a gain of \$14.0 million related to the sale of a portion of our investment in NETsilicon in connection with its initial public offering completed on September 15, 1999.

Income taxes. There was no provision for income taxes for fiscal years 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 to \$26.5 million, or 112.0%, for fiscal 2001 from \$12.5 million for fiscal 2000. The increase in net sales was primarily due to an increase in the deployments of our systems by new and existing customers. In fiscal 2001, seven customers accounted for 91.1% of our net sales compared with three customers accounting for 88.4% in fiscal 2000.

Gross profit. Gross profit increased to \$9.1 million, or 28.2%, for fiscal 2001 from \$7.1 million for fiscal 2000. Gross margin decreased to 34.3% of net sales for fiscal 2001 from 56.8% for fiscal 2000. The gross margin percentage decrease resulted from the shipment of higher margin products to a single customer in fiscal 2000 and lower margin product shipments to multiple customers with long term purchase commitments or strategic alliance agreements in fiscal 2001.

30

Selling and marketing. Sales and marketing expenses increased to \$14.0 million, or 52.8% of net sales, for fiscal 2001 from \$5.6 million, or 44.8% of net sales for fiscal 2000. The increase in sales and marketing expenses resulted from personnel additions to the sales and marketing staff, increased travel expenses, trade show participation, and advertising expenses. This increase is also attributable to expenses related to the opening of five foreign sales offices located in China, Singapore, Germany, Belgium and the United Kingdom. The number of sales and marketing personnel increased to 65 at January 31, 2001 from 30 at January 31, 2000.

Engineering, research and development. Engineering, research and development expenses increased to \$20.4 million, or 77.0% of net sales, for fiscal 2001 from \$3.4 million, or 27.2% of net sales, for fiscal 2000. The increase in engineering, research and development expenses was the result of increased expenditures associated with the continuing development of our existing products as well as future technologies, increases in engineering personnel and, increases in employee relocation and recruiting expenses. The number of engineering personnel increased to 91 at January 31, 2001 from 23 at January 31,

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

2000.

General and administrative. General and administrative expenses increased to \$9.0 million, or 34.0% of net sales, for fiscal 2001 from \$3.8 million, or 30.4% of net sales, for fiscal 2000. The increase in general and administrative expenses reflects the hiring of additional executive and administrative personnel and higher operating expenses necessary to strengthen our infrastructure to support our continuing growth. The number of general and administrative personnel increased to 32 at January 31, 2001 from 16 at January 31, 2000.

Deferred and other stock compensation. Deferred and other stock compensation for the year ended January 31, 2001 includes \$1.7 million of amortization of deferred stock compensation and \$184,000 of expense resulting from the value of stock options granted to consultants. In connection with the grants of stock options with exercise prices determined to be below the fair value of our 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

During the periods prior to January 31, 2000, Meret was an integral portion of the "Optical Networking" business unit which also included Sorrento. As of January 31, 2000, we separated Meret from the Optical Networking business segment. For periods prior to January 31, 2000, amounts reported for the Meret segment of our business may not be indicative of the results of operations that would have resulted had Meret been operated as a stand-alone entity.

Net sales. Net sales decreased slightly to \$6.3 million, or 10.0%, for fiscal 2001 from \$7.0 million for fiscal 2000. The decrease in net sales was primarily due to changes in product demand in the legacy product family.

Gross profit. Gross profit decreased slightly to \$2.6 million, or 10.4%, for fiscal 2001 from \$2.9 million for fiscal 2000. Gross margin as a percentage of net sales increased slightly to 41.6% for fiscal 2001 compared to 41.0% for the same comparable period last year. The increase in the gross margin percentage from the prior year resulted from changes in the mix of products shipped.

Selling and marketing. Sales and marketing expenses decreased to \$437,000, or 6.9% of net sales, for fiscal 2001 from \$1.4 million, or 20.0% of net sales, for the same comparable period last year. Overall selling and marketing expenses decreased as revenue decreased.

Engineering, research and development. Meret incurred engineering expenses during fiscal 2001 of \$177,000. No engineering expenses were incurred during the fiscal year ended January 31, 2000. After Meret's separation from the Optical Networking segment, we increased engineering expenditures to update older products and we will continue to increase engineering spending in the future to support existing as well as new products.

General and administrative. General and administrative expenses decreased to \$595,000, or 9.4% of net sales during fiscal 2001 from \$640,000, or 9.1% of net sales for the same comparable period last year. After Meret's separation from the Optical Networking segment, the need for general and administrative operations was minimal.

#### Liquidity and Capital Resources

We finance our operations through a combination of internal funds, investments and debt and equity financing. At January 31, 2002, our working capital was \$5.9 million including \$28.1 million of investments in marketable securities and \$14.2 million in cash and cash equivalents. In addition, \$48.8 million of Series A Holder's obligation as a result of their exercised right of redemption has been re-classified at year end January 31, 2002, as a current liability as compared to mezzanine in the Company's liability and owner's equity. The Series A liability can only be paid through lawfully available funds that would normally be generated from SNI profitable operations, which the Company does not currently have available or foresee availability in the near future.

The amounts included in our statement of cash flows for fiscal 2001 are not comparable to our fiscal 2000 amounts due to the inclusion of Entrada and NETsilicon for less than a full year. Readers should refer to Entrada's NETsilicon's annual reports on Form 10-K for information concerning Entrada and NETsilicon.

Our operations used cash flows of \$31.8 million during fiscal 2002 as compared to fiscal 2001 wherein the company incurred a cash flow deficit of \$51.7 million from continuing operations. The decrease in cash flows used by operations in fiscal 2002 was primarily the result of decreases in accounts receivable, combined with the increase in reserves for inventory and accounts receivable, the use of stock for the payment of interest on debentures and the loss on sale of marketable securities. This favorable impact on cash used for operations was partially offset by the negative cash impact of the Company's larger net operating loss and the use of cash to decrease our accounts payable. In addition to the foregoing there were less significant changes associated with changes in amortization and depreciation and other current liabilities.

The Company has incurred significant losses and negative cash flows from operations for the past two years. Sorrento Networks, Inc., the Company's principal operating subsidiary has primarily been the operating entity responsible for these high losses and negative cash flows. The losses have been generated as SNI continues to develop its technology, marketing and sales and operations in its effort to become a major supplier of metro and regional optical networks world-wide. The Company has funded its operations primarily by the sale of securities and the issuance of debt. There can be no assurance that similar funding will be available in the future. Further, with the downturn in the economic environment and decreases in capital spending by telecom carriers, the Company anticipates that its current and future revenues will be negatively impacted. As a result, the Company will need to either raise additional capital in the future or substantially decrease its operating costs and capital spending in order to fund its operations. There can be no assurance that our available cash, future funding or reduction in operating costs will be sufficient to fund our operations in the future.

Our standard payment terms range from net 30 to net 90 days. Receivables from international customers have frequently taken longer to collect. For some of the customers of our optical networking products payment is required within 180 days from the date of shipment. In addition, the downturn in the telecom market has impacted many of the telecom carriers ability to purchase or pay for outstanding commitments within standard payment terms. There can be no assurance that either current or future receivables will not be impacted negatively by this economic environment.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

We do not provide long-term financing to customers buying our equipment, however, we did provide long-term equipment financing to an optical networking customer during fiscal 2000 and the purchase agreement with this customer provides for invoiced installation and other deployment expenses not to exceed 10% of the equipment cost. The terms of this financing provide that the customer may convert any balances outstanding longer than 90 days into a level payment 35-month term note at 11% per annum interest. We financed \$3.3 million of receivables, including deployment expenses, during fiscal 2000 for this customer. During the fourth quarter of fiscal 2000 we exchanged \$3.0 million of the then unpaid balance shares of the customer's 8% convertible preferred stock, an approximately 6% interest on a fully diluted basis. The remaining balance of the note and accrued interest of \$344,000 was paid in cash. During fiscal 2000 we made sales of \$5.5 million and reimbursed deployment expenses of \$120,000 to this customer.

In November 2000, we sold all our shares of our investment in one of Sorrento's customers for \$9.9 million and \$320,000 in accumulated, unpaid dividends. Of the total \$10.3 million due from the purchaser, approximately 7.7% or \$787,000 was held in a segregated escrow

32

account for one year. The gain of \$3.7 million on the sale of the shares is included in investment income in the accompanying income statement in fiscal 2001.

During fiscals 2001 and 2000 we made sales of \$5.7 million and \$5.5 million respectively, to this customer under a long-term equipment financing agreement. The purchase agreement with this customer provides for invoiced installation and other deployment expenses not to exceed 10% of the equipment cost. The terms of the financing agreement provide that the customer may convert any balances outstanding longer than 90 days into a level 35-month term note at 11% per annum interest. We financed \$5.9 million, including deployment expenses of \$210,000, during fiscal 2001 for this customer which was paid in full including accrued interest during January 2001. We financed \$3.3 million of receivables, including deployment expenses of \$120,000, during fiscal 2000 for this customer and \$3.3 million of the then unpaid note was exchanged for our equity interest in the customer. The remaining balance of the note and accrued interest of \$344,000 was paid in cash.

Our investing activities during fiscal 2002 used cash flows of \$4.0 million. Cash used in investing activities during fiscal year 2002 included purchases of property and equipment of \$3.2 million and \$900,000 in purchases of other assets. This was offset by \$144,000 of cash received from the sale of marketable securities and other investments. In fiscal 2001 used cash flows in investing activities of \$12.5 million including \$7.0 million in cash balances at Entrada as of August 31, 2000 when it ceased to be a subsidiary, following the merger with Sync Research. We purchased property and equipment of \$14.4 million, invested \$3.3 million in Entrada and \$3.2 million in one of Sorrento's customers. During fiscal 2001, we received \$4.2 million from the sale of 350,000 of our NSI shares and \$819,000 from the purchasers of our discontinued operations. We received \$9.2 million offset by our investment of \$3.2 million from the investment in one of Sorrento's customers and payment of \$1.8 million on a note receivable. Our financing activities during fiscal 2002 provided the

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Company \$40.1 million and consisted primarily of financing activities from the sale of common stock in March, 2001 of 1,525,9995 shares which generated proceeds of \$9.6 million and a convertible debenture financing in August, 2001 which raised \$29.7 million. In addition to the sale of common stock and convertible debentures, the Company received \$1.1 million from proceeds of stock option and warrant exercises of \$.9 million and long term debt of \$.02 million. Offsetting these amounts were repayments of short-term and long term debt of \$.3 million.

In fiscal 2001 the Company provided cash flows of \$60.6 million which consisted primarily 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 its common stock, \$3.9 million in proceeds from option and warrant exercises, \$2.4 million in proceeds from long term debt offset by repayments of short and long term debt. The financing activities of continuing operations during fiscal 2000 provided cash flows of \$14.3 million which consisted primarily of \$6.9 million in net proceeds from a private placement of our common stock, and \$8.2 million in proceeds from option and warrant exercises offset by preferred stock dividends paid in cash and treasury stock purchases.

We have a line of credit which totals \$2.0 million which was reduced to \$1.0 million subsequent to January 31, 2002. Outstanding borrowings against this lines of credit were \$1.0 million at January 31, 2002. Our credit line is collateralized by accounts receivable, inventory and equipment.

During fiscal 2000 we completed one sale of our common stock receiving net proceeds of \$6.9 million and issued 1,048,440 shares of our common stock in conversions of preferred stock issued in prior years. At January 31, 2000 the liquidation preference of the outstanding preferred stock is \$6.5 million and none of the shares are currently convertible. (See Notes I and J to the Consolidated Financial Statements contained in Part II herein.)

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 Sorrento 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.

In April, 2001 a majority of Series A Shareholders exercised their right to redeem the Series A Preferred Stock. Such request can only be made out of funds deemed to be lawfully available or for sale pro rata portion as to which a lesser amount of lawfull available funds would exist. The Company at the current time does not have such funds which would normally be generated from operating profits of the subsidiary, Sorrento Networks, Inc.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

On August 31, 2000, we completed a merger of Entrada with Sync Research, Inc., 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 we owned 48.9% of Entrada Networks and we have accounted for our interest on our balance sheet at cost as of January 31, 2001.

On December 1, 2000, we distributed 3,107,155 of our Entrada shares 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 January 31, 2001 we distributed 20,182 of our Entrada shares upon the exercise of options and as of January 31, 2001 have reserved 1,080,283 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.

We anticipate that our available cash resources, and marketable securities available for sale together with any necessary cost reductions 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 planned growth, hiring and infrastructure needs. There can be no assurances that our working capital requirements will not exceed our ability to generate sufficient cash internally to support our requirements and that external financing will be available or that, if available, such financing can be obtained on terms favorable to us and our shareholders.

### Critical Accounting Policies and Estimates

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

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



o Inventory is evaluated on a continual basis and reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value and charged to operations in the period in which the facts that give rise to the adjustments become known.

o Accounts receivable balances are evaluated on a continual basis and allowances are provided for potentially uncollectable accounts based on management's estimate of the collectability of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of their ability to make payments, an

34

additional allowance may be required. Allowance adjustments are charged to operations in the period in which the facts that give rise to the adjustments become known.

#### 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.

#### 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. Restatement 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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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 purpose 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.

### Other Matters

See Item 3. "Legal Proceedings" contained herein.

### Item 7A. 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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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.

Item 8. Financial Statements and Supplementary Data.

The information required by Item 8 is set forth in Item 13 of this Form 10-K.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

36

### PART III

Item 10. Directors and Executive Officers of the Company

On April 30, 2002, the Company's directors and executive officers were:

Name	Age	Position
----	---	-----

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Phillip W. Arneson	65	Chief Executive Officer, President, and Chairman of the Board (ii)
Xin Cheng, Ph.D.	46	Director
Donne F. Fisher	63	Director (i), (ii)
Robert L. Hibbard	49	Director (i), (ii)
Gary M. Parsons	52	Director (i)
Joe R. Armstrong	53	Chief Financial Officer
Christopher E. Sue	39	Vice President, Finance
Richard L. Jacobson	59	Sr. Vice President, Legal and Secretary
Sunil Rajadhyksha	48	President, Meret Communications, Inc.

- (i) member of the Audit Committee
- (ii) member of the Compensation Committee

The Company's By-Laws provide that the members of the Board of Directors be elected annually by the Shareholders of the Company for one-year terms. Each director who is not an employee of the Company or its subsidiaries receives \$1,000 for each Board of Directors or committee meeting attended. Directors who serve as the chairman of a committee receive an additional \$500 for each committee meeting attended. The Board of Directors has two committees: Audit and Compensation. There are no family relationships between any directors and officers.

Phillip W. Arneson, 65, has been President and Chief Operating Officer since October 2001 and has served as one of our directors since October 2000. From 1996 to 2001, Mr. Arneson held the position of Executive Vice President for privately held Frandsen Corporation, a diversified financial and manufacturing company where he was responsible for growing the enterprise through acquisitions, internal growth, and strategic partnerships. Additionally, he served as President of two of its operating companies. Mr. Arneson has served several public and private technology companies in executive management, holding positions as Chief Executive Officer, President and Group Vice President as well as having extensive experience as a director of such companies. From 1982 to 1986, he served as Executive Vice President of Allied Signal's Electronic Sector and from 1983 to 1986 as Chief Executive Officer of its subsidiary, Amphenol Corp. In 1986, Mr. Arneson's technology group garnered the prestigious IR-100 award for the development of an integrated fiber optics phase modulator. Mr. Arneson holds a B.S. in Electrical Engineering from the University of Minnesota's Institute of Technology.

Xin Cheng, Ph.D., 45, was our Chairman and Chief Executive Officer from September 2000 to March 2002. He was the President and a director of the Company from September 1995 to March 2002, and was Secretary from June 1993 to February 1997. Dr. Cheng served as the Chief Executive Officer and Chairman of Sorrento Networks Inc., and Meret subsidiaries for fiscal 2002. In 1995, Dr. Cheng founded the optical networking division of the Company. From 1988 to 1990, Dr. Cheng served as Senior Staff Scientist and from 1990 to 1993 as a Director of Advanced Technology for Amoco Technology Company, a photonics technology development company and a subsidiary of Amoco Oil Corporation. While at Amoco, Dr. Cheng led their development of the WDM-based fiber optic high-resolution computer graphics link, a high-dynamic range microwave fiber optic system, a fiber optic HDTV transmission system, multiple fiber optic serial digital video transmission systems as well as other technologies. Dr. Cheng holds a Ph.D. and M.S. in Electrical Engineering from the University of California, Irvine, and a B.S. degree in Physics from Nanjing University, China.

Donne F. Fisher, 63, has served as one of our directors since November 2001 and is chairman of our Audit Committee. Mr. Fisher is currently President of Fisher Capital Partners, Ltd., a private venture capital and

investment company he founded in 1991. From 1982 to 1996, Mr. Fisher held various executive officer positions with Tele-Communications, Inc. ("TCI") and its subsidiaries including Executive Vice President and Treasurer. He was a TCI director from 1980 until 1999 when TCI merged into AT&T Corporation. Since his retirement in 1996, Mr. Fisher has been a consultant to TCI, now AT&T Broadband. Mr. Fisher also serves as a director of Liberty Media Corporation, a former subsidiary of AT&T, and General Communications, Inc., a diversified telecommunications provider.

Robert L. Hibbard, 49, has served as one of our directors since November 2001. Mr. Hibbard is an attorney and management consultant in private practice in which he handles a wide variety of commercial matters including technology licensing and the structuring of merger and acquisitions transactions. From 1997 to 1999, Mr. Hibbard was Chief Executive Officer of Kim Technologies International, Inc., a privately held developer of electromechanical "super" capacitors for wireless applications. From 1994 to 1997, Mr. Hibbard was Vice President and General Counsel at Allied Signal Engines, and from 1987 to 1994, Assistant General Counsel at Allied Signal Aerospace. Mr. Hibbard was a director of Amphenol Corporation, a developer and manufacturer of connectors and interconnect systems.

Gary M. Parsons, 52, has served on our Board of Directors since October 2000. Since 1996, Mr. Parsons has held the position of Chairman of the Board for XM Satellite Radio Holdings, Inc., and in October 2001 was named Chairman and Chief Executive Officer of Mobile Satellite Ventures, LLP. From 1996 to April 2002, Mr. Parsons served in a variety of executive positions, including Chairman of Motient Corporation, a wireless data firm. On January 10, 2002, Motient filed a voluntary bankruptcy petition, and emerged restructured on May 1, 2002. From 1990 to 1996, Mr. Parsons held a number of executive positions at MCI Communications, Inc., including Executive Vice President, Chief Executive Officer of MCImetro, Inc., and President of MCI's Southern Division. From 1984 to 1990, Mr. Parsons held the responsibilities of Executive Vice President at Telecom\*USA, a fiber-optic and long distance venture subsequently acquired by MCI. Mr. Parsons holds a B.S. in Electrical and Computer Engineering from Clemson University and a MBA from the University of South Carolina.

Joe R. Armstrong has served as our Chief Financial Officer since January 2001. He brings over 25 years of corporate finance, investor relations, treasury, legal and management experience to the Company, having spent 15 years with State Of The Art, a leading provider of accounting software. As chief financial officer, vice president, finance and secretary of State Of The Art, he managed two rounds of venture capital financing, the company's initial public offering and several significant acquisitions and mergers. Prior to joining us, Mr. Armstrong most recently served as CFO for The Bohlin Company. Previously, he was director of marketing finance and financial planning for MAI Basic Four Corporation and a certified public accountant for Vicenti, Lloyd and Stutzman, a regional public accounting firm. Mr. Armstrong holds both bachelors and masters degrees in business from Utah State University.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Christopher E. Sue has been our Vice President, Finance since September 1997. From January 1996 to September 1997, he served as Osicom's Chief Financial Officer. Mr. Sue served as Secretary of Osicom from February 1997 to September 1997 and from November 1998 to March 2000. Mr. Sue has served as Meret's Chief Financial Officer since December 1995. From 1993 to 1995, he was Accounting Manager at Haskel International, Inc., and from 1990 to 1993 he was Assistant Controller at Sun Computers, Inc. From 1986 to 1990, Mr. Sue was employed by KPMG Peat Marwick in both its audit and management consulting practices. Mr. Sue is a certified public accountant and holds a B.S. in Accounting and Information Systems from Biola University. Mr. Sue has resigned from his position effective May 17, 2002.

Richard L. Jacobson has been our Senior Vice President, Legal and Secretary since July 2000. Mr. Jacobson was a partner with the law firm of Fulbright & Jaworski, LLP from 1990 to 2000 where his practice consisted primarily of securities litigation and SEC enforcement matters. Prior to joining Fulbright in 1988 he was in private practice in Palo Alto, California, from 1986 to 1988, and in Washington, D.C., from 1980 to 1986. From 1977 to 1979, Mr. Jacobson worked for the SEC, where he was a member of the Trial Unit in the Enforcement Division and served as Special Counsel to the Chairman. He served as a law clerk for Ninth Circuit Judge Walter Ely from 1970 to 1971 and then clerked for Associate United States Supreme Court Justice William O. Douglas from 1971 to 1972. Mr. Jacobson holds a J.D. from the University of Southern California and a S.B. from the University of Chicago.

Sunil Rajadhyksha has served as President and Chief Operating Officer of our Meret Optical business unit since January 2002. From October 2000 to January 2002, he served as Meret's Technology Director. From 1997 to

38

September 2000, Mr. Rajadhyksha provided engineering and software design services to Osicom as a consultant including embedded and network management software projects both directly and through a private company, Codec Corporation, which he founded in 1997. He is currently a director of Codec. Mr. Rajadhyksha was the founder and managing director of Software Exports Pvt. Ltd., a foreign private software development company from 1996 to 2000. He is a of director Codec Communications Pvt. Ltd., a foreign private software development company, which he founded in 1991 and also of Embedded Resource Pvt. Ltd., a foreign private software development company specializing in embedded software, which he founded in 1998. Mr. Rajadhyksha has over twenty years of technical and management experience in networking software, hardware and telecommunications. Mr. Rajadhyksha holds a B.S. from University of Pune in telecommunications and electronics.

Our other key employees, all of whose positions are with our Sorrento subsidiary, include:

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Name ----	Age ---	Position -----
Darin Clause	33	Vice President, Strategic Sales
Subrata Datta	39	Vice President, Engineering
Demetri Elias, Ph.D.	58	Vice President, Marketing
Susan Hamlin	39	Vice President, Sales (North America)
Jin-Yi Pan, Ph.D.	42	Vice President, Systems Architecture
Mark Thurman	52	Vice President, Operations
Li-Ran Wu	49	Vice President, Management Software
Jeff Phillips	32	Vice President, Corporate Development

Darin Clause has served as Sorrento's Vice President, Strategic Sales since September 2000 and joined us in December 1999 as Director, Sales Development. Prior to joining us, Mr. Clause was employed with Pirelli as a Senior Product Manager from 1996 to 1999, where he was responsible for implementation of indoor cabling and connectivity business lines for the CATV, CLEC, Utility and IXC markets and multiple channels. From 1994 to 1996, Mr. Clause was a Project and Sales Engineer for Sumitomo Electric Lightwave, where he was responsible for fiber optic passive component sales. Mr. Clause holds a B.S. in Mechanical Engineering from Clemson University.

Subrata Datta has served as Sorrento's Vice President, Engineering since November 2000 and joined Sorrento upon our acquisition of Distributed Systems International, Inc. in 1996. From 1996 to 1999 he was responsible for all engineering development for the LAN adapter and hub/switch products. Prior to joining Sorrento, Mr. Datta helped develop the ANSI FDDI and FDDI-II standards and design network components and system-level products for DSI. Prior to DSI, Mr. Datta had extensive design experience while working at AT&T Bell Laboratories on the 3B20 Duplex computer system, based on highly fault tolerant architectures, high-reliability and stringent up-time requirements. Before working for AT&T Bell Laboratories, Mr. Datta worked for IBM's Yorktown Research Center where he focused on FDDI development for their RS6000 workstation systems. Mr. Datta holds a M.S. and B.S. in Electrical Engineering from the Cooper Union School of Engineering.

Demetri Elias, Ph.D. has served as Sorrento's Vice President, Marketing since October 2000 and joined Sorrento in April 2000 as Director, Product Line Management. Prior to joining Sorrento, Dr. Elias was with Nortel Networks, a leading optical equipment developer, for over 22 years holding positions in research and development, consulting, product management and marketing. In his most recent Nortel Networks assignments he served as Director, Product Line Management and Director, Strategic Marketing on optical networking products. Dr. Elias holds a Ph.D. in Electrical Engineering from McGill University, Montreal, Canada.

Susan Hamlin has served as Sorrento's Vice President, Sales (North America) since September 2000 and joined Sorrento in November 1999 as Regional Vice President of Sales. Ms. Hamlin is also responsible for Sorrento's customer service group. During her tenure at Pirelli Cables and Systems, Ms. Hamlin was Director of Sales from 1998 to 1999 and responsible for overseeing sales to CATV, CLEC, Utility and IXC markets. From 1997 to 1998, Ms. Hamlin was National Sales Manager - Distribution at Pirelli where she established and implemented Pirelli's sales efforts into the distribution and OEM markets. From 1985 to 1996, Ms. Hamlin held a succession of sales and marketing management positions with AT&T/Lucent Technologies where she was responsible for strategic planning, market development and sales to the Regional Bell Operating Companies. Ms. Hamlin holds a B.S. in

Management Information Systems from Bradley University in Peoria, Illinois and completed executive management programs at Harvard University and the Wharton School of Business.

Jin-Yi Pan, Ph.D., has served as the Vice President, System Architecture, of Sorrento since February 2000. From 1996 to 1999, Dr. Pan was a senior research engineer at Nokia Research Center, the corporate research arm of Nokia Corporation responsible for developing networking system architectures, equipment and software. From 1993 to 1996, Dr. Pan served as a researcher at Bell Communications Research, or Bellcore, the research center created to service the regional bell operating companies in the areas of software, networking standards and architecture. At Bellcore, he participated in the development of network system architecture and protection scheme for MONET, the government funded national optical networking consortium. Dr. Pan holds a Ph.D. in Electrical Engineering from the City University of New York and a B.S. in Optics from Zhejiang University, China.

Marc Thurman has served as Sorrento's Vice President, Operations since April 2001. Mr. Thurman oversees our manufacturing and operations, supply chain management, and quality assurance functions. He brings to us nearly 25 years of manufacturing operations, supply chain management and quality assurance experience on leading edge technologies and products for the computer and telecommunication markets. Mr. Thurman's previous experience includes service since 1971, in various functions at Packard Bell NEC, ComCrypt Systems, IDEA Courier, Inc., Sidereal Corporation, Intel Corporation, RTE Corporation, and Western Electric. In his most recent position, Mr. Thurman had manufacturing responsibilities including internal production, contract manufacturing (EMS) and third party manufacturing (TPM), supporting revenues of \$2 billion. Mr. Thurman holds a B.S. in Electrical Engineering from Oregon State University as well as an M.B.A. degree from University of Portland.

Li-Ran Wu has served as Sorrento's Vice President, Management Software since November 2000 and joined Sorrento in October 1999. Before joining Sorrento, Mr. Wu was a senior consultant and Lead Systems Engineer at Hitachi Telecom where he developed second-generation SONET equipment to complement WDM and OXC products within the OTN. He also developed the WDM information model that was published in 1998. Prior to working at Hitachi, Mr. Wu was with Nortel Networks, Racal Datacom and Taiwan Telecom. While at Nortel he developed a SONET UPSR-based communication messaging protocol. Mr. Wu holds an M.S. in Electrical Engineering from North Carolina State University and a B.S. in Computer Science from Chiao Tung University. He has also completed work on his doctoral thesis at the Georgia Institute of Technology.

Jeff Phillips has served as Sorrento's Vice President, Corporate Development since January 2001. From 1995 to 2000, Mr. Phillips was a Vice President at US Bancorp where he focused on financing for telecom related technology concerns and advisory assignments. Prior to joining US Bancorp, Mr. Phillips was a financial analyst/strategist with Hillebrand GmbH, a European investment group.



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Mr. Phillips began his career as a floor trader at the London International Financial and Futures and Options Exchange (LIFFE) where he focused on Deutsche Mark denominated financial derivatives. Mr. Phillips holds a B.A. in Economics from the University of California at Berkeley.

40

### Item 11. Executive Compensation

The following tables set forth the annual compensation for the Company's Chief Executive Officer ("CEO") for the fiscal year ended January 31, 2002, and for the four most highly compensated executive officers of the Company, other than the CEO, who were serving as executive officers at the end of our fiscal year and whose salary and bonus exceeded \$100,000.

Summary Compensation Table

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation	
		Salary (\$)	Bonus (\$)	Other Annual Compensation (\$)	Restricted Stock Award(s) (\$)	Securities Underlying Options (#)
Xin Cheng, Chairman, (C) Chief Executive Officer	2002	250,291	-	-	-	-
	2001	239,217	-	-	-	175,000
	2000	180,000	8,365	-	-	100,000
Christopher E. Sue, VP (D) Finance	2002	168,500	-	-	-	-
	2001	155,880	-	-	-	110,000
	2000	134,904	27,947	-	-	15,000
John A. Mason, Sr. VP (E) Business Development President, Sorrento Europe	2002	200,000	-	-	-	-
	2001	151,878	-	-	-	42,500
Richard L. Jacobson, Sr. VP Legal and Secretary	2002	251,802	-	-	-	-
	2001	140,850	-	-	-	154,000
S. Rajadhyskha, President Meret	2002	192,055	-	-	-	-

(A) Other compensation for Mr. Sue represents vacation accrual buy-out,

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

- (B) Other compensation for Mr. Jacobson represents relocation related expenses reimbursed by us.
- (C) Employment with the company ended on March 1, 2002
- (D) Mr. Sue resigned from the Company effective May 17, 2002
- (E) Mr. Mason resigned from the Company in March 2002

### Long-Term Incentive Plans

The Company has no long-term incentive plans other than our various stock option plans.

41

### Option Grants - Year Ended January 31, 2002

There were no option grants or shares acquired on exercise of options for the year ended January 31, 2002 for any of the Named Executive Officers.

The following table sets forth information concerning each exercise of stock options during the year ended January 31, 2002 by each of the Named Executive Officers and the January 31, 2002, value of unexercised options.

### Aggregated Option Exercises in Fiscal Year 2002 and January 31, 2002 Option Values

Name -----	Shares Acquired On Exercise (#) -----	Value Realized (\$) -----	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#)		Value of U In-the-Mon at Fiscal Ye ----- Exercisable -----
			----- Exercisable -----	----- Unexercisable -----	
Xin Cheng	-	-	478,001	-	-
Christopher E. Sue	-	-	181,999	-	-
John A. Mason	-	-	105,001	-	-
Richard L. Jacobson	-	-	154,000	-	-
Sunil Rajadhyksha	-	-	35,000	-	-

(A) Options are "in-the-money" if, on January 31, 2002, the market price of the

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Common Stock (\$3.58) exceeded the exercise price of such options. The value of such options is calculated by determining the difference between the aggregate market price of the Common Stock covered by such options on January 31, 2002, and the aggregate exercise price of such options.

### Employment Agreements

In September 2001, we entered into an employment agreement effective October 2001 with Mr. Arneson which provides for a salary of \$210,000 per year, a signing bonus of \$30,000 paid in six monthly installments, a temporary living allowance of \$2,000 per month for two years and 125,000 options to acquire our common stock vesting over two years. This agreement may be terminated for cause. However, should Mr. Arneson be terminated without cause during the first year of employment he will receive a lump-sum severance payment of six month's salary and vesting of all his options. The lump-sum severance payment increases to one year's salary after the first anniversary of his employment with us. In the event of a change of control, merger or sale of the Company, Mr. Arneson is entitled to receive an immediate payment equal to one year's salary and vesting of all his options.

Further, on March 1, 2002 Mr. Arneson assumed the role of Chairman, President and Chief Executive Officer of the Company. On April 30, 2002, our Board of Directors approved an employment agreement with Mr. Arneson regarding the terms of his employment as Chairman, Chief Executive Officer and President. The agreement provides for an annual compensation of \$250,000. The agreement also calls for the vesting, as of March 1, 2002, of the 125,000 options granted Mr. Arneson on September 17, 2001, and the granting of 475,000 additional stock options at a strike price equal to the closing price of the Company's common stock on Nasdaq on March 1, 2002, which shares are to vest at the rate of 20,000 shares per month beginning on April 1, 2002, continuing for 12 months, when 100,000 additional shares vest, and beginning on May 1, 2003, 22,500 shares will vest each month. This grant is also entitled to antidilution protections if certain categories of events occur on or before December 31, 2002. The employment is at will; however, if Mr. Arneson should be terminated without cause or resign in certain circumstances, he would receive a lump sum severance payment of two years' base salary and vesting of all stock options, and he would be required to provide exclusive consulting services for two years following his termination. The agreement also calls for the reimbursement of living expenses at the rate of \$2,750.00 per month while Mr. Arneson remains employed.

On January 25, 2002, the then Board of Directors of Meret Optical Communications, Mr. Cheng and Mr. Sue, approved an employment agreement with Mr. Rajadhyksha appointing him President of Meret and raising his

annual salary to \$210,000 per year. In addition to the increase in salary there were provisions for severance benefits based upon termination without cause or change in control of the Company. Severance benefits for termination without cause or change in control provisions allow Mr. Rajadhyksha to receive a lump sum payment of up to one year's salary and the vesting of all his options to acquire the Company's common stock.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

On March 1, 2002 Dr. Cheng's employment with the Company ended. In April 2002, Dr. Cheng filed a claim in arbitration seeking, among other things, payment of \$500,000 and acceleration of the vesting of options pursuant to alleged contractual obligations of our Sorrento subsidiary. The Company is disputing these claims.

The Board of Directors of Osicom approved a two-year employment contract with Mr. Mason ending May 2002, which provided for a base salary of \$130,900 per year and vesting of all his options to acquire our common stock granted prior to February 1, 2000. This contract may be terminated for cause. However, should Mr. Mason be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his base salary and benefits for two years, vesting of all his options to acquire our common stock, and he is required to provide consulting services to us during the two years following his termination. In March 2002 Mr. Mason notified the Company that he was resigning with cause, relying on an agreement between Mr. Mason and Dr. Cheng in April 2001 that allowed him to resign for cause at any time prior to the expiration of his employment agreement as a result of having been relocated more than 35 miles from his prior employment location. Mr. Mason's resignation under these circumstances entitled him to receive two year salary and benefit continuation and immediate stock vesting.

The Board of Directors of Osicom approved a two-year employment contract with Mr. Sue ending May 2002, which provides for a salary of \$168,500 per year and the vesting of all his options to acquire our common stock granted prior to February 1, 2000. This contract may be terminated for cause. However, should Mr. Sue be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his salary and benefits for two years, vesting of all his options to acquire our common stock and he is required to provide consulting services to us during that period. On May 8, 2002 Mr. Sue resigned from his position effective May 17, 2002 alleging entitlement to the foregoing salary continuation and other benefits. The Company does not believe Mr. Sue is entitled to any such benefits.

The Board of Directors of Osicom entered into a two-year contact with Anne Wallace, Director of Financial Reporting, ending May 22, 2002 which provided her compensation of \$200,000 per year, plus benefits and living expenses while on location at the Company's Santa Monica facility. This contract may be terminated for cause. However, should Ms. Wallace be contact be terminated without good reason, or if she resigns for good reason, she will receive a continuation of compensation and benefits for two years, and vesting of all her options to acquire our common stock. On May 8, 2002 Ms. Wallace gave notice to the Company that she has resigned for good reason, thus alleging entitlement to the foregoing compensation and benefits. The Company does not believe Ms. Wallace is entitled to any such benefits.

The Board of Directors of Osicom entered into a two-year employment contract with Mr. Nimrod Johnson, Corporate Controller, ending May 22, 2002, which provides for a salary of \$97,307 per year and the vesting of all his options to acquire our common stock. This contract may be terminated for cause. However, should Mr. Johnson be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his salary and benefits for two years, vesting of all his options to acquire our common stock and he is required to provide consulting services to us during that period. On May 9, 2002 Mr. Johnson resigned from his position effective May 17, 2002 alleging entitlement to the foregoing salary continuation and other benefits. The Company does not believe Mr. Johnson is entitled to any such benefits.

The Board of Directors of Osicom approved a two-year employment contract with Mr. Jacobson ending in July 2002, which provides for a salary of \$250,000

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

per year. This contract may be terminated for cause. However, should Mr. Jacobson be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his salary and benefits for two years, vesting of all his options to acquire our common stock, and he is required to provide consulting services to us during two years following his termination.

43

On September 30, 2001, we executed a two year consulting agreement with Leonard Hecht whereby Mr. Hecht is be paid a salary at \$250,000 per year plus benefits and the vesting of all his options to acquire our common stock.

In September 2000, the Company's Board of Directors approved a two year consulting agreement with Rohit Phansalkar whereby he is paid a salary of \$250,000 per year plus benefits and the vesting of all his options to acquire our commons stock.

Compliance with Section 16(a) of the Exchange Act

Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires the Company's directors and executive officers and persons who own more than ten percent of a registered class of the Company's equity securities to file reports of beneficial ownership and changes in beneficial ownership with the Securities and Exchange Commission (the "Commission"). The rules promulgated by the Commission under Section 16(a) of the Exchange Act require those persons to furnish the Company with copies of all reports filed with the Commission pursuant to Section 16(a).

Based solely upon a review of Forms 3, Forms 4 and Forms 5 and amendments thereto furnished to us pursuant to Rule 16(a)(3)(e) during the year ended January 31, 2002, and written representations of certain of our directors and officers that no Forms 4 were required to be filed, we believe that all directors, executive officers and beneficial owners of more than 10% of the Common Stock have filed with the Commission on a timely basis all reports required to be filed under Section 16(a) of the Exchange Act.

44

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### Item 12. Security Ownership of Certain Beneficial Owners and Management

The following table sets forth certain information as of April 30, 2002, regarding the ownership of the Common Stock by (i) each Director and nominee for Director of the Company; (ii) each of the present executive officers named in the Executive Officer section above; (iii) each of the executive officers named in the Summary Compensation Table, following; (iv) each person known to the Company to beneficially own 5% or more of Common Stock; and (v) all Directors and executive officers of the Company as a group. Except as indicated, all persons named as beneficial owners of Common Stock have sole voting and investment power with respect to the shares indicated as beneficially owned by them. All persons named have an address at c/o Sorrento Networks Corporation, 9990 Mesa Rim Road, San Diego, California 92121, unless otherwise indicated.

Common Stock ----- Name of Beneficial Owner (A) -----	Number of Shares -----	Percentage of Outstanding Shares (O) -----
Phillip W. Arneson (C)	156,667	
Xin Cheng, Ph.D. (B)	525,735	
Donne F. Fisher (D)	35,000	*
Robert L. Hibbard (E)	35,000	*
Gary M. Parsons (F)	11,667	*
Joe R. Armstrong (G)	63,375	*
Richard L. Jacobson (H)	161,523	*
Christopher E. Sue (I)	173,339	*
John Mason (J)	105,001	*
Sunil Rajadhyksha (K)	21,875	*
Qila, LLC (L)	1,364,549	
15332 Antioch Street		
Pacific Palisades, CA 90272		
All Directors, Nominees and Executive Officers as a Group	1,288,849	

-----  
\* Less than 1%

(A) All information with respect to beneficial ownership of the shares is based upon filings made by the respective beneficial owners with the Securities and Exchange Commission or information provided by such beneficial owners to the Company.

(B) Includes exercisable options held by Dr. Cheng to acquire 426,515 shares of common stock and exercisable options to acquire 51,486 shares of common stock held as custodian or trustee for minor children, as to which beneficial ownership is disclaimed. On March 7, 2000, Dr. Cheng was granted options to acquire 5,000,000 shares of our Sorrento subsidiary's common stock at \$5.45 as the Chairman, CEO and founder of our Sorrento subsidiary. Pursuant to an outstanding conversion offer, Dr. Cheng may elect to convert the Sorrento subsidiary options into options to acquire our common stock at a ratio of 3.9 for 1. Pursuant to the December 1999 stock purchase agreement with FIBR Holdings, LLC the shares of common stock purchased by it including any shares transferred to its members are required to be voted for the nominees recommended by the Board of Directors; in the event FIBR

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Holdings, LLC or its affiliates do not vote for the five nominees proposed, the Board of Directors may do so. As of January 10, 2002 there are 47,704 shares of our common stock held by FIBR Holdings, LLC and its transferee members.

(footnotes continued on next page)

45

(footnotes continued from previous page)

- (C) Includes exercisable options held by Mr. Arneson to acquire 156,667 shares of common stock.
- (D) Includes options to acquire 35,000 shares of common stock held by Mr. Fisher that are exercisable within 60 days. Any shares received upon exercise of these options prior to the November 20, 2002 vesting date are subject to repurchase by the Company. On March 7, 2000, Mr. Fisher was granted options to acquire 100,000 shares of our Sorrento subsidiary's common stock at \$5.45 under its option plan for his services as an advisor to it. Pursuant to an outstanding conversion offer, Mr. Fisher may elect to convert the Sorrento subsidiary options into options to acquire our common stock at a ratio of 3.9 for 1. Mr. Fisher is President of Fisher Capital Partners which holds 183,486 shares of our Sorrento subsidiary's Series A Convertible Preferred Stock. Mr. Fisher is a director of Liberty Media Corporation which owns an 72% economic interest representing a 94% voting interest in UnitedGlobalCom, Inc. ("UGC"). Belmarken Holding, B.V., an indirect subsidiary of UGC, holds 3,027,523 shares of our Sorrento subsidiary's Series A Convertible Preferred Stock. Liberty Media also holds convertible debt of United Pan-Europe Communications, N.V., a subsidiary of UGC, which it has agreed to exchange for additional shares in UGC.
- (E) Includes options to acquire 35,000 shares of common stock held by Mr. Hibbard that are exercisable within 60 days. Any shares received upon exercise of these options prior to the November 13, 2002 vesting date are subject to repurchase by the Company.
- (F) Includes exercisable options held by Mr. Parsons to acquire 11,667 shares of common stock.
- (G) Includes options to acquire 63,375 shares of common stock held by Mr. Armstrong that become exercisable within 60 days.
- (H) Includes exercisable options held by Mr. Jacobson to acquire 152,500 shares of common stock, 333 options that become exercisable within 60 days, and 8,690 shares held in a 401K plan.
- (I) Includes exercisable options held by Mr. Sue to acquire 171,999 shares of common stock that become exercisable within 60 days, and 1,340 shares held in a 401K plan.
- (J) Includes exercisable options held by Mr. Mason to acquire 105,001 shares of

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

common stock that become exercisable within 60 days.

- (K) Includes options to acquire 21,875 shares of common stock held by Mr. Rajadhyksha that become exercisable within 60 days. On March 7, 2000, Mr. Rajadhyksha was granted an option to acquire 400,000 shares of our Sorrento subsidiary's common stock at \$5.45 per share under its option plan for his services as a consultant. Pursuant to an outstanding conversion offer, Mr. Rajadhyksha may elect to convert the Sorrento subsidiary options into options to acquire our common stock at a ratio of 3.9 for 1.
- (L) Represents holdings reported by Qila, LLC and RII Partners, Inc. on January 14, 2002 on Form 13-D, "General Statement of Beneficial Ownership". Includes exercisable options to acquire 757,387 shares of common stock held by R II Partners, Inc., exercisable options to acquire 350,001 shares of common stock held by RT Investments, Inc., 25,334 shares held by the Par and Sharon Chadha Family Trust, and 6,527 shares held by the RRC Pension Trust. Mr. and Mrs. Chadha disclaim ownership in all these shares.
- (M) For each beneficial owner, the "Percentage of Outstanding Shares" equals each owner's actual holdings of shares plus shares represented by unexercised options and warrants held, divided by total shares outstanding of the Company at April 30,, 2002, of 14,543,298 plus the unexercised options and warrants detailed above of the referenced holder only. In other words, individual percentages of the listed holders will not add to the group total because the calculations are made separately for each holder.

46

### Item 13. Certain Relationships and Related Transactions.

In November 2001, we acquired in a like kind exchange furniture having an approximate current value of \$8,000 from Digital Boardwalk, Inc. ("DBI") which is an affiliate of Par Chadha, our former Chairman and CEO. Also, during the fourth quarter of fiscal 2002, our Meret subsidiary retained DBI to consult on various matters, for which DBI charged a consulting fee of approximately \$49,000, and our Sorrento subsidiary retained DBI to consult on a matter for which DBI charged a consulting fee of approximately \$7,000.

During July, 2000 we agreed to loan \$300,000 for three years at the applicable federal rate provided for in Internal Revenue Code Section 1274 to Mr. Jacobson in connection with accepting employment as our Senior Vice President, Legal. This is a full recourse loan and Mr. Jacobson has pledged his options to acquire our common stock and any options he may receive from any of our subsidiaries as collateral. Mr. Jacobson has received \$300,000 in advances under this loan agreement for which the interest rate is 6.6%.

During June 2000, we entered into various agreements with Par Chadha, our former CEO and Chairman, which, among other matters, provides for payments of \$250,000 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



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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, Mr. Chadha exercised 71,112 options, applying the \$500,000 accelerated payment to the exercise. In addition, he exercised 507,388 options for which we are contractually obligated to loan the \$5,034,000 due on the exercise. During September 2001, Mr. Chadha 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 the agreements.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Mr. Chadha returned the 507,388 shares to us for cancellation and we cancelled the receivable due from him and restored the original option agreements. This rescission agreement did not resolve any underlying dispute as to the option loan repayment obligations. We anticipate this dispute will be resolved through binding arbitration. Should Mr. Chadha prevail in the arbitration, the Company may be required to issue him 1,178,500 shares of the Company's stock for no consideration.

During fiscal 2002, we paid a total of \$55,218 to Phillip W. Arneson as a Director of the Company. The amounts paid included \$23,500 for consulting work performed for a special Committee of the Board, \$20,760 for various other consulting services including outsourcing advice and organizational matters, attendance fees of \$6,000 for Board and Committee meetings and \$4,958 in reimbursable expenses. Consulting fees were paid at a rate equal to normal fees for attendance at Board meetings.

During fiscal 2001, we entered into employment agreements with Mr. Hecht, Mr. Phansalkar, Mr. Sue, and Mr. Jacobson which provide for loans to the employees to exercise stock options to acquire our common stock and the stock of our subsidiaries including any required tax withholdings due upon exercise. The loans are for a period not to exceed two years at the applicable federal rate, are full recourse and require the pledge of shares issued upon exercise. As of April 30, 2002 no such loans are outstanding.

During fiscal 2000 we paid \$40,000 to Renn Zaphiropoulos, a then director, for management consulting services.

During fiscal 1998, we made 8% demand loans totaling \$165,000 to Chrysalis Capital Group, which was repaid with interest in April 1999. The loans were collateralized by 20,408 shares of our common stock. During fiscal 2000 and 1999, we paid \$190,070 and \$25,000, respectively, in fees to Chrysalis Capital Group for services rendered in connection with various amended loan and security agreements. Leonard Hecht was a director when such transactions occurred and owns, directly and indirectly, 100% of the outstanding capital stock of Chrysalis Capital Group.

During fiscal 2000 FIBR Holdings, LLC purchased 679,483 unregistered shares of our common stock for \$7,500,000. In connection with this placement Humbert B. Powell, III, then a director, received a finder's fee of \$300,000. Andersen Weinroth Capital Corp. ("AW") received a placement fee of \$300,000 in connection with this placement and Rohit Phansalkar, who subsequently became one of our directors, and later became our Chairman and Chief Executive Officer, was a partner of AW at that time. FIBR Holdings, LLC had the right to nominate one member of the Board of Directors to serve until the annual shareholders' meeting in 2001 and had the right to

participate in any stock offering by our Sorrento Subsidiary, to the extent of \$7,500,000 subject to certain limitations. Mr. Phansalkar was nominated by AW and joined our Board of Directors on January 6, 2000.

On March 3, 2000, our Sorrento subsidiary completed a sale 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. Of these shares, 1,467,891 shares were purchased for \$8,000,000 pursuant to the previously contracted right of participation by entities in which Mr. Phansalkar was partner or member. In addition, AW received a placement fee of \$1,950,000 paid through the issuance by Sorrento of 357,799 shares of its Series A Convertible Preferred Stock. Mr. Phansalkar disclaims beneficial ownership of these shares except to the extent of his beneficial ownership of each entity. In addition, Renn Zaphiropoulos, a former director, purchased 45,872 of these shares for \$250,000.

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) Exhibits and Consolidated Financial Statement Schedules

1. Financial Statements: (see index to financial statements at page F-1)

Independent Certified Public Accountants' Reports

Consolidated Balance Sheets at January 31, 2002 and 2001

Consolidated Statements of Operations for the Years Ended January 31,  
2002, 2001 and 2000

Consolidated Statements Comprehensive Income for the Years Ended January  
31, 2002, 2001 and 2000

Consolidated Statement of Stockholders' Equity for the Years Ended  
January 31, 2002, 2001 and 2000

Consolidated Statements of Cash Flows for the Years Ended January 31,  
2002, 2001 and 2000

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### Notes to Consolidated Financial Statements

#### 2. Exhibits:

- 2. Stock Purchase Agreement dated as of June 1, 1996 between Osicom and BWA (A)
- 3.1 Restated Certificate of Incorporation dated June 14, 1988 (B)
- 3.2 Amended and Restated By-Laws of Registrant (C)
- 3.6 Series D Preferred Stock Certificate of Designation (E)
- 3.9 Certificate of Amendment to the Certificate of Incorporation dated January 16, 1998 - (G)
- 3.10 Certificate of Amendment to the By-Laws dated January 30, 1998 - (G)
- 3.11 Corrected Certificate of Incorporation of Sorrento Networks, Inc. (P)
- 3.12 Certificate of Designation of Series F Preferred Stock (Q)
- 4.1 1988 Stock Option Plan - (H)
- 4.2 Amended and Restated 1997 Incentive and Non-Qualified Stock Option Plan - (G)
- 4.3 1997 Directors Stock Option Plan - (I)
- 4.4 2000 Stock Incentive Plan - (J)
- 4.5 2000 Employee Stock Purchase Plan - (J)
- 4.6 2000 Stock Option/Stock Issuance Plan of Sorrento Networks, Inc. (P)
- 4.7 Form of Senior Convertible 9.75% Debenture due August 2, 2004 (Q)
- 4.8 Form of Warrant dated August 2, 2001 (Q)
- 10.1 Line of Credit Agreement with Coast Business Credit dated May 28, 1995 and Modification dated January 31, 1996 (K)
- 10.5 Agreement dated June 12, 2000 with Par Chadha - (O)
- 10.7 Agreement dated May 22, 2000 with Rohit Phansalkar - (O)
- 10.8 Agreement dated May 22, 2000 with Christopher E. Sue - (O)
- 10.9 Agreement dated August 22, 2000 with Leonard N. Hecht (P)

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

- 10.10 Agreement dated May 22, 2000 with John A. Mason (P)
- 10.10 Agreement dated July 12, 2000 with Richard L. Jacobson (P)
- 10.11 Agreement dated March 1, 2002 with Phillip W. Arneson filed herewith
- 10.13 Securities Purchase Agreement dated as of August 1, 2001 (Q)
- 10.14 Escrow Agreement dated as of August 1, 2001 (Q)
- 10.15 Registration Rights agreement dated as of August 2, 2001 (Q)
  
- 21 Subsidiaries of the Registrant - filed herewith
  
- 23.1 Consent of BDO Seidman LLP - filed herewith
- 23.2 Consent of Arthur Andersen & Co., L.L.P. - filed herewith

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

- A Form S-4 dated September 6, 1996
- B Form 10-QSB for the quarter ended July 31, 1996
- C Form 10-K for the year ended January 31, 1988
- D Form 10-K for the year ended January 31, 1993
- E Form S-3 dated February 25, 1997
- F Form 10-KSB for the year ended January 31, 1997
- G Proxy Statement dated December 1, 1999
- H Proxy Statement dated May 13, 1988
- I Proxy Statement dated November 21, 1997
- J Proxy Statement dated December 11, 2000
- K Form 10-KSB for year ended January 31, 1996
- L Form 8-K dated February 2, 1996
- M Form 8-K dated September 12, 1996
- N Form 8-K dated September 23, 1996
- O Form 10-Q for the quarter ended October 31, 2000
- P Form 10-K for the year ended January 31, 2001

# Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Q Form 8-K dated August 3, 2001

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

(b) Reports on Form 8-K

January 24, 2002 Delaware Supreme Court ruling

50

## SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Independent Certified Public Accountants' Reports	F-2
Consolidated Balance Sheets as of January 31, 2002 and 2001	
Consolidated Statements of Operations and Comprehensive Income for the years ended January 31, 2002, 2001 and 2000	
Consolidated Statements of Shareholders' Equity for the years ended January 31, 2002, 2001 and 2000	F-6
Consolidated Statements of Cash Flows for the years ended January 31, 2002, 2001 and 2000	
Notes to Consolidated Financial Statements	F-10

F-1

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Shareholders of  
Sorrento Networks Corporation

We have audited the accompanying consolidated balance sheets of Sorrento Networks Corporation (a New Jersey corporation) and subsidiaries (the "Company") as of January 31, 2002 and 2001 and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years ended January 31, 2002, 2001 and 2000. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of a foreign subsidiary which statements reflect net assets of \$1,632,000 as of January 31, 2000 and total revenues of \$20,819,000 for the year ended January 31, 2000. These amounts are included in the net investment in and results of discontinued operations in the accompanying financial statements. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for such subsidiary, is based solely on the reports of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted, in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits, and reports of the other auditors, provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and subsidiaries as of January 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years ended January 31, 2002, 2001 and 2000 in conformity with generally accepted accounting principles, in the United States of America.

/s/ BDO Seidman LLP

BDO Seidman LLP  
Los Angeles, California  
March 22, 2002

ARTHUR ANDERSEN

Arthur Andersen & Co.  
21st Floor Edinburgh Tower  
The Landmark  
15 Queen's Road Central  
Hong Kong

REPORT OF INDEPENDENT PUBLIC ACCOUNTS

To: Uni Precision Industrial Limited and Subsidiaries

We have audited the accompanying balance sheets of Uni Precision Industrial Limited and Subsidiaries (the "Group), incorporated in Hong Kong, as of January 31, 2000 and the related statements of income, cash flows, and changes in shareholders' equity for the year ended January 31, 2000, expressed in Hong Kong dollars. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Group as of January 31, 2000, and the results of its operations and cash flows for the year ended January 31, 2000 in conformity with generally accepted accounting principles in the United States of America.

/s/ Arthur Andersen & Co.

Hong Kong,  
March 3, 2000

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
(In Thousands)

January 31, 20

ASSETS

CURRENT ASSETS

Cash and equivalents	\$ 14,243
Accounts receivable, net (Notes D, J and S)	8,081
Inventory, net (Notes B, D and S)	18,810
Prepaid expenses and other current assets (Note N)	1,252
Investment in marketable securities (Note B)	28,120

TOTAL CURRENT ASSETS 70,506

PROPERTY AND EQUIPMENT, NET (Notes C, D and E) 17,411

OTHER ASSETS

Purchased technology, net (Note B)	652
Other assets (Notes A, B and N)	1,671
Investment in former subsidiary (Note A)	99

TOTAL OTHER ASSETS 2,422

TOTAL ASSETS \$ 90,339

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES

Short-term debt (Note D)	\$ 1,043
Current maturities of long term debt (Note E)	362
Accounts payable	5,575
Accrued liabilities and other current liabilities	8,887
Due on redemption of preferred security of subsidiary (Note J)	48,800

TOTAL CURRENT LIABILITIES 64,667

Long-term debt and capital lease obligations (Note E) 3,867  
 Debentures payable, net of unamortized costs and discounts (Note F) 3,489  
 Dividends payable (Note A) 99



Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

TOTAL LIABILITIES	72,122
-----	
COMMITMENTS AND CONTINGENCIES (Notes F, G and H)	
MINORITY INTEREST	
Preferred stock, 8,954 shares issued and outstanding; liquidation preference (Note J)	-
STOCKHOLDERS' EQUITY (Note I)	
Preferred stock, \$.01 par value; liquidation preference \$1,353	1
Common stock, \$.30 par value; 150,000 shares authorized; 14,209 shares issued	
14,200 shares outstanding at January 31, 2002; 12,608 shares issued and	
12,599 shares outstanding at January 31, 2001	4,263
Additional paid-in capital	151,443
Note receivable from option exercise (Note N)	-
Deferred stock compensation	(255)
Accumulated deficit	(161,326)
Accumulated unrealized gain on marketable securities	24,160
Treasury stock, at cost; 9 shares at January 31, 2002 and	
January 31, 2001, respectively	(69)
-----	
TOTAL STOCKHOLDERS' EQUITY	18,217
-----	
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 90,339
=====	

See accompanying notes to consolidated financial statements.

F-4

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

	2002	Twelve Jan 20
	-----	-----
NET SALES (Notes B and J)	\$ 40,827	\$ 4
COST OF SALES	31,507	3
-----		
GROSS PROFIT	9,320	1
-----		

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

OPERATING EXPENSES		
Selling and marketing	16,165	1
Engineering, research and development	13,656	2
General and administrative	12,770	1
Deferred compensation	812	
Other operating expenses	3,071	
-----		
TOTAL OPERATING EXPENSES	46,474	6
-----		
LOSS FROM OPERATIONS	(37,154)	(5)
-----		
OTHER INCOME (CHARGES)		
Investment income (loss)	(1,368)	
Interest expense	(3,311)	
Other income (charges)	(99)	
Gain on sale of marketable securities (Note A)	(1,204)	
-----		
TOTAL OTHER INCOME (CHARGES)	(5,982)	
-----		
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAX	(43,136)	(4)
LOSS FROM DISCONTINUED OPERATIONS (NET OF INCOME TAX PROVISION OF \$-0-, \$-0-, AND \$246)	-	
ESTIMATED LOSS ON DISPOSAL OF DISCONTINUED OPERATIONS	-	
-----		
NET LOSS	\$ (43,136)	\$ (4)
=====		
INCOME (LOSS) PER COMMON SHARE (Note M)		
BASIC		
WEIGHTED AVERAGE COMMON SHARES		
OUTSTANDING (RESTATED, IN THOUSANDS)	13,966	1
NET INCOME (LOSS) PER COMMON SHARE:		
Continuing operations	(3.10)	
Discontinued operations	n/a	
-----		
BASIC NET LOSS PER COMMON SHARE	\$ (3.10)	\$
=====		
DILUTED		
WEIGHTED AVERAGE COMMON SHARES		
OUTSTANDING (RESTATED, IN THOUSANDS)	16,175	1
NET INCOME (LOSS) PER COMMON SHARE:		
Continuing operations	(4.36)	
Discontinued operations	n/a	
-----		
DILUTED NET LOSS PER COMMON SHARE	\$ (4.36)	\$
=====		
COMPREHENSIVE INCOME AND ITS COMPONENTS CONSIST OF THE FOLLOWING:		
Net loss	\$ (43,136)	\$ (4)
Unrealized gains (losses) from marketable securities:		
Unrealized holding gains (losses) arising during the period	(20,789)	(12)

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Reclassification adjustment for gains included in net income -

---

NET COMPREHENSIVE INCOME (LOSS) \$ (63,925) \$ (16

---

See accompanying notes to consolidated financial statements.

F-5

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES  
For the Year Ended January 31, 2002

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(In Thousands)

	COMMON STOCK		PREFERRED STOCK		ADDITIONAL PAID IN CAPITAL	NOTES RECEIVABLE OPTIONS
	Shares	Amount	Shares	Amount		
Balance at January 31, 2001	12,608	\$ 3,782	2	\$1	\$114,994	\$ (5,034)
Debentures private placement (Notes F)	478				28,414	
Stock option and warrant exercises (Notes I, J and M)	(403)	23			(1,321)	5,034
Unrealized losses on available for sale securities (Note B)						
Deferred stock compensation of subsidiary (Note B)					187	
Expenses paid with stock issuances (Note I)					(18)	
Amortization of deferred stock compensation (Note B)						
Private placement subsidiary (Note J)	1,526	458			9,187	
Deemed dividend						

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

(Note I)

Net loss

=====						
BALANCE AT						
JANUARY 31, 2002	14,209	\$4,263	2	\$1	\$151,443	\$ --
=====						
	ACCUMULATED	TREASURY		ACCUMULATED	TOTAL	
	DEFICIT	STOCK		UNREALIZED	STOCKHOLDERS'	
		Shares	Amount	GAIN	EQUITY	
-----						
Balance at						
January 31, 2001	\$ (118,010)	9	\$ (69)	\$ 44,949	\$ 39,733	
Debtentures						
private placement						
(Notes F)					28,414	
Stock option and						
warrant exercises						
(Notes I, J and M)					3,736	
Unrealized losses on						
available for sale						
securities (Note B)				(20,789)	(20,789)	
Deferred stock compensation						
of subsidiary (Note B)						-
Expenses paid with stock						
issuances (Note I)						(18)
Amortization of deferred stock						
compensation (Note B)						812
Private placement						
subsidiary (Note J)						9,645
Deemed dividend						
(Note I)	(180)					(180)
Net loss	(43,136)					(43,136)
-----						
BALANCE AT						
JANUARY 31, 2002	\$ (161,326)	9	\$ (69)	\$ 24,160	\$ 18,217	
=====						

See accompanying notes to consolidated financial statements.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES  
For the Year Ended January 31, 2001

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(In Thousands)

	COMMON STOCK		PREFERRED STOCK		ADDITIONAL PAID IN CAPITAL	RETAINED EARNINGS
	Shares	Amount	Shares	Amount		
Balance at January 31, 2000	11,483	\$3,445	5	\$1	\$102,418	
Preferred stock conversions (Note I)	167	50	(3)	-	(50)	
Stock option and warrant exercises (Notes J, K and M)	919	276			8,619	
Unrealized losses on available for sale securities (Note B)						
Deferred stock compensation of subsidiary (Note B)					2,788	
Amortization of deferred stock compensation (Note B)						
Distribution of shares of subsidiary (Note A)						
Deemed dividend (Note J)						
Dividends paid (Note I)	39	11			1,219	
Net loss						
<b>BALANCE AT JANUARY 31, 2001</b>	<b>12,608</b>	<b>\$3,782</b>	<b>2</b>	<b>\$1</b>	<b>\$114,994</b>	

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

	ACCUMULATED DEFICIT	TREASURY STOCK Shares	Amount	ACCUMULATED UNREALIZED GAIN	TOTAL STOCKHOLDERS EQUITY
Balance at January 31, 2000	\$ (67,771)	9	\$ (69)	\$ 164,514	\$ 202,538
Preferred stock conversions (Note I)					-
Stock option and warrant exercises (Notes J, K and M)					3,861
Unrealized losses on available for sale securities (Note B)				(119,565)	(119,565)
Deferred stock compensation of subsidiary (Note B)					-
Amortization of deferred stock compensation (Note B)					1,908
Distribution of shares of subsidiary (Note A)	(5,122)				(5,122)
Deemed dividend (Note J)	(1,982)				(1,982)
Dividends paid (Note I)	(1,230)				-
Net loss	(41,905)				(41,905)
<b>BALANCE AT JANUARY 31, 2001</b>	<b>\$ (118,010)</b>	<b>9</b>	<b>\$ (69)</b>	<b>\$ 44,949</b>	<b>\$ 39,733</b>

See accompanying notes to consolidated financial statements.

F-7

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES  
For the Year Ended January 31, 2000

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(In Thousands)

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

	COMMON STOCK		PREFERRED STOCK		ADDITIONAL PAID IN CAPITAL
	Shares	Amount	Shares	Amount	
Balance at January 31, 1999	8,924	\$2,677	12	\$1	\$85,183
Common stock placements, net (Note J)	679	204			6,658
Preferred stock conversions (Note I)	1,048	314	(7)		(314)
Stock option and warrant exercises (Notes J and K)	820	246			8,298
Expenses paid with stock issuances (Note J)	3	1			58
Costs attributed to stock issuances					(81)
Treasury stock purchases					
Unrealized gains on available for sale securities (Note B)					
Pre-acquisition deficit and additional paid in capital related to former subsidiary (Note A)					2,433
Deemed dividend (Note H)					103
Dividends paid (Note I)	9	3			80
Net loss					
<b>BALANCE AT JANUARY 31, 2000</b>	<b>11,483</b>	<b>\$ 3,445</b>	<b>5</b>	<b>\$1</b>	<b>\$102,418</b>

	TREASURY STOCK	ACUMULATED UNREALIZED GAIN	TOTAL STOCKHOLDERS' EQUITY
	Shares	Amount	

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Balance at				
January 31, 1999	80	\$ (524)	\$	\$ 38,858
Common stock placements, net (Note J)				6,862
Preferred stock conversions (Note I)				-
Stock option and warrant exercises (Notes J and K)	(16)	119		8,663
Expenses paid with stock issuances (Note J)	(75)	489		548
Costs attributed to stock issuances				(81)
Treasury stock purchases	20	(153)		(153)
Unrealized gains on available for sale securities (Note B)			164,514	164,514
Pre-acquisition deficit and additional paid in capital related to former subsidiary (Note A)				- 5,461
Deemed dividend (Note H)				-
Dividends paid (Note I)				(481)
Net loss				(21,653)
-----				
BALANCE AT				
JANUARY 31, 2000	9	\$ (69)	\$164,514	\$202,538
=====				

See accompanying notes to consolidated financial statements.



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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

	Year
	2002
<hr style="border-top: 1px dashed black;"/>	
CASH FLOWS FROM OPERATING ACTIVITIES	
Net income (loss) from continuing operations	\$(43,136)
<hr style="border-top: 1px dashed black;"/>	
Adjustments to reconcile net loss to net cash used in operating activities:	
Intangible assets valuation allowances (Note B)	-
Depreciation and amortization	2,794
Accounts receivable, option receivables and inventory reserves	9,309
Expenses paid through issuances of securities	1,309
(Gain)loss on sale of marketable securities	1,204
Non-cash interest on debentures (Note F)	994
Deferred and other stock compensation (Note B)	812
Other non-cash	794
Changes in assets and liabilities net of effects of business entity divestitures:	
Increase in accounts receivable	6,360
Increase in inventories	(8,247)
(Increase) decrease in other current assets	(438)
Increase(decrease) in accounts payable	(2,729)
Increase (decrease) in accrued expenses	(751)
Increase (decrease) in other current liabilities	(63)
<hr style="border-top: 1px dashed black;"/>	
NET CASH USED IN OPERATING ACTIVITIES	(31,788)
<hr style="border-top: 1px dashed black;"/>	
NET CASH PROVIDED BY DISCONTINUED OPERATIONS	-
<hr style="border-top: 1px dashed black;"/>	
NET CASH USED IN OPERATING ACTIVITIES	(31,788)
<hr style="border-top: 1px dashed black;"/>	
CASH FLOWS USED IN INVESTING ACTIVITIES:	
Purchase of property and equipment	(3,235)
Software development costs (Note B)	-
Cash received from sale of marketable securities and other investments (Notes A and B)	144
Expenditures for investments	-
Purchase of other assets (Note B)	(895)
Other receivables (Note M)	-
Cash of former subsidiary (Note A)	-
Advances to affiliates, net of repayments (Note A)	-
Investing activities of discontinued operations	-
<hr style="border-top: 1px dashed black;"/>	
NET CASH USED IN INVESTING ACTIVITIES	(3,986)
<hr style="border-top: 1px dashed black;"/>	
CASH FLOWS FROM FINANCING ACTIVITIES:	

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Proceeds from short-term debt, net of repayments (Note D)	(172)
Proceeds from long-term debt (Note E)	26
Repayment of long-term debt (Note E)	(39)
Proceeds from debentures ( Note F)	29,749
Proceeds from convertible preferred stock issued by subsidiary (Note J)	-
Proceeds from common stock issued by subsidiary (Note I)	-
Proceeds from common stock (Note I)	9,645
Proceeds from stock option and warrant exercises (Notes I, J and K)	861
Dividends paid	-
Treasury stock purchases	-
Other	(18)
Financing activities of discontinued operations	-
<hr style="border-top: 1px dashed black;"/>	
NET CASH PROVIDED BY FINANCING ACTIVITIES	40,052
<hr style="border-top: 1px dashed black;"/>	
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,278
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	9,965
<hr style="border-top: 1px dashed black;"/>	
CASH AND CASH EQUIVALENTS - END OF PERIOD	\$14,243
<hr style="border-top: 3px double black;"/>	

See accompanying notes to consolidated financial statements.

F-9

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

---

Sorrento Networks Corporation (formerly Osicom Technologies, Inc.) (the "Company," "We," "Our," or "Us") through our 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 and Europe. Our former subsidiary, Entrada Networks moved its facilities to Irvine, California. Our former subsidiary, NETsilicon, Inc., is located in Waltham, Massachusetts. 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.

The accompanying consolidated financial statements are the responsibility of the management of the Company.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### A. THE COMPANY, BASIS OF PRESENTATION AND DISCONTINUED OPERATIONS

The Company, incorporated in New Jersey on July 7, 1981 as Osicom Technologies, Inc., operates as a holding company for its various subsidiaries and their divisions, more fully described below. The companies and assets acquired have been integrated in accordance with product lines: Sorrento Networks (regional and metropolitan optical networking products), Meret Optical (distance extension networking equipment), Entrada Networks (storage area networks as well as remote access and internetworking equipment), and NETsilicon, Inc. (formerly Embedded Networking Solution products). For reference purposes acquired businesses have been identified by legal entity, which is not indicative of our operational integration.

Sorrento Networks - This segment consists of Sorrento Networks, Inc. ("Sorrento"). Sorrento develops and markets end-to-end intelligent optical networking solutions for regional and metropolitan applications.

Meret Optical - This segment consists of Meret Communications, Inc. ("Meret" doing business as Meret Optical Communications), and Sciteq Communications, Inc. ("Sciteq"). Meret designs, manufactures, and markets distance extension networking equipment. Sciteq designs and markets products based on radio frequency synthesis technologies.

Entrada Networks - This segment consisted of Osicom Technologies, a Delaware corporation (formerly known as Cray Communications, Inc., "Cray"), Rockwell Network Systems ("RNS", a division of Cray), and Distributed Systems International, Inc. ("DSI"). Entrada Networks develops, manufactures and markets an extensive range of communications products and systems for storage area networks, remote access and internetworking markets. On August 31, 2000, we completed a merger of Entrada 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 additional 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 operations 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

F-10

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

(In Thousands, except share and per share amounts)

---

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 January 31, 2001 we distributed 20,182 of our Entrada shares upon the exercise of options and as of January 31, 2002 and 2001 have reserved 826,000 and 1,080,283 shares respectively 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 326,034 Entrada shares owned by us are accounted for as an "available for sale security". Under this accounting, these shares are marked-to-market at the end of each reporting period. The difference between our basis and the fair market value, as reported on Nasdaq, is a separate element of stockholders' equity and is included in the computation of comprehensive income. More information concerning Entrada is available in its public filings with the Securities and Exchange Commission.

NETsilicon - This segment consists of NETsilicon, Inc. ("NSI"). On September 15, 1999 NSI completed an initial public offering in which 6,037,500 shares of its common stock were sold (3,537,500 shares by NSI and 2,500,000 shares by us). NSI received net proceeds of \$22,249 and we received net proceeds of \$15,382. In addition, NSI repaid advances due us of \$5,884. In connection with the initial public offering by NSI our remaining 55.4% interest became non-voting shares. 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.

In October 2000, we sold 350,000 shares of our investment in NSI for \$4,219. The purchasers had the right to receive additional NSI shares from us if the three day average high for the NSI common stock, as quoted on Nasdaq, at December 31, 2000 was less than the price paid to us by the purchasers but not less than \$8.00 per share. We issued an additional 177,344 shares of NSI to the purchasers, reducing the price per share we received to \$8.00 per share. Our former Chairman and CEO purchased 100,000 of these shares of NSI for \$1,164 and received an additional 45,546 shares pursuant to the price protection provision. As a result of this transaction, our remaining interest is approximately 7.0 million shares of NSI, or 50.6% as of January 31, 2002 and 2001, and continues to be accounted for as a marked-to-market security. More information concerning NSI is available in its public filings with the Securities and Exchange Commission.

On February 13, 2002 NSI completed a merger with Digi International, Inc. In connection with the merger, we exchanged our 6,972,656 shares of NSI for 2,324,683 shares of Digi International, Inc. and \$13,574 in cash.

Discontinued Operations - Our Far East business unit, consisting of Uni Precision Industrial Limited ("Uni"), has been accounted for as a discontinued operation pursuant to our formal adoption on May 15, 1999 of a plan to sell this division. As of January 31, 2000, we sold Uni to a group led by its Hong Kong-based management for \$2,500 in cash in repayment of our advances to Uni and a \$3,000 non-voting redeemable preferred security. This security has not been

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

considered in the estimated proceeds from disposal due to the uncertainty of future collection. Net assets disposed and amounts due from the purchasers, at their expected realizable values, are included in other assets in the accompanying balance sheets. During the year ended January 31, 2001 we received

F-11

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

payments of \$819. Due to the continuing economic downturn in Asia and the decline in the value of marketable securities held as collateral from the purchasers, we recorded a \$700 reserve against the remaining balance due of \$1,688 during fiscal 2001. During fiscal 2002, we recorded a \$988 reserve to write-down the remaining receivable balance.

During the year ended January 31, 2000, we recorded a reduction to the estimated realizable value of the net assets of this discontinued operation of \$11,644 which has been separately presented as the estimated loss on the disposal of discontinued operations in the accompanying income statement. Net assets of discontinued operations at January 31, 2000 consist of:

	2000
	----
Cash	\$ 398
Accounts receivable, net	2,862
Inventory, net	2,135
Other current assets	367
Property, plant and equipment, net	7,962
Excess cost over net assets acquired	-
Other non-current assets	342
	-----
Total assets	14,066
	-----
Accounts payable and other current liabilities	4,444
Short-term debt	791
Long-term debt, current portion	448
Long-term debt, non-current portion	918
Deferred income taxes	-
Intercompany payable	5,833
	-----
Total liabilities	12,434
	-----

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Net assets to be disposed of	1,632
Less: valuation adjustment	(1,632)
	-----
	-
Recoverable receivable	2,833
	-----
Due from disposal of discontinued operations	\$ 2,833
	=====

Operating results of this discontinued operation for the year ended January 31, 2000 is shown separately in the accompanying income statement. The operating results of this discontinued operation for the year ended January 31, 2000 consist of:

	2000
	----
Net sales	\$ 20,819
Gross profit	5,022
Loss from operations	(11,948)
Net loss	(12,419)

Cash flows of this discontinued operation for the year ended January 31, 2000 is shown separately in the accompanying statement of cash flows. The cash flows provided by (used in) this discontinued operation for the year ended January 31, 2000 consist of:

	2000
	----
Operating activities	\$ 953
Investing activities	(5,519)
Financing activities	(1,298)

F-12

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----  
B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Principles of Consolidation - The balance sheets and the consolidated statement of operations for the years ended January 31, 2002 and 2001 and the consolidated statement of operations for the year ended January 31, 2000 reflect our accounts and all subsidiaries controlled by us after the elimination of significant intercompany transactions and balances. The consolidated statement of operations for the year ended January 31, 2001 includes the results of Entrada through August 31, 2000 after which date we no longer controlled Entrada. The consolidated statement of operations for the year ended January 31, 2000 includes the results of NSI through September 15, 1999 after which date we no longer controlled NSI. (See Note A). The consolidated group is referred to individually and collectively as the "Company," "We," "Our," or "Us".

Use of Estimates - The financial statements are prepared in conformity with generally accepted accounting principles which require management to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities and the values of purchased assets and assumed liabilities in acquisitions. Actual results could differ from these estimates.

Cash and Cash Equivalents - All cash on hand and in banks, certificates of deposit and other highly-liquid investments with original maturities of three months or less, when purchased are considered to be cash equivalents.

Accounts and Notes Receivable - In the normal course of business, we extend unsecured credit to our customers related to the sales of various products. Typically credit terms require payment within thirty days from the date of shipment. For some of the customers of our optical networking products payment is required within 180 days from the date of shipment and at January 31, 2002 \$1,601 of net receivables are due within 180 days. We evaluate and monitor the creditworthiness of each customer on a case-by-case basis.

Allowance for Doubtful Accounts - We provide an allowance for doubtful accounts based on our continuing evaluation of our customers' credit risk. We generally do not require collateral from our customers.

Inventory - Inventory, comprised of raw materials, work in process, finished goods and spare parts, are stated at the lower of cost (first-in, first-out method) or market. Inventories at January 31, 2002 and 2001 consist of:

	2002	2001
Raw material	\$14,593	\$10,201
Work in process	879	4,310
Finished goods	9,806	2,882
	25,278	17,393
Less: Valuation reserve	(6,468)	(2,792)
	\$18,810	\$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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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. At January 31, 2002, and 2001 marketable securities were as follows:

F-13

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

	Cost -----	Unrealized Gains -----	Market -----
-----			
January 31, 2002:			
NETsilicon	\$3,938	\$24,142	\$28
Entrada	22	18	---
	-----	-----	---
	\$3,960	\$24,160	\$28
	=====	=====	====
January 31, 2001:			
NETsilicon	\$3,938	\$42,303	\$46
Entrada	1,371	2,646	4
	-----	-----	---
	\$5,309	\$44,949	\$50
	=====	=====	====

Fair Value of Financial Instruments - The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. We believe that there are no material differences between the recorded book values of our financial instruments and their estimated fair value.

Property and Equipment - Property and equipment are recorded at historical cost. Depreciation and amortization are provided over the estimated useful lives of the individual assets or the terms of the leases if shorter using accelerated and straight-line methods. Useful lives for property and equipment range from 3 to 15 years. Depreciation of land improvements and



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

buildings is computed using the straight-line method over 39 years.

Capitalized leases are initially recorded at the present value of the minimum payments at the inception of the contracts, with an equivalent liability categorized as appropriate under current or non-current liabilities. Such assets are depreciated on the same basis as described above. Interest expense, which represents the difference between the minimum payments and the present value of the minimum payments at the inception of the lease, is allocated to accounting periods using a constant rate of interest over the lease.

Property and equipment are reviewed for impairment whenever events or circumstances indicate that the asset's undiscounted expected cash flows are not sufficient to recover its carrying amount. We measure impairment loss by comparing the fair market value, calculated as the present value of expected future cash flows, to its net book value. Impairment losses, if any, are recorded currently.

Software Development - Software development costs where technological feasibility has not been established are expensed in the period in which they occurred, otherwise, development costs that will become an integral part of our products are deferred in accordance with Statement of Financial Accounting Standards Nos. 2 and 86. The deferred costs are amortized using the straight-line method over the remaining estimated economic life of the product or the ratio that current revenues for the product bear to the total of current and anticipated future revenues for that product. Amortization expense for the years ended January 31, 2002, 2001 and 2000 was \$0, \$1,046 and \$1,841, respectively, over 3 to 5 years. Accumulated amortization was \$398 as of January 31, 2002 and 2001.

The recoverability of capitalized software costs are reviewed on an ongoing basis primarily based upon projections of discounted future operating cash flows from each software product line. The excess amount, if any, of the remaining net book value over the calculated amount is fully reserved. During the quarters ended April 30, 2000 and January 31, 2000 we recorded reductions to the net book value of our capitalized software development costs of \$435 and \$1,742, respectively, recorded as engineering expense, to reflect the decline in the net realizable value of these assets as a result of changing market conditions.

F-14

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----  
Purchased Technology - Technology assets were acquired in connection with the acquisition of Sciteq. These assets were analyzed during and after the

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

close of the acquisition. The discounted projected future cash flow from proven technology and software are capitalized and amortized over their remaining estimated economic life (7 years) using the straight-line method. Accumulated amortization was \$1,994 and \$1,623 at January 31, 2002 and 2001, respectively.

We assess the recoverability of purchased technology primarily by determining whether the amortization of the net book value of purchased technology over its remaining life can be recovered through undiscounted future operating cash flows of the acquired operation. The amount of the impairment, if any, of the net book value of the excess cost over net assets acquired is measured by determining the fair value of these assets primarily based on projected discounted future operating cash flows from the purchased technologies using a discount rate commensurate with our cost of capital.

Research and Development - We expense research and development costs as incurred in accordance with Statement of Financial Accounting Standards ("SFAS") No. 2, "Accounting for Research and Development Costs". Research and development costs are costs associated with products or processes for which technological feasibility has not been proven and future benefits are uncertain. In-process research and development purchased by us includes the value of products and processes in the development stage and have not reached technological feasibility; this amount is expensed at the date of purchase.

Other investments - Other investments, included in other assets, include non-marketable securities held in other companies including a privately held competitive local exchange carrier. During the fourth quarter of fiscal 2000 we exchanged \$3,000 of trade receivables due us from this customer for 333,334 shares of its convertible preferred stock, a 5.9% equity interest on a fully diluted basis. These shares were entitled to a cumulative preferred dividend of \$240 per year, were entitled to nominate one member to the customer's board of directors, vote as part of single class for one member of its board of directors and were convertible into 333,334 shares of its common stock. During March and September 2000 we purchased an additional 269,608 shares of this customer's convertible preferred stock for \$3,235, bringing our equity interest on a fully diluted basis to 9.7%. These shares were entitled to a cumulative preferred dividend of \$259 per year and are convertible into 269,608 shares of its common stock.

In November 2000, we sold all our shares for \$9,937 and \$320 in accumulated, unpaid dividends. Of the total \$10,257 due from the purchaser, approximately 7.7% or \$787 is held in a segregated escrow account for one year. The gain of \$3,701 on the sale of the shares is included in investment income in the accompanying income statement. Due to a dispute, a \$787 reserve against the remaining escrow balance was recorded during the fiscal year ended January 31, 2002.

During the years ended January 31, 2001 and 2000 we made sales of \$5,746 and \$5,496 respectively, to this customer under a long-term equipment financing agreement. The purchase agreement with this customer provides for invoiced installation and other deployment expenses not to exceed 10% of the equipment cost. The terms of the financing agreement provide that the customer may convert any balances outstanding longer than 90 days into a level 35-month term note at 11% per annum interest. We financed \$5,971, including deployment expenses of \$210, during fiscal 2001 for this customer which was paid in full including accrued interest during January 2001. We financed \$3,328 of receivables, including deployment expenses of \$120, during fiscal 2000 for this customer and \$3,000 of the then unpaid note was exchanged for our equity interest in the customer. The remaining balance of the note and accrued interest of \$344,000 was paid in cash.

Revenue Recognition - We generally recognize product revenue when the products are shipped, all substantial contractual obligations, if any, have been

satisfied, and the collection of the resulting receivable is

F-15

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

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

Warranty and Customer Support - We typically warrant our products against defects in materials and workmanship for a period of one to five years from the date of sale and a provision for estimated future warranty and customer support costs is recorded when revenue is recognized. To date, warranty and customer support costs have not been material.

Income Taxes - Income taxes are accounted for in accordance with Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes." The statement employs an asset and liability approach for financial accounting and reporting of deferred income taxes generally allowing for recognition of deferred tax assets in the current period for future benefit of net operating loss and research credit carryforwards as well as items for which expenses have been recognized for financial statement purposes but will be deductible in future periods. A valuation allowance is recognized, if on the weight of available evidence it is more likely than not that some portion or all of the deferred tax assets will not be realized. (See Note L).

Advertising - We expense advertising expenditures as incurred.

Income and Loss Per Common Share - Basic income and loss per common share is computed by dividing net income or loss available to common shareholders by the weighted average number of common shares outstanding during each period presented. Diluted EPS is based on the weighted average number of common shares outstanding as well as dilutive potential common shares, which in our case consist of convertible securities outstanding, shares issuable under stock benefit plans, and shares issuable pursuant to warrants. In computing diluted EPS, net income or loss available to common shareholders is adjusted for the after-tax amount of interest expense recognized in the period associated with convertible debt. Potential common shares are not included in the diluted

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

loss per share computation for the years ended January 31, 2002 and 2001 as they would be anti-dilutive. All references in the financial statements of common shares and per share data give effect to the 1-for-3 stock split effective July 24, 1998. (See Note M).

Foreign Currency Translation - Our foreign operations have been translated into U.S. dollars in accordance with the principles prescribed in SFAS No. 52, "Foreign Currency Translation". For the periods presented the current rate method was used whereby all assets and liabilities are translated at period end exchange rates, and the resultant translation adjustments would have been included as a separate component of stockholders' equity had such adjustments been material. Revenues and expenses are translated at the average rates of exchange prevailing throughout the period, and the resultant gains and losses are included in net earnings.

Stock-Based 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. The amount of deferred stock compensation 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 fiscal years ended January 31, 2002 and 2001, we amortized \$625 and \$1,724 of the total \$2,604 initially

F-16

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

---

recorded for deferred stock compensation. (See Note J).

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 Task 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 Networks subsidiary granted by it to its consultants; during the fiscal years ended January 31, 2002 and 2001, we recorded \$187 and \$184 for options granted to consultants. (See Note J).

The FASB issued Interpretation ("FIN") No. 44, "Accounting for Certain

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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 was 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 on our financial position or results of operations.

Computer Software for Internal Use - 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," is effective for financial statements with fiscal years beginning after December 15, 1998. The SOP provides guidance on accounting for the costs of computer software developed or obtained for internal use. The SOP requires that we continue to capitalize certain costs of software developed for internal use once certain criteria are met. The adoption of SOP 98-1 had no effect on our financial position or results of operations.

Start-up Costs - Statement of Opinion 98-5, "Reporting on the Costs of Start-up Activities," is effective for financial statements for fiscal years beginning after December 31, 1998. The SOP provides guidance and examples of the types of expenses associated with one-time (start-up) activities which under this SOP must be expensed as incurred. The adoption of SOP 98-5 had no effect on our financial position or results of operations.

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.

# Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

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.

## C. PROPERTY AND EQUIPMENT

Property and equipment of the Company consisted of the following components as of January 31, 2002 and 2001:

	2002
Manufacturing, engineering and plant equipment and software	\$15,354
Office furniture and fixtures	4,359
Land and building	6,650
Leasehold and building improvements	1,294
Total property and equipment	27,657
Less: Accumulated depreciation	(10,246)
Net book value	\$ 17,411

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Depreciation expense for fiscal 2002, 2001 and 2000 was \$2,422, \$3,404 and \$2,413, respectively.

### D. SHORT TERM DEBT

Short term debt at January 31, 2002 and 2001 consisted of the following:

	2002 -----
Floating interest rate loan (2.5% over Coast's prime rate) secured by all the tangible assets of Meret; weighted average interest rate for the year ended January 31, 2002 was 22.0%	\$ 1,043 =====

Meret has a line of credit of \$2,000 from Coast Business Credit ("Coast"); the line of credit is collateralized by substantially all the assets of Meret including accounts receivable, inventory and property and equipment. We have guaranteed this line to the extent of \$1,000. This line of credit provides for interest at 2.5%

F-18

### SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

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

-----

over the bank's prime rate but not less than 8% (8% at January 31, 2002) with a minimum monthly interest of \$8. Advances are limited to 80% of eligible accounts receivable and 40% of eligible inventory limited to \$740; this line also provides for a \$500 letter of credit sub-line. Subsequent to January 31, 2002, the Loan and Security Agreement was amended reducing the line of credit to \$1,000, adjusting the advance rate for eligible inventory to 20%, limited to \$370, eliminating minimum monthly interest with an expiration date of July 1, 2002. The highest amount outstanding was \$1,259 and \$3,001 during fiscal years 2002 and 2001, respectively. The average amount outstanding was \$1,122 and \$1,419 during fiscal years 2002 and 2001, respectively.

The Company is in compliance with its debt covenants at January 31, 2002.

### E. LONG TERM DEBT

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Long term debt at January 31, 2002 and 2001 consisted of the following:

	2002
	-----
Variable rate 30 year mortgage note payable (5.5% over LIBOR rate); interest rate at January 31, 2002 was 8.95%	\$1,283
Fixed rate 30 year mortgage note payable; interest rate at January 31, 2002 was 7.6%	2,385
Obligations under finance leases (See Note G)	561
	-----
	4,229
Less: Current portion	362
	-----
	\$3,867
	=====

On March 25, 1996, Meret purchased land and building in San Diego, California for \$1,779 in cash. On April 24, 1996, Meret entered into a mortgage agreement with a lender in the amount of \$1,331 amortized over 30 years with an adjustable interest rate of 5.5% over the LIBOR rate, adjusted bi-annually. Monthly principal and interest payments are \$11. The interest rate at January 31, 2002 was 8.95%. Net book value of the property securing this mortgage was \$1,593 and \$1,623 at January 31, 2002 and 2001, respectively.

In October 2000, we completed our purchase of a 41,000 square foot facility immediately adjacent to our existing San Diego, California facility. The purchase price was \$4,805 including the assumption of existing indebtedness of \$2,417. Monthly principal and interest payments are \$18 and at the end of the 30 year term on January 1, 2010 the remaining balance of \$2,109 is due. The loan has a fixed interest rate of 7.6%. Net book value of the property securing this mortgage was \$5,394 and \$5,411 at January 31, 2002 and 2001, respectively.

Long term debt including capitalized leases at January 31, 2002 is payable by year as follows:

2003	\$ 362
2004	234
2005	104
2006	54
2007	59
2008 and later	3,416
	-----
	\$4,229
	=====



# Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

## F. DEBENTURES

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 year ended January 31, 2002 of \$2,567 included the stated 9.75% interest of \$1,575 which is paid in common stock, amortization of issuance costs of \$81 and amortization of the fair value of the warrants issued to the purchasers and placement agent and the deemed beneficial conversion feature of \$911. We issued 487,211 shares of our common stock in payment of \$1,307 interest. At January 31, 2002 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	81
Value of warrants and deemed beneficial conversion feature	911
	-----
	\$ 3,489
	=====

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### G. LEASES AND OTHER COMMITMENTS

Rental expense under operating leases was \$1,256, \$1,277 and \$1,533 for the years ended January 31, 2002, 2001 and 2000, respectively. The table below sets forth minimum payments under capital and operating leases with remaining terms in excess of one year, at January 31, 2002:

	Capital Leases	Ope Le
	-----	--
2003	\$359	\$1
2004	203	
2005	56	
2006	-	
2007	-	
	----	--
	\$618	\$1
		==

F-20

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

---

Less: Amount representing interest	(57)
	----
Present value of minimum annual rentals	\$561
	====

The net book value of equipment under capital leases was \$1,071 and \$714 at January 31, 2002 and 2001, respectively.

We currently reimburse Entrada on a prorata basis for space in its San Diego facility utilized by Meret. During the twelve and five months ended January 31, 2002 and 2001, we paid \$48 and \$15 to Entrada under this month to month agreement.

In March 2001, our Meret subsidiary entered into a \$2.7 million

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

supplier agreement. The agreement requires a minimum monthly cash outlay of \$50,000 extending over a period of fifty four months. The remaining balance at January 31, 2002 of \$2.0 million is expected to end in March 2005. The product being acquired is a component used in a product for one of Meret's customers for which there is a five year sales contract.

We entered into a two year employment contract in May 2000, with Rohit Phansalkar, our immediate past Chairman and Chief Executive Officer ending May 2002, which provides for a salary of \$250 per year. He resigned as our CEO in September 2000, in order that the CEO of our Sorrento subsidiary, Dr. Xin Cheng, became our CEO and Chairman of the Board. His contract requires us to continue his salary and benefits for two years, during which he is available to provide consulting services to us.

Four of our officers, an employee and consultant have two year employment agreements ending in May, July and August 2002, which provide for salaries totaling \$1,096 per year. These contracts may be terminated for cause. However, should any of these individuals be terminated without cause or resign in certain circumstances they will receive a continuation of their salary and benefits for two years, and they are required to provide consulting services to us during that period. In addition, these agreements provide for loans to exercise previously granted stock options to acquire our common stock and the stock of our subsidiaries including any required tax withholdings due upon exercise. The loans are for a period not to exceed two years at the then applicable federal rate, are full recourse and require the pledge of shares issued upon exercise. No amounts have been loaned to these persons to date.

### H. LITIGATION

On September 10, 2001, holders of a portion of the outstanding Series A Preferred Stock of our Sorrento subsidiary obtained a preliminary injunction from the Delaware Court of Chancery 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. On January 23, 2002, the Delaware Supreme Court affirmed the granting of the preliminary injunction.

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 claims 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.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

The new defendants have all moved to dismiss the amended complaint. Management believes the allegations contained in the amended complaint are without merit.

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 also believes that these motions are without merit.

Currently, hearings on all pending motions have been taken off calendar at the request of all parties, pending the resolution of ongoing settlement discussions between the Company and the plaintiffs. While the Company is encouraged at the progress of these negotiations, there can be no assurance that a settlement will be reached.

During June 2000, we entered into various agreements with Par Chadha, our former CEO and Chairman, which, among other matters, provides for payments of \$250,000 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, Mr. Chadha exercised 71,112 options, applying the \$500,000 accelerated payment to the exercise. In addition, he exercised 507,388 options for which we are contractually obligated to loan the \$5,034,000 due on the exercise. During September 2001, Mr. Chadha 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 the agreements.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Mr. Chadha returned the 507,388 shares to us for cancellation and we cancelled the receivable due from him and restored the original option agreements. This rescission agreement did not resolve any underlying dispute as to the option loan repayment obligations. We anticipate this dispute will be resolved through binding arbitration. Should Mr. Chadha prevail in the arbitration, the Company may be required to issue him 1,178,500 shares of the Company's stock for no consideration.

In April 2002, our former Chairman and CEO, Dr. Xin Cheng, filed a claim in arbitration seeking, among other things, payment of \$500 and acceleration of the vesting of options pursuant to alleged contractual obligations of our Sorrento subsidiary. The Company is disputing these claims.

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

### I. STOCKHOLDERS' EQUITY

The Company is authorized to issue the following shares of stock:

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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:

F-22

SORRENTO NETWORKS CORPORATION  
 AND SUBSIDIARIES

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

2,500 shares of Preferred Stock, Series A  
 1,000 shares of Preferred Stock, Series B  
 10,000 shares of Preferred Stock, Series C  
 3,000 shares of Preferred Stock, Series D  
 1,000,000 shares of Preferred Stock, Series E

The Company has outstanding the following shares of preferred stock:

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

The Series A preferred stock was issued in August, 1992 in exchange for \$2,500 of trade debt. The Series A preferred stock accrued cumulative dividends at 6% and was convertible into common stock (i) at the option of the holder at the market price of our common stock provided the market price equals or exceeds \$202.50, and (ii) at our option at 110% of the market price our common stock. These shares of preferred stock were redeemable at our option at \$1,000 per share. During October 2000 we elected to convert all the outstanding Series A shares and during November 2000 we issued 80,276 shares of our common stock in conversion of the preferred shares and 39,509 shares of our common stock in payment of the accrued, unpaid dividends of \$1,230.

We recorded a deemed dividend of \$1,459 during the quarters ended July 31 and October 31, 1998 with respect to our Series C preferred stock. This amount represents the difference between the liquidation value of the Series C preferred stock and the estimated market value of the common shares issuable upon conversion as of the issue date of the Series C preferred shares assuming that all such shares were convertible beginning 90 days from issuance. We also

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

paid dividends in cash of \$481 during the year ended January 31, 2000 with respect to the Series C preferred stock.

In November, 1998, we assigned to an unrelated third party the right to redeem 2,000 shares of the Series C preferred stock. The assignee redeemed the shares for \$2,500. In consideration for the assignee's acceptance of new terms with respect to conversion and other features of the Series C preferred stock, we issued an additional 500 shares of Series C preferred stock to the assignee and three year warrants exercisable at \$10.66 to acquire 70,000 shares of common stock. The modified Series C stock is convertible at the lesser of (i) 86% of the average closing bid price for the common stock for the five days prior to conversion, and (ii) \$8.528. After registration of the underlying common stock the Series C preferred stock is convertible at multiple intervals over 150 days. The remaining 355 shares of Series C preferred stock held by the redeemed shareholder were modified to provide for a fixed conversion price of \$5.81 and received a three year warrant exercisable at \$10.66 to acquire 20,000 shares of common stock. The Series C shares were converted during August 1999 and the warrant was exercised during January, 2000 for which we received net proceeds of \$213.

All of these revised Series C preferred shares were converted prior to January 31, 2000; an aggregate of 1,906,206 shares of our common stock have been issued in conversions of these Series C preferred shares of which 1,048,440 shares were issued during the year ended January 31, 2000.

During January 2001, we issued 86,464 shares of our common stock in conversion of 1,500 shares of our Series D preferred stock. The remaining 1,353 shares of our non-voting, non-dividend bearing Series D preferred stock are being held in escrow pending resolution of acquisition contingencies including liabilities related to

F-23

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

---

funding deficits related to a terminated defined benefit pension plan of Entrada. Payments by the seller towards these liabilities will have no effect on our financial results and payments, if any, by us will reduce the face value of the preferred stock. Each share of Series D preferred stock is convertible into common stock at the then market value and we have the right to redeem the shares prior to conversion for 100% of their conversion value.

### J. OTHER CAPITAL STOCK TRANSACTIONS AND BUSINESS ACQUISITIONS

Stock Split - In July, 1998, approval was granted for a one for three reverse stock split effective July 24, 1998. The effect of this stock split was

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

reflected in the financial statements retroactively as if the stock split occurred at the beginning of the earliest period reported.

Private Placements - Immediately prior to its merger with Sync Research our Entrada subsidiary completed a private placement of 2,431,818 of its common shares receiving net proceeds of \$7,851. We purchased 1,001,818 of these shares for \$3,306. (See Note A).

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.

On March 3, 2000, our Sorrento subsidiary 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. Subsequent to the purchase of 2,697,248 of these shares an officer and director of the purchaser joined the Board of Directors of Sorrento. One of our then outside directors purchased 45,872 shares and a then director of Sorrento purchased 91,744 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. 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 to be redeemed at the shares then adjusted liquidation preference. If such a request is made in writing, our Sorrento subsidiary has the obligation to redeem the shares in cash, if funds are lawfully available to such a redemption, or for such pro rata portion as to which a lesser amount of lawfully available funds would exist. The net proceeds from the issuance of these shares has been classified as a minority interest in the accompanying financial statements as of January 31, 2001. The difference between the net proceeds received on the sale of these shares and

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

their liquidation preference of \$48,800 will be recorded as a deemed dividend during the period from issuance to March 31, 2001. During the years ended January 31, 2002 and 2001, we recorded a deemed dividend of \$180 and \$1,982 with respect to the Sorrento Series A shares. As of January 31, 2002 the Series A Preferred Stock has been reclassified as a current liability since the holders have exercised their right to redeem the shares.

We made sales of products to affiliates of two of the purchasers of Sorrento's Series A Preferred Stock. During the years ended January 31, 2002 and 2001, we made sales of \$2,076 and \$3,281 to the subsidiaries of the purchaser of 33.8% of the shares of which \$1,601 and \$3,281 was outstanding at January 31, 2002 and 2001 under 180 days terms. During the fiscal years ended January 31, 2002 and 2001, we made sales of \$2,553 and \$4,781 to the subsidiaries of the purchaser of 6.2% of the shares of which \$2 and \$2496 was outstanding at January 31, 2002 and 2001 respectively.

In December, 1999 we issued 679,483 unregistered shares of common stock receiving net proceeds of \$6,862. In connection with this placement one of our then outside directors received a finder's fee of \$300. In addition, we paid a \$300 finders fee to an entity in which our immediate past Chairman and CEO, who was not a director at the time, was an officer. The holder had the right to request us to register their shares upon the earlier of December 1, 2000 or the disposition of substantially all of our NSI shares. The holder had the right to nominate one member of the Board of Directors to serve until the next annual shareholders' meeting and had the right to participate in any stock offering by Sorrento to the extent of \$7,500 subject to certain limitations. Our immediate past Chairman and CEO was the purchaser's appointee to our Board of Directors.

Debentures payable - We issued 143,115 shares of our common stock in conversions of these securities and accrued interest thereon during the year ended January 31, 1999. We had the right to call the debentures prior to conversion at 90% of face value and had the right to assign this call option. The debentures bore interest at 8% beginning specified periods after date of issue payable in our common shares. The debentures were convertible at the average closing price as reported by Nasdaq for the five preceding business days not to exceed \$18.00 per share.

Warrants - During the year ended January 31, 2001, we issued 13,009 shares of our common stock upon the cashless exercise by our lender of 16,668 warrants with exercise prices ranging from \$10.02 to \$15.94. (See Note D).

During the year ended January 31, 2000, 125,000 of the 265,340 warrants held by a former strategic partner were exercised by an assignee. The remaining warrants expired unexercised.

We have outstanding warrants to purchase 33,334 shares at \$12.00 which expire December 31, 2002 may be redeemed by us for \$1,000.

K. STOCK OPTION PLANS



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

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. The following table summarizes the activity in the plans:

F-25

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

	Number of Shares	
	-----	-----
Shares under option at January 31, 1999	2,424,175	
Granted	998,213	
Exercised	(717,373)	
Canceled	(516,960)	
	-----	
Shares under option at January 31, 2000	2,188,055	
Granted	3,878,068	
Exercised	(890,898)	
Canceled	(107,990)	
	-----	
Shares under option at January 31, 2001	5,067,235	
Granted	873,688	
Exercised	(98,267)	
Canceled	(1,232,116)	
	-----	
Shares under option at January 31, 2002	4,610,540	
	=====	

Additional information relating to stock options outstanding and exercisable at January 31, 2002 summarized by exercise price are as follows:

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Exercise Price Per Share	Shares	Outstanding		Exercisab	
		Weighted Average		Shares	Weigh Exer
		Life (Years)	Exercise Price		
\$3.00 - \$9.99	1,334,924	7.28	\$ 6.32	932,930	
\$10.00 - \$19.99	641,728	6.62	\$14.92	508,668	\$
\$20.00 - \$29.99	573,038	7.65	\$22.42	408,038	\$
\$30.00 - \$39.99	645,450	7.91	\$35.89	645,375	\$
\$40.00 - \$69.13	1,415,400	8.22	\$54.02	1,293,533	\$
	-----			-----	
\$3.00 - \$69.13	4,610,540	7.61	\$28.30	3,788,544	\$
	=====			=====	

All stock options issued to employees have an exercise price not less than the fair market value of the Company's common stock on the date of grant, and in accordance with the accounting for such options utilizing the intrinsic value method there is no related compensation expense recorded in the Company's financial statements. Had compensation cost for stock-based compensation been determined based on the fair value at the grant dates in accordance with the method delineated in Statement of Accounting Standards No. 123, the Company's net loss and loss per share for the years ended January 31, 2002, 2001 and 2000, would have been increased to the pro forma amounts presented below:

	2002	2001
	-----	-----
Net loss:		
As reported	\$ (43,136)	\$ (41,905)
Pro forma	(46,978)	(103,130)
Loss per share:		
Basic EPS as reported	\$ (3.10)	\$ (3.71)
Pro forma basic EPS	(3.38)	(8.87)
Diluted EPS as reported	(4.36)	(3.71)
Pro forma diluted EPS	(4.59)	(8.87)

F-26

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

The fair value of option grants is estimated on the date of grant utilizing the Black-Scholes option-pricing model with the following weighted average assumptions for grants during the year ended January 31, 2002: expected life of option 3 years, expected volatility of 140%, risk free interest rate of 2.91% to 4.50% based upon the date of grant and a 0% dividend yield. The fair value, at date of grant, using these assumptions range from \$2.30 to \$5.63 and the weighted average was \$4.18. The assumptions for the year ended January 31, 2001 were expected life of option 3 to 5 years, expected volatility of 85%, risk free interest rate of 4.89% to 6.75% and a 0% dividend yield. The fair value, at date of grant, using these assumptions range from \$8.97 to \$40.09 and the weighted average was \$22.17. The assumptions for the year ended January 31, 2000 were expected life of option 3 to 4 years, expected volatility of 85%, risk free interest rate of 5.56% and a 0% dividend yield. The fair value, at date of grant, using these assumptions range from \$2.73 to \$22.15 and the weighted average was \$7.68.

In addition our Sorrento subsidiary adopted its 2000 Stock Option/Stock Issuance Plan in February 2000 under which it has granted options to certain of its employees, directors and consultants. All options are generally granted 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, either through immediate purchase of the shares at fair value or as a bonus tied to performance of services or the attainment of prescribed milestones. No milestones were attained and, no stock has been issued under the stock issuance program and option activity for the plan for the year ended January 31, 2002 is summarized as follows:

	Number of Shares
Shares under option at January 31, 2000	-
Granted	22,071,074
Exercised	-
Canceled	(3,335,170)
Shares under option at January 31, 2001	18,735,904
Granted	1,193,064
Exercised	(22,300)
Canceled	(4,592,236)
Shares under option at January 31, 2002	15,314,432

Additional information relating to the stock options of our Sorrento subsidiary outstanding and exercisable at January 31, 2002 summarized by exercise price are as follows:

		Outstanding		Exercisable	
		Weighted Average			
Exercise Price	Shares	Life (Years)	Exercise Price	Shares	Weighted Average
Per Share	-----	-----	-----	-----	-----
\$2.00	715,975	8.05	\$2.00	464,978	
\$5.45	14,527,612	8.26	\$5.45	10,230,528	
\$6.85	70,845	8.52	\$6.85	36,195	
	-----			-----	

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

\$2.00 - \$6.85	15,314,432	8.25	\$5.30	10,731,701
	=====			=====

The holders of the options of our Sorrento subsidiary 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 year ended January 31, 2002 and 2001, no options were converted.

F-27

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

L. INCOME TAXES

The Company's provision for taxes on income for the years ended January 31, 2002, 2001 and 2000 consists of:

	Non-U.S. ----- Discontinued Operations -----
Year ended January 31, 2002:	
Current	\$ -
Deferred	-
	-----
Total	\$ - =====
Year ended January 31, 2001:	
Current	\$ -
Deferred	-
	-----
Total	\$ - =====
Year ended January 31, 2000:	
Current	\$ -
Deferred	(246)
	-----
Total	\$ (246) =====

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

The Company's domestic operations generate permanent and temporary differences for depreciation, amortization, valuation allowances and tax attributes arising from acquisitions. The Company has recorded a 100% valuation allowance against its deferred tax assets, including net operating loss and research credit carryforwards, in accordance with the provisions of Statement of Financial Accounting Standards No. 109. Such allowance is recognized if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

	2002
Deferred tax assets:	
Valuation allowances	\$ 3,283
Research and development credits	63
Tax loss carryforwards	55,004
Purchase accounting	2,057
Depreciable assets	583
Other liabilities and reserves	2,334
Gross deferred tax assets	63,324
Less: valuation allowance	(63,324)
Deferred tax asset	\$ -

At January 31, 2002, the Company has federal net operating losses which may be available to reduce future taxable income. Among potential adjustments which may reduce available loss carryforwards, the Internal Revenue Code of 1986, as amended, (IRC), reduces the extent to which net operating loss carryforwards may be utilized in the event there has been an "ownership change" of a company as defined by applicable IRC provisions. The Company believes that the issuances of its equity securities and transfers of ownership of outstanding equity securities may have resulted in one or more such ownership changes and intends to analyze the impact of such transfers on the continued availability, for tax purposes, of the Company's net operating losses incurred through January 31, 2002. Further

F-28

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

ownership changes in the future, as defined by the IRC, may reduce the extent to which any net operating losses may be utilized. These NOL carryforwards expire as follows:

2007	\$ 5,140
2008	3,097
2009	2,794
2010	1,052
2011	386
2012	4,678
2018	14,257
2019	11,243
2020	32,394
2021	39,786
2022	42,328
	-----
	\$157,155
	=====

The reconciliation between income tax expense and a theoretical United States tax computed by applying a rate of 35% for the years ended January 31, 2002, 2001 and 2000, is as follows:

	2002	2001	
	-----	-----	
Income (loss) before income taxes	\$(43,136)	\$(41,905)	\$
Theoretical tax (benefit) at 35%	\$(15,098)	\$(14,667)	\$
Impact of purchase accounting	-	101	
Impact of non-qualified stock options	(434)	(3,978)	
Change in valuation allowance	16,862	18,499	
Other individually immaterial items	(1,330)	45	
	-----	-----	
	\$ -	\$ -	\$
	=====	=====	=

### M. EARNINGS PER SHARE CALCULATION

The following data show the amounts used in computing basic earnings per share. The number of shares used in the calculations for the years ended January 31, 2002, 2001 and 2000 reflect a 1-for-3 stock split effective July 24, 1998.

	2002	2001	
	-----	-----	
Net loss	\$ (43,136)	\$ (41,905)	\$ (
Less: deemed dividend	(180)	(1,982)	
Less: preferred dividends paid	-	-	
Less: accrued, unpaid preferred dividends	-	(118)	
	-----	-----	
Net loss available to common shareholders used in basic EPS	\$ (43,316)	\$ (44,005)	\$ (

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

	=====	=====	=====
Average number of common shares used in basic EPS	13,966,067	11,854,848	9,6
	=====	=====	=====

For the year ended January 31, 2000 our convertible preferred stock was antidilutive. Accordingly, the weighted average number of dilutive potential common stock of 463,401 and the dividends paid on these preferred shares of \$564 are excluded from the calculation of diluted EPS. We incurred a net loss from continuing operations

F-29

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

for the years ending January 31, 2002, 2001 and 2000. Accordingly, the effect of dilutive securities including convertible debentures, 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.

	2002	2001
	-----	-----
Net loss available to common shareholders used in basic EPS	\$ (43,316)	\$ (44,005)
Interest on convertible debt	(27,135)	-
	-----	-----
Net loss available to common shareholders after Assumed conversions of dilutive securities	\$ (70,451)	\$ (44,005)
	=====	=====
Average number of common shares used in basic EPS	13,966,067	11,854,848
Effect of dilutive securities:		
Convertible preferred stock	-	22,046
Stock benefit plans	130,639	1,628,255
Stock benefit plan of Sorrento	23,910	-
Warrants	72,983	93,384
Convertible debentures	2,208,739	-
	-----	-----
Average number of common shares and dilutive potential common stock used in diluted EPS	16,402,338	13,958,533

=====

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 with exercise prices in excess of the average market price for the period are excluded because their effect would be antidilutive.

Options to purchase common shares that were outstanding but were not included in the computation of diluted earnings per share because their exercise price was greater than the average market price of the common shares for the period. Options outstanding were 4,734,458 for the fiscal year ended January 31, 2002. All three years were also not dilutive because of losses.

#### N. OTHER RELATED PARTY TRANSACTIONS

Summarized below are all material related party transactions entered into by us and our subsidiaries during the periods presented not otherwise disclosed in these notes.

In November 2001, we acquired in a like kind exchange furniture having an approximate current value of \$8,000 from Digital Boardwalk, Inc. ("DBI") which is an affiliate of Par Chadha, our former Chairman and CEO. Also, during the fourth quarter of fiscal 2002, our Meret subsidiary retained DBI to consult on various matters, for which DBI charged a consulting fee of approximately \$49,000, and our Sorrento subsidiary retained DBI to consult on a matter for which DBI charged a consulting fee of approximately \$7,000.

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. At January 31, 2002 the balances of this loan was \$316, consisting of principal and accrued interest. The loan was fully reserved as of January 31, 2002.

During June 2000, we entered into various agreements with Par Chadha, our former CEO and Chairman, which, among other matters, provides for payments of \$250,000 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, Mr. Chadha exercised 71,112 options, applying the \$500,000 accelerated payment to the exercise. In addition, he exercised 507,388 options for which we are contractually obligated to loan the \$5,034,000 due on the exercise. During September 2001, Mr. Chadha notified us that he does not have any obligations under the agreements. We have notified him that we do not agree with his



## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

---

interpretation of his repayment obligations under the terms of the agreements.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Mr. Chadha returned the 507,388 shares to us for cancellation and we cancelled the receivable due from him and restored the original option agreements. This rescission agreement did not resolve any underlying dispute as to the option loan repayment obligations. We anticipate this dispute will be resolved through binding arbitration. Should Mr. Chadha prevail in the arbitration, the Company may be required to issue him 1,178,500 shares of the Company's stock for no consideration.

During December 2001, we entered into an agreement whereby the 507,388 option exercise was rescinded. Mr. Chadha 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 year ended January 31, 2002 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. This dispute is being negotiated between Mr. Chadha and the Company, see details in Note H.

During fiscal 2000 FIBR Holdings, LLC purchased 679,483 unregistered shares of our common stock for \$7,500,000. In connection with this placement Humbert B. Powell, III, then a director, received a finder's fee of \$300,000. Andersen Weinroth Capital Corp. ("AW") received a placement fee of \$300,000 in connection with this placement and Rohit Phansalkar, who subsequently became one of our directors, and later became our Chairman and Chief Executive Officer, was a partner of AW at that time. FIBR Holdings, LLC had the right to nominate one member of the Board of Directors to serve until the annual shareholders' meeting in 2001 and had the right to participate in any stock offering by our Sorrento Subsidiary, to the extent of \$7,500,000 subject to certain limitations. Mr. Phansalkar was nominated by AW and joined our Board of Directors on January 6, 2000.

On March 3, 2000, our Sorrento subsidiary completed a sale 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. Of these shares, 1,467,891 shares were purchased for \$8,000,000 pursuant to the previously contracted right of participation by entities in which Mr. Phansalkar was partner or member. In addition, AW received a placement fee of \$1,950,000 paid through the issuance by Sorrento of 357,799 shares of its Series A Convertible Preferred Stock. Mr. Phansalkar disclaims beneficial ownership of these shares except to the extent of his beneficial ownership of each entity. In addition, Renn Zaphiropoulos, a former director, purchased 45,872 of these shares for \$250,000.

During the year ended January 31, 2000 we paid \$40 to a then outside director for management consulting services rendered to us and our subsidiaries.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

During the years ended January 31, 2000 we paid \$190 in fees for assistance in obtaining the amended loan and security agreements to an entity controlled by a then outside director. During the year ended January 31, 1998 we made 8% demand loans in the amount of \$165 to an entity controlled by a then outside director which was fully repaid, including interest thereon, during April 1999. The loan was collateralized by 20,408 shares of the Company's common stock.

F-31

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

-----

### O. SUPPLEMENTAL CASH FLOW DISCLOSURES

Interest expense and taxes paid approximated the related expenses for the years ended January 31, 2002, 2001 and 2000. During fiscal 2002, common shares were issued as interest payments on debentures and neither provided nor used cash.

Common shares issued upon a cashless warrant exercise applied to an outstanding short term note during the year ended January 31, 2000 neither provided nor used cash. Accordingly, the \$1,100 value assigned to such stock has been excluded from the statement of cash flows.

### P. CONCENTRATIONS OF CREDIT RISK

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of temporary cash investments and trade receivables. As regards the former, we place our temporary cash investments with high credit financial institutions and limits. At times such amounts may exceed the F.D.I.C. limits. We limit the amount of exposure with any one financial institution and believe that no significant concentration of credit risk exists with respect to cash investments. No accounts at a single bank accounted for more than 10% of current assets.

Although we are directly affected by the economic well being of significant customers listed in the following tables, we do not believe that significant credit risk exists at January 31, 2002. We perform ongoing evaluations of our customers and require letters of credit or other collateral arrangements as appropriate. Accordingly, trade receivable credit losses have not been significant.

The following data shows the customers accounting for more than 10% of net receivables at January 31 2002 and 2001:

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

	2002	2001
	-----	-----
Customer A	-	15.6%
Customer B	-	2.4
Customer C	19.8	20.5
Customer D	13.9	20.6
Customer E	24.7	14.1
Customer F	3.9	12.0
Customer G	20.4	-

The following data shows the customers accounting for more than 10% of net sales during the years ended January 31, 2002, 2001 and 2000:

	2002	2001
	-----	-----
Customer A	6.3%	10.7%
Customer B	6.9	12.9
Customer C	5.1	7.3
Customer D	21.1	9.3
Customer E	14.4	4.2
Customer F	13.2	4.9
Customer G	4.0	-

F-32

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

Q. SUBSEQUENT EVENTS

The Board of Directors of Osicom approved a two-year employment contract with Mr. Mason ending May 2002, which provided for a base salary of \$130,900 per year and vesting of all his options to acquire our common stock granted prior to February 1, 2000. This contract may be terminated for cause. However, should Mr. Mason be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his base salary and benefits for two years, vesting of all his options to acquire our common stock, and he is required to provide consulting services to us during the two years following his termination. In March 2002 Mr, Mason notified the Company that he was resigning with cause, relying on an agreement between Mr.

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Mason and Dr. Cheng in April 2001 that allowed him to resign for cause at any time prior to the expiration of his employment agreement as a result of having been relocated more than 35 miles from his prior employment location. Mr. Mason's resignation under these circumstances entitled him to receive two year salary and benefit continuation and immediate stock vesting.

The Board of Directors of Osicom approved a two-year employment contract with Mr. Sue ending May 2002, which provides for a salary of \$168,500 per year and the vesting of all his options to acquire our common stock granted prior to February 1, 2000. This contract may be terminated for cause. However, should Mr. Sue be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his salary and benefits for two years, vesting of all his options to acquire our common stock and he is required to provide consulting services to us during that period, On May 8, 2002 Mr. Sue resigned from his position effective May 17, 2002 alleging entitlement to the foregoing salary continuation and other benefits. The Company does not believe Mr. Sue is entitled to any such benefits.

The Board of Directors of Osicom entered into a two-year contact with Anne Wallace, Director of Financial Reporting, ending May 22, 2002 which provided her compensation of \$200,000 per year, plus benefits and living expenses while on location at the Company's Santa Monica facility. This contract may be terminated for cause. However, should Ms. Wallace be contact be terminated without good reason, or if she resigns for good reason, she will receive a continuation of compensation and benefits for two years, and vesting of all her options to acquire our common stock . On May 8, 2002 Ms. Wallace gave notice to the Company that she has resigned for good reason, thus alleging entitlement to the foregoing compensation annd benefits. The Company does not believe Ms. Wallace is entitled to any such benefits.

The Board of Directors of Osicom entered into a two-year employment contract with Mr. Nimrod Johnson, Corporate Controller, ending May 22, 2002, which provides for a salary of \$97,307 per year and the vesting of all his options to acquire our common stock. This contract maybe terminated for cause. However, should Mr. Johnson be terminated without cause or resign in certain circumstances prior to the end of the contract term he will receive a continuation of his salary and benefits for two years, vesting of all his options to acquire our common stock and he is required to provide consulting services to us during that period. On May 9, 2002 Mr. Johnson resigned from his position effective May 17, 2002 alleging entitlement to the foregoing salary continuation and other benefits. The Company does not believe Mr. Johnson is entitled to any such benefits.

### R. SEGMENT INFORMATION

Information for the years ended January 31, 2002, 2001 and 2000 in the table below is presented on the same basis utilized by the Company to manage its business. The segments according to product lines are as follows; Sorrento Networks, Optical Networking, Entrada Networks and NETsilicon. Export sales and certain income and expense items are reported in the geographic area where the final sale to customers is made, rather than where the transaction originates. We have no material long term assets outside the United States. The accounting policies of the segments are the same as the policies described in the "Summary of Significant Accounting Policies". Each segment operates independent of one another. The company evaluates the performance of each segment and distributes resources to them based on earnings before income taxes, excluding corporate charges ("Segment Operating Profit")

2002	2001	2000
-----	-----	-----

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Net sales:			
United States	\$28,341	\$36,923	\$53,158
Asia	1,340	247	12,982
Europe	10,130	7,285	1,656
Other	1,016	186	576
	-----	-----	-----
Total net sales	\$40,827	\$44,641	\$68,372
	=====	=====	=====

	Sorrento Networks -----	Meret Optical -----	Other -----	Consolidated -----
As of January 31, 2002 except				
Revenues from external customers	\$ 36,034	\$ 4,793	\$ -	\$ 40,827
Cost of goods sold	28,384	3,123	-	31,507
Gross profit	7,650	1,670	-	9,320
Operating income/(loss) from operations	(28,993)	246	(8,407)	(37,154)
Depreciation and amortization expense	2,039	543	212	2,794
Valuation allowance additions:				
Receivables and inventory	5,328	269	987	5,597
Other	812	-	1,788	2,600
Capital asset additions, net	3,116	67	52	3,235
Total assets	36,089	7,282	46,968	90,339

F-33

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

	Sorrento Networks -----	Meret Optical -----	Entrada Networks -----	Other -----
As of January 31, 2001 except for Entrada which is				

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

as of August 31, 2000:

Revenues from external customers	\$ 26,477	\$6,272	\$11,892	\$ -
Cost of goods sold	17,344	3,661	10,465	-
Gross profit	9,133	2,611	1,427	-
Operating income/(loss) from continuing operations	(36,147)	1,031	(7,859)	(7,440)
Depreciation and amortization expense	2,593	515	1,024	254
Valuation allowance additions:				
Receivables and inventory	642	678	4,327	700
Other	1,979	-	434	-
Capital asset additions, net	8,320	157	444	5,492
Total assets	36,524	9,088	n/a	67,511

	Sorrento Networks -----	Meret Optical -----	Entrada Networks -----	NETsilicon -----
As of January 31, 2000 except for NETsilicon which is as of September 14, 1999:				
Revenues from external customers	\$ 12,511	\$6,953	\$28,771	\$20,137
Cost of goods sold	5,415	4,100	17,498	9,577
Gross profit	7,096	2,853	11,273	10,560
Operating income/(loss) from continuing operations	(5,754)	415	(3,124)	2,540
Depreciation and amortization expense	825	1,021	2,118	660
Valuation allowance additions:				
Receivables and inventory	373	657	911	733
Other	-	-	1,742	-
Capital asset additions, net	1,839	(576)	140	721
Total assets	7,973	7,925	16,135	n/a

F-34

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

S. VALUATION AND QUALIFYING ACCOUNTS

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

Changes in the inventory valuation reserve were as follows:

Balance at February 1, 1999	\$ 3,489
Additions charged to costs and expenses	1,600
Amounts used during year	(589)
Balance of NSI at September 15, 1999	(430)
	-----
Balance at January 31, 2000	4,070
Additions charged to costs and expenses	3,689
Amounts used during year	(55)
Balance of Entrada at August 31, 2000	(4,912)
	-----
Balance at January 31, 2001	2,792
Additions charged to costs and expenses	4,038
Amounts used during year	(362)
	-----
Balance at January 31, 2002	\$ 6,468
	=====

Changes in the accounts receivable valuation reserve were as follows:

Balance at February 1, 1999	\$ 1,136
Additions charged to costs and expenses	1,074
Amounts used during year	(279)
Balance of NSI at September 15, 1999	(728)
	-----
Balance at January 31, 2000	1,203
Additions charged to costs and expenses	1,958
Amounts used during year	(570)
Balance of Entrada at August 31, 2000	(1,589)
	-----
Balance at January 31, 2001	1,002
Additions charged to costs and expenses	1,558
Amounts used during year	(821)
	-----
Balance at January 31, 2002	\$ 1,739
	=====

F-35

SORRENTO NETWORKS CORPORATION  
AND SUBSIDIARIES

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

## Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

### T. UNAUDITED QUARTERLY FINANCIAL DATA (Unaudited)

Amounts in thousands, except per share amounts.

	First Quarter -----	Second Quarter -----	Third Quarter -----	Fourth Quarter -----
<b>Year ended January 31, 2002:</b>				
Net sales	\$ 14,497	\$ 7,998	\$ 10,066	\$ 8,266
Gross profit	4,929	1,296	1,321	1,774
Loss from operations	(5,768)	(10,961)	(15,924)	(10,483)
 Net loss	 (5,768)	 (10,961)	 (15,924)	 (10,483)
Net loss per share:				
Basic	(0.45)	(0.77)	(1.11)	(0.74)
Diluted	(0.45)	(2.06)	(1.11)	(0.74)
 <b>Year ended January 31, 2001:</b>				
Net sales	\$ 10,048	\$ 11,376	\$ 10,849	\$ 12,368
Gross profit	1,855	3,842	3,509	3,965
Loss from continuing operations	(12,837)	(13,524)	(6,903)	(8,641)
 Net loss	 (12,837)	 (13,524)	 (6,903)	 (8,641)
Net loss per share:				
Basic	(1.15)	(1.21)	(0.63)	(0.74)
Diluted	(1.15)	(1.21)	(0.63)	(0.74)
 <b>Year ended January 31, 2000:</b>				
Net sales	\$ 19,129	\$ 17,206	\$ 18,948	\$ 13,089
Gross profit	8,878	8,120	9,328	5,456
Income (loss) from continuing operations	(1,043)	(2,493)	14,246	(8,300)
Provision for income taxes	-	-	(3,406)	3,406
Loss from discontinued operations	(1,229)	(120)	(9,307)	(13,407)
Net income (loss)	(2,272)	(2,613)	1,533	(18,301)
Net income (loss) per share:				
Basic	(0.29)	(0.30)	0.13	(1.66)
Diluted	(0.29)	(0.30)	0.14	(1.66)

F-36

### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.



Edgar Filing: SORRENTO NETWORKS CORP - Form 10-K

SORRENTO NETWORKS CORPORATION

By: \_\_\_\_\_ /s/ Joe R. Armstrong Date: May 16, 2002  
Joe R. Armstrong  
Chief Financial Officer  
Principal Accounting Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

By: \_\_\_\_\_ /s/ Phil Arneson Date: May 16, 2002  
Phil Arneson  
Chairman and Director  
Chief Executive Officer

By: \_\_\_\_\_ /s/ Donne Fisher Date: May 16, 2002  
Donne Fisher  
Director

By: \_\_\_\_\_ /s/ Gary M. Parsons Date: May 16, 2002  
Gary M. Parsons  
Director

By: \_\_\_\_\_ /s/ Robert Hibbard Date: May 16, 2002  
Robert Hibbard  
Director

By: \_\_\_\_\_ /s/ Xin Cheng Date: May 16, 2002  
Xin Cheng  
Director

STATEMENT OF DIFFERENCES

-----  
The trademark symbol shall be expressed as..... 'TM'  
The registered trademark symbol shall be expressed as..... 'r'