

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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

=====

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(thousands)

(Unaudited)
April 30, 2004

ASSETS		
CURRENT ASSETS		
Cash and cash equivalents.....		\$ 11,008
Accounts receivable, net.....		5,651
Inventory, net.....		11,899
Prepaid expenses and other current assets.....		620
Investment in marketable securities.....		460
Notes receivable		270

TOTAL CURRENT ASSETS.....		29,908

PROPERTY AND EQUIPMENT, NET.....		12,938

OTHER ASSETS		
Purchased technology, net.....		100
Other assets.....		645
Notes receivable.....		55

TOTAL OTHER ASSETS.....		800

TOTAL ASSETS.....		\$ 43,646
		=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of long term debt.....		\$76
Accounts payable.....		2,026
Deferred revenue.....		619
Accrued professional fees.....		395
Other accrued liabilities and current liabilities.....		4,439

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

TOTAL CURRENT LIABILITIES.....	7,555
Long-term debt and capital lease obligations.....	3,522
Debentures payable.....	11,728
TOTAL LIABILITIES.....	22,805
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY	
Preferred stock, \$.01 par value; liquidation preference \$1,353.....	1
Common stock, \$.001 par value; 150,000,000 shares authorized; 17,063,627 shares issued and 17,063,183 shares outstanding at April 30, 2004; and 16,314,917 shares issued and 16,315,361 shares outstanding at January 31, 2004.....	17
Additional paid-in capital.....	218,924
Accumulated deficit.....	(198,443)
Accumulated other comprehensive gain.....	411
Treasury stock, at cost; 444 shares at April 30, 2004 and January 31, 2004, respectively.....	(69)
TOTAL STOCKHOLDERS' EQUITY.....	20,841
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....	\$ 43,646

See accompanying notes to consolidated financial statements.

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(thousands, except per share amounts)

	Three Months Ended April 30,	
	2004	2003
	----	----
NET SALES	\$ 6,093	\$ 7,861
COST OF SALES	3,930	5,907
	-----	-----
GROSS PROFIT	2,163	1,954
	-----	-----
OPERATING EXPENSES		
Selling and marketing	1,985	2,175

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Engineering, research and development	2,352	1,644
General and administrative	2,713	1,599
Deferred stock compensation	--	51
Other operating expenses	10	103
	-----	-----
TOTAL OPERATING EXPENSES	7,060	5,572
	-----	-----
LOSS FROM OPERATIONS	(4,897)	(3,618)
	=====	=====
OTHER INCOME (EXPENSES)		
Interest expense	(296)	(2,665)
Other income	519	61
	-----	-----
TOTAL OTHER INCOME (EXPENSES)	(223)	(2,604)
	-----	-----
NET LOSS	\$ (4,674)	\$ (6,222)
LOSS PER SHARE:		
NET LOSS APPLICABLE TO COMMON SHARES	\$ (4,674)	\$ (6,222)
	=====	=====
BASIC WEIGHTED AVERAGE COMMON SHARES		
OUTSTANDING	16,649	886
	-----	-----
BASIC NET LOSS PER COMMON SHARE	\$ (0.28)	\$ (7.02)
	=====	=====
DILUTED WEIGHTED AVERAGE COMMON SHARES		
OUTSTANDING	16,649	1,109
	-----	-----
DILUTED NET LOSS PER COMMON SHARE	\$ (0.28)	\$ (14.33)
	=====	=====
COMPREHENSIVE LOSS AND ITS COMPONENTS CONSIST OF		
THE FOLLOWING:		
Net loss	\$ (4,674)	\$ (6,222)
Components of other comprehensive income:		
Unrealized holding gains arising during the period	30	1,060
	-----	-----
NET COMPREHENSIVE LOSS	\$ (4,644)	\$ (5,162)
	=====	=====

See accompanying notes to consolidated financial statements.

F-3

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES
For the three months ended April 30, 2004

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (Unaudited)
(thousands)

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

	Common Stock		Preferred Stock		Addition Paid in Capital
	Shares	Amount	Shares	Amount	
Balance at January 31, 2004	16,315	\$16	2	\$1	\$216,4
Common Stock Issuance	748	1			2,4
Unrealized (losses) on available for sale securities					
Foreign currency translation adjustments					
Net loss					
Balance at April 30, 2004	17,063	\$17	2	\$1	\$218,9

	Accumulated Deficit	Treasury Stock		Other Compreh gain
		Shares	Amount	
Balance at January 31, 2004	\$(193,769)	1	\$(69)	\$381
Common Stock Issuance				
Unrealized (losses) on available for sale securities				(9)
Foreign currency translation adjustments				39
Net loss	(4,674)			
Balance at April 30, 2004	\$(198,443)	1	\$(69)	\$411

See accompanying notes to consolidated financial statements.

F-4

SORRENTO NETWORKS CORPORATION
AND SUBSIDIARIES
For the three months ended April 30, 2003

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (Unaudited)
(thousands)

	Common Stock		Preferred Stock		Additional Paid In Capital	Deferred Stock Compensat
	Shares	Amount	Shares	Amount		
Balance at January 31, 2003.....	886	\$5,318	2	\$1	\$144,887	\$ (5)
Unrealized losses on available for sale securities.....						
Deferred stock compensation of subsidiary.....					46	(46)
Amortization of deferred stock compensation.....						51
Net loss.....	---	-----	-	--	-----	----
Balance at April 30, 2003.....	886	\$5,318	2	\$1	\$144,933	\$ --

	Treasury Stock		Other Comprehensive Loss	Total Stockholders' Equity
	Shares	Amount		
Balance at January 31, 2003.....	1	\$(69)	\$2,928	\$(34,476)
Unrealized losses on available for sale securities.....			1,060	1,060
Deferred stock compensation of subsidiary.....				--
Amortization of deferred stock compensation.....				--
Net loss.....	-	-----	-----	(6,222)
Balance at April 30, 2003.....	1	\$(69)	\$3,988	\$(39,587)

See accompanying notes to consolidated financial statements.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

SORRENTO NETWORKS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(thousands)

	Three Month April 3 ----- 2004 -----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	\$ (4,674)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	577
Accounts receivable and inventory reserves	127
Other non cash	38
Non-cash interest on debentures	--
Deferred and other stock compensation	--
Changes in assets and liabilities:	
(Increase) decrease in accounts receivable	(2,024)
Decrease in inventories	1,757
Decrease in other current assets	352
Decrease in accounts payable	(861)
Decrease in deferred revenue	(259)
Increase (decrease) in accrued and other current liabilities	(1,310)
NET CASH USED IN OPERATING ACTIVITIES	(6,277)
CASH FLOWS FROM INVESTING ACTIVITIES:	
(Purchase) disposal of property and equipment	(990)
Certificate of Deposit redemption	36
Other assets	(2)
NET CASH PROVIDED USED IN INVESTING ACTIVITIES	(956)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from common stock	665
Payments of short-term debt, net	(25)
Repayment of long-term debt	(16)
NET CASH PROVIDED BY FINANCING ACTIVITIES	624
DECREASE IN CASH AND CASH EQUIVALENTS	(6,609)
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	17,617
CASH AND CASH EQUIVALENTS - END OF PERIOD	\$11,008

See accompanying notes to consolidated financial statements.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

The Company

Sorrento Networks Corporation (the "Company," "We," "Our," or "Us") through its subsidiaries designs, manufactures and markets integrated networking and bandwidth aggregation and optical access 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 and Sunnyvale, California and various sales offices located in the United States and Europe. We market and sell our products and services through a broad array of channels including worldwide distributors, value added resellers, local and long distance carriers and governmental agencies.

Recent Developments

In April, 2004, the Company announced its agreement to be acquired by Zhone Technologies, Inc. ("Zhone"). Under the terms of the agreement, Zhone will issue 0.9 of a share of Zhone common stock for each outstanding share of Sorrento common stock and each option, warrant and other security exercisable or convertible into Sorrento common stock will be assumed by Zhone and become exercisable or convertible into Zhone common stock, with appropriate adjustments based on the merger exchange ratio. The proposed stock-for-stock transaction is intended to qualify as tax-free to the stockholders of Sorrento.

The Form S-4 Registration Statement relating to the proposed merger of the two companies has been declared effective by the Securities and Exchange Commission. Zhone and Sorrento also received notification of early termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act. Stockholder meeting for both Zhone and Sorrento have been scheduled for June 30, 2004, for stockholders of record as of May 25, 2004. Subject to the approval of the stockholders of both companies, and other conditions to closing, Zhone and Sorrento anticipate compliance with all remaining closing conditions and for the transaction to be completed on July 1, 2004.

Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial data for the three months ended April 30, 2004 and 2003 along with financial data for January 31, 2004, has been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The January 31, 2004 balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, we believe that the disclosures we have made are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K/A for the year ended January 31, 2004.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

management to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities. Actual results could materially differ from these estimates. In the opinion of Management, all adjustments (which include normal recurring adjustments and charges described in the notes to the financial statements) necessary to present fairly the financial position, results of operations and cash flows for the quarters ended April 30, 2004 and 2003 have been made. The results of operations for the quarter ended April 30, 2004 are not necessarily indicative of the operating results for the full year.

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

7

debt and equity financing. There can be no assurance that similar funding will be available in the future. Our future capital requirements may vary materially from those now planned including the need for additional working capital to accommodate planned growth, hiring and infrastructure needs. There can be no assurances that our working capital requirements will not exceed our ability to generate sufficient cash internally to support our requirements and that external financing will be available or that, if available, such financing can be obtained on terms favorable to us and our shareholders.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities. Actual results could materially differ from these estimates. In the opinion of Management, all adjustments (which include normal recurring adjustments and charges described in the notes to the financial statements) necessary to present fairly the financial position, results of operations and cash flows for the quarters ended April 30, 2004 and 2003 have been made.

Certain reclassifications have been made to prior year presentations to conform to the Fiscal 2005 presentation.

Deferred Stock Compensation

We account for employee-based stock compensation utilizing the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, compensation cost for stock options issued to employees is measured as the excess, if any, of the fair market price of our common stock at the date of grant over the amount an employee must pay to acquire the stock. This amount appears as a separate

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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 three months ended April 30, 2004 and 2003 it amortized \$0 and \$5 thousand, respectively, of the total \$2.6 million initially recorded for deferred stock compensation.

For non-employees, who are not directors, we compute the fair value of stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," and Emerging Issues Tax Force (EITF) 96-18, "Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." All such amounts relate to options to acquire common stock of our subsidiary Sorrento Networks, Inc. ("SNI") granted by it to its consultants; during the three months ended April 30, 2004 and 2003 it recorded \$0 and \$46 thousand, respectively, for options granted to consultants.

Recent Accounting Pronouncements

In December 2003, the SEC issued SAB 104, which supersedes SAB 101, Revenue Recognition in Financial Statements. The primary purpose of SAB 104 is to rescind the accounting guidance contained in SAB 101 related to multiple element revenue arrangements, which was superseded as a result of the issuance of EITF 00-21. We adopted EITF 00-21 and SAB 104 with no material impact on our financial statements.

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

In November 2002, the FASB issued FIN 45, which expands previously issued accounting guidance and disclosure requirements for certain guarantees. FIN 45 requires us to recognize an initial liability for the fair value of an obligation assumed by issuing a guarantee. The provision for initial recognition and measurement of the liability will be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not materially affect our consolidated financial statements.

In November 2002, the Emerging Issues Task Force ("EITF") reached a

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003.

Balance Sheet Detail

Inventories at April 30, 2004 and January 31, 2004 consist of:

	April 30, 2004 ----	January 31, 2004 ----
Raw material	\$ 18,828	\$ 20,744
Work in process	2,483	3,133
Finished goods	4,738	5,416
	-----	-----
	26,049	29,293
Less: Valuation reserve	(14,150)	(15,400)
	-----	-----
	\$ 11,899	\$ 13,893
	=====	=====

Marketable Securities--Marketable securities, which consist of equity securities that have a readily determinable fair value and do not have sale restrictions lasting beyond one year from the balance sheet date, are classified into categories based on our intent. Our investment in Entrada Network's, Inc. ("ENI") is classified as available for sale and is 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 April 30, 2004, and January 31, 2004, marketable securities were as follows:

	Cost ----	Unrealized Gains -----	Market Value -----
April 30, 2004:			
Entrada Networks	\$ 31	\$47	\$ 78
Certificate of Deposit	382	--	382
	----	---	----
	\$413	\$47	\$460
	====	===	=====
January 31, 2004:			
Entrada Networks	\$31	\$56	\$ 87
Certificate of Deposit	416	1	417
	----	---	----
	\$447	\$57	\$504
	====	===	=====

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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

The carrying value of finite life intangible assets, consisting of purchased technology of our subsidiary Meret Optical, as of April 30, 2004, is \$0 thousand, net of amortization. The change in the net carrying amount of finite life intangible assets during the three months ended April 30, 2004 is due to amortization of \$20 thousand.

Debentures - During August 2001, we completed a private placement of our 9.75% convertible debentures receiving net proceeds of \$29.8 million. The debentures, due August 2, 2004 had a face value of \$32.2 million, which was convertible into our common stock at \$144.20 per share. At maturity, we could have elected to redeem

9

the debentures for cash and we had the option of paying the interest on these debentures in shares of our common stock. In addition, the purchasers received four year warrants to acquire an additional 167,592 shares of our common stock at \$144.20 per share and the placement agent received five year warrants to acquire 5,583 shares of our common stock, equity securities, options or warrants at a price less than \$144.20 per share or at a discount to the then market price. The conversion price and warrant exercise were subject to adjustment.

In accordance with Emerging Issues Task Force ("EITF") No. 00-27 we accounted for the fair value of warrants issued to the purchasers and placement agent and the fair value of the deemed beneficial conversion feature, which resulted solely as a result of the required accounting, of the debenture as a reduction to the face value of the debentures with an offsetting increase to additional paid in capital. These amounts, as well as the issuance costs paid in cash, were amortized as additional interest expense over the period the debentures were outstanding.

On March 6, 2003, we and our wholly-owned subsidiary Sorrento Networks, Inc. entered into an Exchange Agreement with the holders of our 9.75% Senior Convertible Debentures (the "9.75% Debentures") and the Series A Convertible Preferred Stock (the "Preferred Stock") of Sorrento Networks, Inc. The Exchange Agreement and associated documents contemplated an exchange (the "Exchange") of the 9.75% Debentures and the Preferred Stock at closing into shares of common stock and \$12.5 million of our new 7.5% Secured Convertible Debentures (the "7.5% Debentures"). Certain holders of the Preferred Stock would also receive additional 7.5% Debentures of approximately \$600 thousand to pay certain legal fees.

The Exchange Agreement was approved by shareholders on May 29, 2003 and was completed and became effective on June 4, 2003 pursuant to which we exchanged current outstanding debentures and Series A Preferred Stock for common stock and

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

an issuance of a smaller principal amount of 7.5% Debentures.

Interest expense on the 7.5% debentures for the three months ended April 30, 2004 was \$223 thousand.

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

In November 2003 and February 2004, we exchanged \$421 thousand and \$660 thousand in our senior convertible debentures for 148,988 and 155,975 shares of common stock respectively. The exchange was made under SEC regulation 3(a)(9) governing the exchange of such securities. At April 30, 2004 and January 31, 2004 the 7.5% debentures payable totaled \$11,728 and \$12,388 respectively

Stockholders' Equity

We are authorized to issue the following shares of stock:

150,000,000 shares of Common Stock (\$.001 par value)

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

3,000 shares of Preferred Stock, Series D

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

As of April 30, 2004, we had outstanding the following shares of preferred stock:

	Shares Outstanding -----	Par Value -----	Liquidation Preference -----
Series D.....	1,353	\$0.01	\$1,353
	-----	-----	-----
	1,353	\$0.01	\$1,353
	=====	=====	=====

In May 2004, the Company retired its Series D stock which was outstanding as of April 30, 2004 by issuing 496,155 shares of common stock. A portion of the common stock issued, which was subsequently sold and amounted to \$500,000 is being held in escrow under the terms of an agreement between the Company and

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Anite Corporation for possible losses or claims that may arise related to a pension plan that we acquired in 1996 upon the purchase of a division of a company that later became Entrada Networks. Entrada was subsequently spun-off and merged with another entity in August 2000, but as part of the spin-off, we maintained certain obligations under the pension plan as discussed in the section of Contingent Liabilities of this report.

Other Capital Stock Transactions

Each share of SNI's Series A Convertible Preferred Stock was convertible into one share of SNI's common stock at the option of the holder, voted on an "as converted" basis except for election of directors, and had a liquidation preference of \$5.45 per share. The shares were automatically convertible into SNI's common stock upon an underwritten public offering by SNI with an aggregate offering price of at least \$50.0 million. As SNI did not complete a \$50.0 million public offering by March 1, 2001, the holders of more than 50% of the then outstanding Series A shares had the right to request in writing that SNI redeem them at the adjusted liquidation preference. On receipt of such a request, SNI had the obligation to redeem the shares in cash, if funds were lawfully available for such redemption, or to redeem such pro rata portion as to which a lesser amount of lawfully available funds existed. In April 2001, SNI received written redemption requests from holders of a majority of the Series A shares. The difference between the net proceeds received on the sale of these shares and their liquidation preference of \$48.8 million was recorded as a deemed dividend during the period from issuance to March 31, 2001.

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

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

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

On August 8, 2003, we acquired LuxN Inc. for a combination of stock, warrants, and cash. Stockholders of LuxN were given the option of exchanging shares of LuxN stock for either their pro-rata portion of LuxN's net cash or shares of Sorrento's common stock. In addition to the cash or Sorrento common stock, stockholders of LuxN have the right to receive warrants to purchase an aggregate of 400 thousand shares of Sorrento common stock, with an exercise price of \$3.05 per share, the fair market value on the date of the acquisition. At closing, Sorrento issued approximately 1.4 million shares of common stock with the remaining approximately 500 thousand shares of common stock issued upon stockholder approval.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Stock Option Plans

We have five stock option plans in effect: The 2003 Equity Incentive Plan, the 2000 Stock Incentive Plan, the 1988 Stock Option Plan, the 1997 Incentive and Non-Qualified Stock Option Plan and the 1997 Director Stock Option Plan. The stock options have been made available to certain employees and consultants. All options are granted at not less than fair value at the date of grant and have terms varying from 3 to 10 years. The purpose of

11

these plans is to attract, retain, motivate and reward our officers, directors, employees and consultants to maximize their contribution towards our success.

We account for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net loss, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

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

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

For the three months
April 30

2004	2003
------	------

Net loss:

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

As reported	\$ (4,674)	\$ (6,222)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(964)	(222)
Pro forma	\$ (5,638)	\$ (6,444)
Loss per share:		
Basic EPS as reported	\$ (0.28)	\$ (0.34)
Pro forma basic EPS	\$ (0.34)	\$ (0.34)
Diluted EPS as reported	\$ (0.28)	\$ (0.34)
Pro forma diluted EPS	\$ (0.34)	\$ (0.34)

Earnings Per Share Calculation

The following data show the amounts used in computing basic earnings per share for the quarters ended April 30, 2004 and 2003.

	Three Months Ended April 30,	
	2004	2003
Net loss available to common shareholders used in basic EPS.....	\$ (4,674)	\$ (6,222)
Average number of common shares used in basic EPS.....	16,648,757	886,050

We had a net loss for the quarter ended April 30, 2004. Accordingly, the effect of dilutive securities including convertible preferred stock, vested and non-vested stock options and warrants to acquire common stock are not

included in the calculation of EPS because their effect would be antidilutive. Our convertible debentures create a dilutive situation even though the company had a net loss for the quarter. The following data shows the effect on income and the weighted average number of shares of dilutive potential common stock.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

	Three Months Ended April 30,	
	2004	2003
	----	----
Net loss available to common shareholders used in basic EPS	\$ (4,674)	\$ (6,222)
Less: Convertible debt issuance costs		(12,260)
Plus: Convertible debt interest		2,584
	-----	-----
Net loss available to common shareholders used in diluted EPS	\$ (4,674)	\$ (15,898)
	=====	=====
Average number of common shares used in basic EPS	16,648,757	886,050
Effect of dilutive securities:		
Convertible debentures	--	223,301
	-----	-----
Average number of common shares and dilutive potential common stock used in diluted EPS	16,648,757	1,109,351
	=====	=====

Common stock options and warrants of 680,086 and 2,056,101 shares of common stock for convertible debentures, for the three month period, are excluded from the computation, as the effect was anti-dilutive.

Litigation

From time to time, we are involved in various other legal proceedings and claims incidental to the conduct of our business. Although it is impossible to predict the outcome of any outstanding legal proceedings, we believe that such legal proceedings and claims, individually and in the aggregate, are not likely to have a material adverse effect on our financial position, results of operations, or cash flows. As of April 30, 2004, there were no outstanding lawsuits filed against the Company.

Contingent Liabilities

In the merger agreement among our predecessor corporation (Osicom Technologies, Inc.), Entrada, and Sync Research, Inc., Osicom agreed to indemnify and hold our former subsidiary harmless against liability arising from the termination of a certain pension plan if the subsidiary's losses exceeded \$250 thousand, but only for such losses that exceeded \$250 thousand. The pension plan was acquired as a result of the purchase of a division of Cray Communications in 1996, which later became Entrada.

Upon the acquisition of this former subsidiary, the seller had the right to terminate the plan for five years following the acquisition and was responsible for funding the plan. If the pension plan was not terminated in the five years following the acquisition, the agreement called for the parties to agree as to a mutually satisfactory arrangement for the termination or continuation of the plan. In the third quarter, we were advised by the successor corporation that the termination cost of the pension plan could total approximately \$2.9 million

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

if the plan was terminated. Continued funding of the pension plan also remains an unresolved issue and if funding is not kept current with regard to legal requirements the pension plan could default. As of April 30, 2004, we held in escrow approximately \$500 thousand in Series D Preferred Stock as a security against possible losses resulting from this pension plan. As of this date, the parties have not agreed to a resolution regarding the pension plan in future periods. In May 2004, the Series D Preferred Stock was converted into common stock and \$500 thousand in cash is being held in escrow pending resolution of the pension plan.

While we do not believe that we are liable for the continued costs associated with future funding or a cost associated upon termination, it is possible the pension plan could result in litigation among the parties if they cannot agree to an acceptable resolution. The Company has reserved approximately \$1 million for possible contingencies which we believe is adequate to cover potential claims regarding the plan.

Concentration Of Credit Risk

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

Although we are directly affected by the economic well being of significant customers listed in the following tables, we do not believe that significant credit risk exists at April 30, 2004. We perform ongoing evaluations of our customers and require letters of credit or other collateral arrangements as appropriate. Accordingly, trade receivable credit losses have not been significant.

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

	April 30, 2004

Customer A.....	23.0%
Customer B.....	15.6%
Customer C.....	10.9%
Customer D.....	8.6%
Customer E.....	0.3%

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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

	April 30, 2004 -----
Customer A.....	23.0%
Customer B.....	11.3%
Customer C.....	11.3%
Customer D.....	--%
Customer E.....	1.1%
Customer F.....	0.7%

Segment Information

	Optical Networking(1) -----	Meret Optical -----	Other -----	Total -----
Three Months Ended April 30, 2004				
Revenues from external customers	\$ 5,183	\$ 910	--	\$ 6,093
Cost of goods sold	3,558	372	--	3,930
Gross profit	1,625	538	--	2,163
Segment income (loss) from operations	(3,950)	457	(1,404)	(4,897)
Depreciation and amortization expense	534	23	20	577
Valuation allowance additions (reductions):				
Receivables and inventory	(1,080)	(42)	--	(1,122)
Capital asset disposals, net	991	--	--	991
Total assets	23,781	5,311	14,554	43,646

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Three Months Ended April 30, 2003

Revenues from external customers	\$ 6,760	\$1,101	--	\$ 7,861
Cost of goods sold	5,053	854	--	5,907
	-----	-----	-----	-----
Gross profit	1,707	247	--	1,954
	-----	-----	-----	-----
Segment income (loss) from operations	(2,961)	120	(777)	(3,618)
Depreciation and amortization expense	887	129	24	1,040
Valuation allowance additions:				
Receivables and inventory	(178)	(11)	--	(189)
Capital asset additions, net	(775)	--	--	(775)
Total assets	25,005	5,382	17,702	48,089

(1) Optical Networking consists of subsidiaries Sorrento Networks and LuxN Inc.

Subsequent Events

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

Certain statements contained in this Quarterly Report on Form 10-Q, including, without limitation, statements containing the words "believes", "anticipates", "estimates", "expects", and words of similar import constitute "forward-looking statement" within the meaning of the Private Securities Litigation Reform Act of 1995.

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the consolidated unaudited financial statements and related notes thereto. Further reference should be made to our Form 10-K/A for the year ended January 31, 2004, including the consolidated audited financial statements and notes thereto.

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

Forward-Looking Statements--Cautionary Statement

All statements other than statements of historical fact contained in this Form 10-Q, in our future filings with the Securities and Exchange Commission, in our press releases and in our oral statements made with the approval of an authorized executive officer are forward-looking statements. Words such as "propose," "anticipate," "believe," "estimate," "expect," "plan", "intend," "may," "should", "could," "will" and similar expressions are intended to identify such forward-looking statements. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Although we believe that our expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risk and uncertainties and no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those forward-looking statements include without limitation: (1) Our ability to fund our operations until such time that revenue and orders improve, including its ability to raise additional equity or debt financing; (2) unanticipated technical problems relating to our products; (3) Our ability, or lack thereof, to make, market and sell optical networking products that meet with market approval and acceptance; (4) the greater financial, technical and other resources of our many, larger

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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

15

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

Results of Operations/Comparison of the Quarters ended April 30, 2004 and 2003.

Net sales. Our consolidated net sales decreased \$1.8 million or 22% to \$6.1 million for the quarter ended April 30, 2004 compared to net sales of \$7.9 million for the quarter ended April 30, 2003. Sorrento Networks, Inc. and LuxN, Inc. make up the optical networking segment. Net sales for Sorrento Networks Inc., ("SNI") the Company's primary operating subsidiary, decreased \$3.7 million or 54% to \$3.1 million for the quarter ended April 30, 2004 as compared to net sales of \$6.8 million for the quarter ended April 30, 2003. This decrease reflects lower domestic sales resulting from a continuing decline in the telecom market. The addition of the LuxN business accounted for a \$1.9 million increase in sales in the quarter over prior year.

During the three months ended April 30, 2004 SNI shipped product to a broader base of customers of which seventeen customers represented a combined 94% of our revenues. During the quarter ended April 30, 2003, we shipped product to fourteen customers of which five customers represented a combined 92% of our net sales. We expect to continue experiencing significant fluctuations in our quarterly revenues as a result of our long and variable sales cycle as well as our concentrated customer base.

Net sales for Meret decreased to \$910 thousand, or by 17% for the quarter ended April 30, 2004 from \$1.1 million for the comparable quarter last year. This decrease is due to the continuing decline in the telecommunications market.

Gross profit. Cost of sales consists principally of the costs of components, subcontract assembly from outside manufacturers, and in-house system integration, quality control, final testing and configuration costs. Gross margin percent on a consolidated basis increased to 35% in fiscal 2005 from 25% in fiscal 2004 due to the consolidation of entities and elimination of rent allocations to subsidiary entities.

Gross profit for the optical networking line of business decreased to \$1.6 million for the quarter ended April 30, 2004, as compared to \$1.7 million in the quarter ended April 30, 2003. The gross margin decrease was primarily the result of lower sales.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

For the quarter ended April 30, 2004 gross profit for Meret increased to \$538 thousand, or by 118%, from \$247 thousand for the comparable quarter last year. Meret's gross margins increased to 59% for the quarter ended April 30, 2004 from 22% for the comparable quarter last year. The gross margin increase was primarily the result of product mix and lower fixed manufacturing overhead.

Selling and marketing. Selling and marketing expenses consist primarily of employee compensation and related costs, commissions to sales representatives, tradeshow expenses and travel expenses. Consolidated selling and marketing expenses decreased to \$2.0 million or 33% of net sales, for the quarter ended April 30, 2004 from \$2.1 million, or 28% of net sales for the quarter ended April 30, 2003. This decrease was primarily the result of cost reduction efforts implemented that have resulted in reductions in travel expenses, advertising expenses and personnel costs.

Engineering, research and development. Engineering, research and development expenses consist primarily of compensation related costs for engineering personnel, facilities costs and materials used in the design, development and support of our technologies. All research and development costs are expensed as incurred. We continue to manage our research and development cost in relation to the changes in our sales volume and available capital resources in our development efforts to enhance existing products and introduce new products to our product offering. Our consolidated engineering, research and development expenses increased to \$2.4 million, or 39% of net sales, for the quarter ended April 30, 2004 from \$1.6 million, or 21% of net sales, for the quarter ended April 30, 2003. The increase primarily reflects the increased personnel costs associated with projects acquired with the LuxN business

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.

16

Consolidated general and administrative expenses increased to \$2.3 million, or 45% of net sales, for the quarter ended April 30, 2004 from \$1.6 million, or 21% of net sales, for the quarter ended April 30, 2003. The increase in expense was primarily the result of increased personnel costs, legal expenses related to fund raising activities and strategic partnership development and the discontinuance of rent allocation to various subsidiaries.

Deferred and other stock compensation. Deferred and other stock compensation for the quarter ended April 30, 2004 has been fully recognized, thus there is no expense recognized in the quarter for the amortization of the value of stock options granted to consultants. The quarter ended April 30, 2003 includes \$51 thousand of amortization of deferred stock compensation resulting from the amortization of the value of stock options granted to consultants. These costs were incurred in connection with the grants of stock options with exercise prices determined to be below the fair value of Sorrento's common stock on the date of grant, Sorrento recorded deferred stock compensation of \$2.6 million.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Other income (charges). Other income (charges) from operations was a \$223 thousand for the quarter ended April 30, 2004 compared to a \$2.6 million charge for the quarter ended April 30, 2003. The current quarter consisted primarily of interest expense associated with our convertible debentures and mortgages partially offset with interest income from our certificates of deposit and reversal of an over-accrual for the LuxN acquisition.

The quarter ended April 30, 2003 consisted primarily of costs associated with our convertible debenture which includes deferred interest of \$765 thousand, amortization of issuance costs of \$203 thousand and amortization of the fair value of the warrants issued to the purchasers and placement agent and the deemed beneficial conversion feature of \$1.6 million.

Income taxes. There was no provision for income taxes for the quarters ended April 30, 2004 and 2003. 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 ownership changes made as a result of the Exchange Agreement dated June 4, 2003, future availability of the tax benefits is not assured. In addition, we provided a valuation allowance in full for our deferred tax assets, as it is our opinion that it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Liquidity and Capital Resources

We finance our operations through a combination of internal funds, investments and debt and equity financing. At April 30, 2004 our working capital was a positive \$22.4 million and included \$5.7 million of accounts receivable and \$11.0 million in cash and cash equivalents. This is compared to negative working capital in the same quarter prior year of \$25.8 million. The primary reason for the negative working capital condition last year is that \$48.8 million, reflecting the obligation due to Series A Holders obligation as a result of their right of redemption, was classified at year end January 31, 2002, as a current liability. The Series A liability can only be paid through lawfully available funds that would normally be generated from SNI profitable operations, which we do not currently have available or foresee the availability of in the near future. As previously discussed, we have restructured the balances of both our Senior Convertible Debentures of \$32.2 million and the SNI Series A Preferred liability of \$48.8 million.

The Company is in the process of complying with certain refinancing of its mortgages on Company owned buildings, which may have technically been required within 12 months following the closing of the restructuring on June 4, 2003. Due to the pending merger with Zhone we anticipate either paying off the mortgages upon the close of the transaction or refinancing the mortgages immediately following the close of the merger.

Operations

Our operations used cash flows of \$6.3 million during the quarter ended April 30, 2004. During the quarter ended April 30, 2003 continuing activities used cash flows of \$5.0 million. The increase in cash flows used by operations resulted primarily as the result of the combination of increasing our accounts receivable balances and reducing our current liabilities for the quarter.

We have incurred significant losses and negative cash flows from operations for the past two years. Sorrento Networks, Inc., our principal operating subsidiary has primarily been the operating entity responsible for these high losses and negative cash flows. The losses have been generated as SNI continues to develop its technology, marketing and sales and operations in its effort to

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

become a major supplier of metro and regional optical networks world-wide.

17

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

Our standard payment terms range from net 30 to net 60 days. Receivables from international customers have frequently taken longer to collect. In addition, the downturn in the telecom market has impacted many of the telecom carriers ability to purchase or pay for outstanding commitments within standard payment terms. Our collection on receivables has increased to 85 days of average sales days outstanding as compared to 57 days outstanding for the same period in the prior year. The increase in receivables and the lack of improvement in the inventory have contributed to increased use of operating cash. There can be no assurance that the continued economic environment will not impact either current or future receivables negatively or our ability to control inventory levels. We do not provide long-term financing to customers buying our equipment.

Investing Activities

Our investing activities during the quarter ended April 30, 2004 used cash flows of \$956 thousand from the purchase of property and equipment, which was related to demo equipment that we placed in service with both current and potential new customers. During the quarter ended April 30, 2003, investing activities provided cash flows of \$1.1 million. We disposed of property and equipment of \$775 thousand and had a \$313 thousand decrease in other assets.

Financing Activities

During the quarter ended April 30, 2004, financing activities provided cash flows of \$624 thousand, which consisted primarily of proceeds from the sale of common stock. Our financing activities during the quarter ended April 30, 2003 used cash of \$65 thousand consisting primarily of the repayment of debt.

We anticipate that we will need additional working capital to fulfill our capital working requirements for the next year. While we have made significant

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

cost reductions to bring our losses more in line with our anticipated or projected revenues, there is no assurance the volume of future revenues will be sufficient to allow us to meet our financial obligations for future periods. Further, we anticipate we will need to sell our marketable securities to finance our working capital needs for future periods. Our holdings of marketable securities are highly volatile and do not trade in large volume. There can be no assurance that when we need to sell our holdings in marketable securities we will be able to obtain a market value price for the securities without negatively impacting the price of such securities. We continue to reduce our operating costs and have initiated activities to raise additional working capital. Our future capital requirements may vary materially from those now planned including the need for working capital to accommodate planned growth, hiring and infrastructure needs. There can be no assurances that our working capital requirements will not exceed our ability to generate sufficient cash internally to support our requirements and that external financing will be available or that, if available, such financing can be obtained on terms favorable to us and our shareholders.

Contractual Cash Obligations

The following tables quantify our future contractual obligations and commercial commitments as of April 30, 2004 (dollars in thousands):

18

Contractual Obligations

	Total	Payments due in fiscal years			
		Remainder 2005	2006	2007	2008
	-----	-----	-----	-----	-----
Long-term Debt	\$3,573	\$37	\$54	\$58	\$63
Capital Leases	26	26	--	--	--
Operating Leases	636	367	148	46	41
7.5% convertible debentures (a)	11,728	--	--	11,728	--
	-----	-----	-----	-----	-----
Total	\$15,963	\$430	\$202	\$11,832	\$104
	=====	=====	=====	=====	=====

(a) Maturity date, August 2, 2007

Note: As a result of the capital restructuring which became effective on June 4, 2003, the debt obligations to our convertible debenture holders of \$32,200 and Series A preferred stock holders of \$48,800, were eliminated and a new convertible debenture of \$12,500 was issued, with a maturity date of August 2, 2007.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Securities Authorized For Issuance Under Equity Compensation Plans

The following table provides information as of April 30, 2004 regarding compensation plans (including individual compensation arrangements) under which equity securities of Sorrento are authorized for issuance.

Plan Category	Number of Securities To Be Issued Upon Exercise Of Outstanding Options, Warrants and Rights ----- (a) -----	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights ----- (b) -----	Number Remaining Future Is Compen (Excludi Reflected -----
Equity Compensation Plans Approved by security Holders *(FIBR)	1,132,982 -----	\$34.30 -----	-----
Equity Compensation Plans not Approved by Security Holders (SNI)	1,886,167 -----	\$ 5.35 -----	2 -----
Total	3,019,149 -----	\$16.21 -----	2 -----

* As adjusted for stock splits.

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

Critical Accounting Policies and Estimates

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

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

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

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

- o Inventory. Inventory is evaluated on a continual basis and management must make estimates about the future customer demand for our products, taking into account both the economic conditions and growth potential of our customers. Reserve adjustments are made based on management's estimate of future sales value, if any, of specific inventory items. Reserve adjustments are made for the difference between the cost of the inventory and the estimated market value and charged to operations in the period in which the facts that give rise to the adjustments become known. A misinterpretation or misunderstanding of these conditions or uncertainty in the future outlook of our industry or the economy, or the failure to estimate correctly, could result in inventory losses in excess of the provisions determined to be appropriate at the time of the balance sheet.
- o Accounts receivable. Accounts receivable balances are evaluated on a continual basis and management regularly reviews the financial stability of individual customers. This analysis involves a judgment of the customers' current and projected financial condition and the positive or negative effects of the current and projected industry outlook, as well as that of the economy in general. Allowances are provided for potentially uncollectible accounts based on management's estimate of the collectability and the probability of default of customer accounts. If the financial condition of a customer were to deteriorate, resulting in an impairment of their ability to make payments, an additional allowance may be required. Allowance adjustments are charged to operations in the period in which the

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

facts that give rise to the adjustments become known.

- o Intangible assets. We currently have intangible assets that include assets with finite lives, such as our purchased technology. The determination of related estimated useful lives and whether these assets are impaired involves judgments based upon short and long-term projections of future performance. We have no goodwill or indefinite life intangible assets. Other intangible assets with finite lives continue to be amortized over their useful lives.
- o Legal contingencies. We are subject to proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to securities, environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for the contingencies is based on a careful analysis of each individual issue with the assistance of outside legal counsel. Our reserves may change in the future due to new developments in each matter or changes in approach such as a change in settlement strategy in dealing with these matters.
- o Income taxes. We currently have no provisions for income taxes. We have carry forward domestic federal net operating losses, which may be available, in part, to reduce future taxable income in the United States. However, due to potential adjustments to the net operating loss carry forwards as provided by the Internal Revenue Code with respect to ownership changes made as a result of the Exchange Agreement dated June 4, 2003, future availability of the tax benefits is not assured. In addition, we provided a valuation allowance in full for our deferred tax assets, as it is our opinion that it is more likely than not that some portion or all of the deferred tax assets will not be realized.

20

Impact of Recent Accounting Pronouncements

In June 2002, FASB issued Statement of Financial Accounting Standards ("SFAS") No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force ("EITF") Issue No. 94-3. We have adopted the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of a company's commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amount recognized. Adoption of this standard did not have any immediate effect on our consolidated financial statements.

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

In November 2002, the FASB issued FIN 45, which expands previously issued accounting guidance and disclosure requirements for certain guarantees. FIN 45 requires us to recognize an initial liability for the fair value of an obligation assumed by issuing a guarantee. The provision for initial recognition and measurement of the liability will be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not materially affect our consolidated financial statements.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003.

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

In December 2003, the SEC issued SAB 104, which supersedes SAB 101, Revenue Recognition in Financial Statements. The primary purpose of SAB 104 is to rescind the accounting guidance contained in SAB 101 related to multiple element revenue arrangements, which was superseded as a result of the issuance of EITF 00-21. We adopted EITF 00-21 and SAB 104 with no material impact on our financial statements.

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.

Subsequent Event

In April 2004, the Company announced its agreement to be acquired by Zhone Technologies, Inc. ("Zhone"). Under the terms of the agreement, Zhone will issue 0.9 of a share of Zhone common stock for each outstanding share of Sorrento common stock and each option, warrant and other security exercisable or convertible into Sorrento common stock will be assumed by Zhone and become exercisable or convertible into Zhone common stock, with appropriate adjustments based on the merger exchange ratio. The proposed stock-for-stock transaction is intended to qualify as tax-free to the stockholders of Sorrento.

The Form S-4 Registration Statement relating to the proposed merger of the two companies has been declared effective by the Securities and Exchange Commission. Zhone and Sorrento also received notification of early termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act. Stockholder meetings for both Zhone and Sorrento have been scheduled for June 30, 2004, for stockholders of record as of May 25, 2004. Subject to the approval of the stockholders of both companies and meeting the closing conditions as described in the proposed merger agreement and proxy. Zhone and Sorrento anticipate compliance with all remaining closing conditions and for the transaction to be completed on July 1, 2004.

Fluctuations in Revenue and Operating Results

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

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.

22

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

Our chief executive officer and our chief financial officer, after evaluating our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-15(e) and 15d-15(e) as of the end of the period covered by this Quarterly Report on Form 10-Q (the "Evaluation Date") have concluded that as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Internal Control Over Financial Reporting.

There was no significant change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

23

PART II
OTHER INFORMATION

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

Item 1: Legal Proceedings

None

Item 2: Changes in Securities and Use of Proceeds

Not Applicable

Item 3: Defaults Upon Senior Securities

Not Applicable

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

None

Item 5: Other Information

Not Applicable

Item 6: Exhibits and Reports on Form 8-K

A. Exhibits

Exhibit Number	Description of Exhibit
-----	-----
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 (the "Exchange Act").
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act.
32.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and 18 U.S. C. Section 1350.
32.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and 18 U.S.C. Section 1350.

B. Reports on Form 8-K

On February 17, 2004, we filed a Current Report on Form 8-K, disclosing a press release announcing that our registration statement on Form S-3 (File No. 333-112358) was declared effective by the Securities and Exchange Commission. The information was provided under item 5 of Form 8-K.

On April 26, 2004, we filed a Current Report on Form 8-K, disclosing the execution of and Agreement and plan of Merger, dated as of April 22, 2004, with Zhone Technologies, Inc., and Selene Acquisition Corp., and disclosing a press release announcing our financial results for the fourth quarter and full fiscal year ended January 31, 2004. The information was provided under Item 5

Edgar Filing: SORRENTO NETWORKS CORP - Form 10-Q

and Item 12, respectively, of Form 8-K.

24

SIGNATURES

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

SORRENTO NETWORKS CORPORATION
(REGISTRANT)

June 11, 2004

By: /s/ JOE R. ARMSTRONG

Joe R. Armstrong,
Chief Financial Officer
Principal Accounting Officer

25