FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **2005-05-02** | Period of Report: **2005-03-31**
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HI/FN INC

CIK:**1065246**| IRS No.: **330732700** | State of Incorp.:**DE** | Fiscal Year End: **0930**
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SIC: **3674** Semiconductors & related devices

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2005

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

For the Transition Period From _____ to _____

COMMISSION FILE NUMBER 0-24765

hi/fn, inc.

(Exact Name of Registrant as specified in its Charter)

Delaware	**33-0732700**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

750 University Avenue, Los Gatos, California 95032
(Address of principal executive offices and Zip Code)

Registrant' s telephone number, including area code: **(408) 399-3500**

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 ☑ NO ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES ☑ NO ☐

The number of shares outstanding of the Registrant' s Common Stock, par value $.001 per share, was 14,089,284 at April 25, 2005.

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HIFN, INC.

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PART 1 – FINANCIAL INFORMATION

Item 1. Financial Statements

HIFN, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)
(unaudited)

	March 31, 2005	September 30, 2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 29,475	$ 16,816
Short-term investments	21,958	33,216
Accounts receivable, net	6,529	5,653
Inventories	1,891	2,051
Prepaid expenses and other current assets	1,260	988
Total current assets	61,113	58,724
Property and equipment, net	1,813	1,737
Intangible assets, net	11,682	13,338
Other assets	2,184	2,443
	$ 76,792	$ 76,242
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 4,593	$ 4,323
Accrued expenses and other current liabilities	8,086	7,690
Total current liabilities	12,679	12,013
STOCKHOLDERS' EQUITY:		
Common stock	14	14
Additional paid-in capital	162,822	161,500
Accumulated other comprehensive loss	(58)	(50)
Accumulated deficit	(98,665)	(97,235)
Total stockholders' equity	64,113	64,229
	$ 76,792	$ 76,242

See accompanying notes to condensed consolidated financial statements.

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HIFN, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
Net revenues				
Processors	$ 11,974	$ 8,564	$ 23,153	$ 13,286
Software licenses and other	1,091	1,809	2,442	4,224
Total net revenues	13,065	10,373	25,595	17,510
Costs and operating expenses:				
Cost of revenues - processors	4,159	2,753	7,976	4,103
Cost of revenues - software licenses and other	138	120	276	240
Research and development	5,294	5,681	10,708	10,370
Sales and marketing	2,184	1,943	4,103	3,631
General and administrative	1,579	1,228	2,756	2,221
Amortization of intangible assets	828	1,318	1,656	1,469
Purchased in-process research and development	-	-	-	3,337
Total costs and operating expenses	14,182	13,043	27,475	25,371
Loss from operations	(1,117)	(2,670)	(1,880)	(7,861)
Interest and other income, net	267	109	456	211
Loss before income taxes	(850)	(2,561)	(1,424)	(7,650)
Provision for income taxes	4	-	6	-
Net loss	$ (854)	$ (2,561)	$ (1,430)	$ (7,650)
Net loss per share, basic and diluted	$ (0.06)	$ (0.20)	$ (0.10)	$ (0.63)
Weighted average shares outstanding, basic and diluted	14,052	12,892	14,010	12,141

See accompanying notes to condensed consolidated financial statements.

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HIFN, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended March 31,	
	2005	2004
Cash flows from operating activities:		
Net loss	$ (1,430)	$ (7,650)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	477	670
Amortization of intangible assets	1,656	1,469
Amortization of deferred stock compensation	-	87
Loss on disposal of fixed assets	-	175
Purchased in-process research and development	-	3,337
Changes in assets and liabilities:		
Accounts receivable	(876)	(1,365)

Inventories	160	(734)
Prepaid expenses and other current assets	(272)	(831)
Other assets	259	433
Accounts payable	622	500
Accrued expenses and other current liabilities	396	(2,149)
Net cash provided by (used in) operating activities	992	(6,058)
Cash flows from investing activities:		
Purchase of certain assets and intellectual property	-	(15,755)
Sales (purchases) of short-term investments, net	11,250	(29,401)
Purchases of property and equipment	(553)	(347)
Net cash provided by (used in) investing activities	10,697	(45,503)
Cash flows from financing activities:		
Proceeds from private placement financing, net	-	30,980
Proceeds from issuance of common stock	1,322	2,431
Installment payments on acquired software licenses	(352)	-
Net cash provided by financing activities	970	33,411
Net increase (decrease) in cash and cash equivalents	12,659	(18,150)
Cash and cash equivalents at beginning of period	16,816	41,080
Cash and cash equivalents at end of period	$ 29,475	$ 22,930

See accompanying notes to condensed consolidated financial statements.

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HIFN, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 − Basis of Presentation

The condensed consolidated financial statements of hi/fn, inc. (“Hifn” or the “Company”) include the accounts of the Company and its wholly-owned subsidiaries, Hifn Limited, Hifn Netherlands B.V. and Hifn International, and its wholly-owned subsidiary, Saian Microsystems, Inc. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The accompanying condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the Financial Statements and notes thereto included in the Company’ s Form 10-K for period ending September 30, 2004. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, which the Company believes are necessary for a fair presentation of the Company’ s financial position as of March 31, 2005 and its results of operations for the three and six months ended March 31, 2005 and 2004, respectively. These condensed consolidated financial statements are not necessarily indicative of the results to be expected for the entire year.

The Company anticipates that its existing cash, cash equivalents as well as short-term investments will fund any anticipated operating losses and purchases of capital equipment as well as provide adequate working capital for the next twelve months. The Company' s liquidity is affected by many factors including, among others, the extent to which the Company pursues additional capital expenditures, the level of the Company' s product development efforts, the risk of acceptance and pricing of the Company' s products and other factors related to the uncertainties of the industry and general economic conditions. Accordingly, there can be no assurance that events in the future will not require the Company to seek additional capital sooner or, if so required, that such capital will be available on terms acceptable to the Company.

On February 6, 2004, the Company entered into a securities purchase agreement with certain investors for the private placement of 2.2 million shares of the Company' s Common Stock at a price of $15.00 per share for aggregate proceeds of $30.9 million, net of expenses of approximately $2.1 million. The shares were issued and paid for on February 6, 2004. The Company intends to apply the net proceeds for working capital and general corporate purposes, as well as for strategic purposes in connection with selected acquisitions that may be considered in the future to expand its product and service offerings. On April 9, 2004, the Registration Statement related to the private placement was declared effective by the Securities and Exchange Commission.

Note 2 − Stock Options

The Company uses the intrinsic value method of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its employee stock options, and presents disclosure of pro forma information required under Statement of Financial Accounting Standards Board ("FASB") Statement No. 123, "Accounting for Stock-Based Compensation" as amended by FASB Statement No. 148, "Accounting for Stock-Based Compensation − Transition and Disclosure − an amendment of FASB Statement No. 123."

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Had compensation expense for the Company' s stock-based compensation plans been determined based on the fair value method, the Company' s net loss and net loss per share would have been as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
	(in thousands, except per share data)			
Net loss:				
As reported	$ (854)	$ (2,561)	$ (1,430)	$ (7,650)
Add: stock-based employee compensation recorded in the Statement of Operations	-	87	-	223
Less: fair value of stock-based employee compensation	(1,010)	(2,054)	(2,396)	(4,330)
Pro forma	$ (1,864)	$ (4,528)	$ (3,826)	$ (11,757)
Net loss per share:				
Basic and diluted				
As reported	$ (0.06)	$ (0.20)	$ (0.10)	$ (0.63)
Pro forma	(0.13)	(0.35)	(0.27)	(0.97)

The fair value of each stock option is estimated on the date of grant using the Black-Scholes model with the following assumptions used for grants during the respective periods:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
Estimated option life	2.86 years	4.0 years	2.86 years	4.0 years
Risk-free interest rate	3.75%	2.66%	3.50%	2.78%
Expected volatility	56.3%	81.3%	57.1%	87.5%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%
Weighted average estimated fair value	$3.77	$8.87	$3.73	$7.49

Note 3 − Net Loss Per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding for the period, without consideration for the dilutive impact of potential common shares that were outstanding during the period. Diluted earnings per share is computed using the weighted average number of common and common equivalent shares outstanding for the period. Common equivalent shares consist of incremental common shares issuable upon the exercise of stock options, using the treasury method, and are excluded from the calculation of diluted net loss per share if anti-dilutive. Outstanding options to purchase shares of common stock and their weighted shares equivalents excluded from the computation of diluted earnings because of their anti-dilutive impact were as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
Outstanding options to purchase common stock	4,130,516	3,994,304	4,148,699	4,183,654
Weighted equivalent shares	423,057	981,118	426,611	828,239

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Note 4 − Balance Sheet Details

	March 31, 2005	September 30, 2004
	(in thousands)	
Property and equipment:		
Computer equipment	$ 6,741	$ 6,357
Furniture and fixtures	1,048	1,020
Leasehold improvements	989	937
Office equipment	847	758
	9,625	9,072
Less: accumulated depreciation	(7,812)	(7,335)
	$ 1,813	$ 1,737
Intangible assets:		
Developed and core technology	$ 17,460	$ 17,460
Workforce	413	413
Patents	600	600
	18,473	18,473
Less: accumulated amortization	(7,820)	(6,164)

	10,653	12,309
Goodwill	1,029	1,029
	$ 11,682	$ 13,338
Accrued expenses and other current liabilities:		
Accrued vacant facility lease cost	$ 2,161	$ 2,530
Accrued non-recurring engineering costs	1,821	1,819
Deferred income and revenue	1,440	692
Compensation and employee benefits	2,031	1,963
Other	633	686
	$ 8,086	$ 7,690

Note 5 − Comprehensive Income (Loss)

Other comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income (loss) includes unrealized gains and losses on the Company' s available-for-sale investments. The components of comprehensive loss are as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
Net loss	$ (854)	$ (2,561)	$ (1,430)	$ (7,650)
Unrealized loss on financial instruments	(20)	-	(8)	-
Comprehensive loss	$ (874)	$ (2,561)	$ (1,438)	$ (7,650)

Note 6 – Segment and Geographic Information

The Company operates in one industry segment comprising the design, development and marketing of high-performance, multi-protocol packet processors − semiconductor devices and software. Sales by major geographic area are based on the geographic location of the distributor, manufacturing subcontractor or OEM who purchased our products which may be different from the geographic locations of our end customers.

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	Three Months Ended March 31,		Six Months Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
North America:				
United States	$ 4,133	$ 2,883	$ 9,125	$ 5,518
Other	499	703	1,539	1,190
Total North America	4,632	3,586	10,664	6,708
Asia:				
Hong Kong	4,992	2,057	9,010	3,303

Malaysia	879	1,569	1,793	2,686
Singapore	996	682	1,772	1,312
Japan	553	388	825	640
Taiwan	37	1,023	65	1,443
Other	419	175	481	267
Total Asia	7,876	5,894	13,946	9,651
Europe and other	557	893	985	1,151
Total	$ 13,065	$ 10,373	$ 25,595	$ 17,510

The Company' s long-lived assets, consisting of net property and equipment, are primarily in the United States.

Note 7 – Income Taxes

The Company has a full valuation allowance for its net deferred tax assets associated with its U.S. operations due to uncertainty as to their realization. The provision for income taxes for the quarter and six months ended March 31, 2005 primarily reflect taxes on the Company' s non-U.S. operations.

Note 8 – Guarantees and Product Warranties

In November 2002, the FASB issued FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 requires that a liability be recorded in the guarantor' s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity' s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. Agreements that we have determined to be within the scope of FIN 45 include hardware and software license warranties, indemnification arrangements with officers and directors and indemnification arrangements with customers with respect to intellectual property. To date, the Company has not incurred material costs in relation to any of the above guarantees and, accordingly, adoption of this standard did not have a material impact on its financial position, results of operations or cash flows.

As permitted under Delaware law, the Company has agreements that provide indemnification of officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company' s request in such capacity. The indemnification period is effective for the officer' s or director' s lifetime. The maximum potential amount of future payments that the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid. All of the indemnification agreements were grandfathered under the provisions of FIN 45 as they were in effect prior to December 31, 2002. As a result of the insurance policy coverage, the Company believes the estimated fair value of the potential liability under these agreements is minimal. Accordingly, the Company has not recorded any liabilities for these agreements as of March 31, 2005.

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party,

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generally business partners or customers, for losses suffered or incurred in connection with patent, copyright or other intellectual property infringement claims by any third party with respect to the Company' s products. The term of these indemnification agreements is generally perpetual, effective after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. To date, the Company has not incurred costs to defend lawsuits or settle claims related to these indemnification agreements. Accordingly, the Company has not recorded any liabilities for these agreements as of March 31, 2005. However, the Company may, in the future, record charges related to indemnification obligations and, depending upon the nature of any such lawsuit or claim, the estimated fair value of such indemnification obligations may be material.

The Company warrants that its hardware products are free from defects in material and workmanship under normal use and service and that its hardware and software products will perform in all material respects in accordance with the standard published specifications in effect at the time of delivery of the licensed products to the customer. The warranty periods generally range from three months to one year for software and one year for hardware. Additionally, the Company warrants that its maintenance services will be performed consistent with generally accepted industry standards through completion of the agreed upon services. The Company' s policy is to provide for the estimated cost of product and service warranties based on specific warranty claims and claim history as a charge to cost of revenues. To date, the Company has not incurred significant expense under its product or service warranties. As a result, the Company has not recorded an accrual related to product or warranty services as of March 31, 2005. The Company assesses the need for a warranty accrual every quarter. There is no assurance that a warranty accrual will not be necessary in the future.

Other Commitments

In connection with the purchase of a pattern matching technology in September 2004, the Company has potential obligations aggregating $900,000, the payments for which are contingent upon achievement of certain development milestones. Such payments, if any, are due within fiscal 2005. As of March 31, 2005, none of the development milestones have been met.

Note 9 − Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R ("SFAS No. 123R"), "Share-Based Payment," and amendment to Statement of Financial Accounting Standards No. 123 ("SFAS No. 123"), "Accounting for Stock-Based Compensation" and Statement on Financial Accounting Standards No. 95, "Statement of Cash Flows." The revised standard addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company' s equity instruments or that may be settled by the issuance of such equity instruments. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB 25. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. The effective date for SFAS No. 123R, as amended on April 14, 2005, is for annual periods beginning after June 15, 2005. The Company has not yet determined which fair-value method and transitional provision it will follow. Currently, we disclose the pro forma net income (loss) and related pro forma income (loss) per share information in accordance with SFAS 123 and Statement on Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation Costs−Transition and Disclosure." The adoption of SFAS No. 123R will have a material effect on the Company' s results of operations.

Note 10 − Subsequent Events

On April 25, 2005, the Company' s Board of Directors authorized a stock repurchase program whereby the Company may repurchase up to $10 million in value of the Company' s common stock from time to time through open market and privately negotiated transactions. The expiration date of the program is April 25, 2006.

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

Cautionary Statement Regarding Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements in this report usually contain the words "will," "estimate," "anticipate," "expect," "believe," or similar expressions and variations or negatives of these words. All forward-looking statements including, but not limited to, (1) our estimated completion and cost of development work on the next generation network processor; (2) our belief that the Company will likely not realize the benefits of certain deferred tax assets and our consideration of future taxable income; (3) our belief that our existing cash resources will fund any anticipated operating loses, purchases of capital equipment and provide adequate working capital for the next twelve months; (4) our belief that that there can be no assurance that events in the future will not require us to seek additional capital sooner or, if so required, that such capital will be available at all or on terms acceptable to us; (5) our intention to apply the net proceeds of our private placement of 2.2 million shares for working capital, general corporate and strategic purposes; (6) our belief that off-balance sheet arrangements are not likely to have a future effect on the Company' s financial condition; revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that may be material to investors; (7) our understanding that the Company may, in the future, record material charges related to indemnification obligation; (8) our expectation that operating results will continue to fluctuate; (9) our expectation that our products in the network processor market fulfill security needs in the iSCSI market; (10) our expectation that our significant customers may differ in the future; (11) our expectation that our markets will become increasingly competitive; (12) our belief that we may change our supply arrangements to assume more product manufacturing responsibilities; (13) our belief that we may enter into volume purchase agreements; (14) our expectation that the average selling prices of our products will decrease in the future; (15) our expectation that we will make additional acquisitions in the future; and (16) our belief that our stock price will fluctuate in the future, are inherently uncertain as they are based on management' s expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. As a result, our actual results may differ materially from the forward-looking statements contained herein. Factors that could cause actual results to differ materially from those described herein include, but are not limited to, (1) the development of the packet processor market; (2) our ability to anticipate market trends and the requirements of network storage equipment vendors; (3) our continued growth in the market for network security equipment, (4) our ability to establish and maintain relationships with network and storage equipment vendors; (5) our ability to evolve with industry standards and rapid technological change; (6) our ability to compete in competitive markets; (7) our ability to protect our intellectual property; (8) our dependence upon independent manufacturers and limited sources of supply; (8) our ability to develop and introduce new products; (9) our ability to integrate businesses, products, technologies or personnel that we acquire; (10) the volatility of the stock market; and (11) those factors discussed under "Trends, Risks and Uncertainties" elsewhere in this Quarterly Report on Form 10-Q. Our forward-looking statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

Overview

hi/fn, inc., together with its subsidiaries, (referred to as "Hifn," "we," "us" or "our") is a flow classification and network security specialist company supplying most major network equipment vendors with patented technology to improve network packet processing. We design, develop and market high-performance, multi-protocol packet processors − semiconductor devices and software − designed to enable secure, high-bandwidth network connectivity, comprehensive differentiation of business-critical application network traffic from other general purpose network traffic and efficient compression, encryption/compression and public key cryptography, providing our customers with high-performance, interoperable implementations of a wide variety of industry-standard networking and storage protocols. Our products are used in networking and storage equipment such as routers, remote access concentrators, switches, broadband access equipment, network interface cards, firewalls and back-up storage devices.

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Hifn' s encryption/compression and public key processors allow network equipment vendors to add bandwidth enhancement and security capabilities to their products. Our encryption/compression and public key processors provide key algorithms used in virtual private networks ("VPNs"), which enable businesses to reduce wide area networking costs by replacing dedicated leased-lines with lower-cost IP-based networks such as the Internet. Using VPNs, businesses can also provide trading partners and others with secure, authenticated access to the corporate network, increasing productivity through improved communications. Storage equipment vendors use our compression processor products to improve the performance and capacity of mid- to high-end tape back-up systems.

Hifn' s flow classification technology enables network equipment vendors to add unique traffic differentiation capabilities to their products. Our flow classification solutions provide precise details about packets and data traversing a network and are used in deploying quality of service ("QoS") and classes of service ("CoS"), which enables businesses to enhance the effectiveness of using the public Internet network. Using QoS- or CoS-enabled network equipment, businesses can maintain more consistent and reliable interactions with their customers and business partners.

In December 2003, Hifn acquired certain assets and intellectual property related to the network processor line of International Business Machines Corporation ("IBM"). This acquisition complements our security processor business, expands our product offerings to include programmable network processors designed for network traffic and provides us with technology upon which we can build our next generation processors. These products feature efficient programming models that eliminate stage processing and reduce packet latency, thereby optimizing packet processing at high speeds.

Critical Accounting Policies

The Company' s critical accounting policies are disclosed in the Company' s Form 10-K for the year ended September 30, 2004 and have not changed materially as of March 31, 2005.

Results of Operations

The following table sets forth the percentage relationship of certain items to the Company' s revenues during the periods shown:

Net Revenues.

Net revenues by category, as a percentage of total net revenues and the year-over-year change were as follows:

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
Processors	$ 11,974	$ 8,564	40%	$ 23,153	$ 13,286	74%
Software licenses and other	1,091	1,809	(40%)	2,442	4,224	(42%)
	$ 13,065	$ 10,373	26%	$ 25,595	$ 17,510	46%

	% of net revenues	% of net revenues	% of net revenues	% of net revenues
Processors	92%	83%	90%	76%
Software licenses and other	8%	17%	10%	24%
	100%	100%	100%	100%

Net revenues increased by $2.7 million for the quarter ended March 31, 2005 as compared to net revenues for the quarter ended March 31, 2004. Our processor revenues increased $3.4 million during the three months ended March 31, 2005 compared to the same period in the prior year. The average selling price of these processors remained at relatively the same levels. Accordingly, the increase in processor revenues between the comparative periods is attributable to the increase in the volume of processor units sold during the period. The increase in processor revenues was offset by a decrease in revenues from software license and royalties of $718,000 resulting from the variability in demand for and timing of customers' purchase of certain of the Company's licensed software products.

Net revenues increased by $8.1 million for the six months ended March 31, 2005 as compared to the same period in the prior year. The increase reflects an increase in our processor revenues of $9.9 million and was attributable to increases of $6.6 million in revenues generated from the sale of network processors related to the technology acquired from IBM and $3.3 million in revenues from our data compression and encryption processor products as a result of higher volume of customer purchases. The average selling price of these processors remained at relatively the same levels. Therefore, the increase in processor revenues between the comparable periods is attributable to the increase in volume. The net increase in processor revenues was offset by a decrease in revenues from software license and royalties of $1.8 million resulting from the variability in demand for and timing of customers' purchase of certain of the Company's licensed software products.

Semiconductor and software sales to Cisco, an OEM producer of networking equipment, comprised 46% of revenues for both the three months and six months ended March 31, 2005 and 36% and 43% of revenues for the three and six months ended March 31, 2004, respectively. Semiconductor sales to Quantum, an OEM producer of high-performance tape storage devices, through its manufacturing subcontractor, comprised 14% and 13% of revenues for the three and six months ended March 31, 2005, respectively, and 17% and 20% of revenues for the three and six months ended March 31, 2004, respectively. Semiconductor sales to Huawei, an OEM producer of networking equipment, comprised 12% and 11% of revenues for the three and six months ended March 31, 2005, respectively.

Cost of Revenues.

Cost of revenues by category, as a percentage of each respective revenue category and the year-over-year change were as follows:

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
Processors	$ 4,159	$ 2,753	51%	$ 7,976	$ 4,103	94%
Software licenses and other	138	120	15%	276	240	15%
	$ 4,297	$ 2,873	50%	$ 8,252	$ 4,343	90%

	% of revenue category	% of revenue category		% of revenue category	% of revenue category	
Processors	35%	32%		34%	31%	
Software licenses and other	13%	7%		11%	6%	
Total	33%	28%		32%	25%	

Cost of revenues consists primarily of semiconductors which were manufactured to our specifications by third parties for resale by us. Cost of processor revenues as a percentage of net processor revenues increased three percentage points for the three months ended March 31, 2005 as compared to the same period in fiscal 2004. The Company's product sales in the three months ended March 31, 2005 include a higher proportion of network processors, which carry a higher cost of revenues as compared to all other processors. As a result, processor cost of revenues as a percentage of net revenues increased. During the three months ended March 31, 2005 and 2004, we sold $11,000 and $186,000, respectively, in inventories that had previously been written down.

Cost of processor revenues as a percentage of net processor revenues increased three percentage points for the six months ended March 31, 2005 as compared to the same period in fiscal 2004. The Company' s product sales in the six months ended March 31, 2005 includes a higher proportion of network processors, which carry a higher cost of revenues as compared to all other processors. As a result, processor cost of revenues as a percentage of net revenues increased. During the six months ended March 31, 2005 and 2004, we sold $41,000 and $372,000, respectively, in inventories that had previously been written down.

Cost of software licenses and other revenues is primarily comprised of engineering labor related to support and maintenance of sold licenses. The fluctuation in software licenses and other costs as a percentage of software licenses and other revenues is dependent upon the mix of licensed software and royalties earned during the period.

Operating Expenses

Research and Development.

	Three Months Ended March 31,		Year-over-Year	Six Months Ended March 31,		Year-over-Year
(dollars in thousands)	**2005**	**2004**	**Change**	**2005**	**2004**	**Change**
Research & development expenses	$ 5,294	$ 5,681	(7%)	$ 10,708	$ 10,370	3%
As a percentage of net revenues	41%	55%		42%	59%	

Research and development costs consist primarily of salaries, employee benefits, overhead, outside contractors and non-recurring engineering fees. Such research and development expenses decreased $387,000 for the three months ended March 31, 2005 over the same period in the prior year. The decrease reflects decreases in expenses for engineering and consulting services of $486,000, of which $383,000 related to a reduction in utilization of outside engineering services as outsourced projects were completed and the remaining $103,000 of which related to a reduction in consulting fees related to the transfer of the technical designs of the IBM network processors. Additionally, software maintenance expense decreased $116,000 as a result of the consolidation of certain software maintenance arrangements coupled with the termination of maintenance arrangements related to completed projects. The decreases were partially offset by an increase in salaries and benefits of $224,000, of which $181,000 relates to headcount additions in our China subsidiary of an average of thirty-five engineers.

Research and development costs for the six months ended March 31, 2005 increased $338,000 compared to the same period in the prior year. The increase is the net effect of an increase in salaries and benefits of $531,000, of which $288,000 relates to headcount additions in our China subsidiary of an average of thirty-one engineers over the six-month period, and an increase of $538,000 in non-recurring engineering costs as a result of the timing of tape-out and mask activities related to products in development. These increases were partially offset by a reduction in engineering services costs of $461,000 as outsourced projects were completed and were transferred into the tape-out and mask process, as well as a reduction in software maintenance expense of $278,000 as a result of the consolidation of certain software maintenance arrangements coupled with the termination of maintenance arrangements related to completed projects

Sales and Marketing.

	Three Months Ended March 31,		Year-over-Year	Six Months Ended March 31,		Year-over-Year
(dollars in thousands)	**2005**	**2004**	**Change**	**2005**	**2004**	**Change**
Sales & development expenses	$ 2,184	$ 1,943	12%	$ 4,103	$ 3,631	13%
As a percentage of net revenues	17%	19%		16%	21%	

Sales and marketing expenses consist primarily of salaries, commissions and benefits of sales, marketing and support personnel as well as consulting, advertising, promotion and overhead expenses. Such expenses increased $241,000 for the three months ended March 31, 2005 over the same period in the prior year. The increase primarily relates to an increase in salaries and benefits of $170,000 due to salary increases in connection with the employee performance reviews in October 2004, an increase in sales plan bonus due to higher sales levels and an increase in average headcount during the period of one sales and two marketing staff. The increase was also attributable to an increase in sales representative commissions of $134,000 due to a higher level of sales made through sales representatives.

Sales and marketing expenses increased $472,000 during the six months ended March 31, 2005 as compared to the same period in the prior year. The increase was mainly the result of increased salaries and benefits of $235,000 due to salary increases in connection with the employee performance reviews in October 2004 and an increase in average headcount during the period with the addition of one sales and two marketing staff members and increased sales representative commissions of $226,000 due to a higher level of sales made through sales representatives.

General and Administrative.

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
General & administrative expenses	$ 1,579	$ 1,228	29%	$ 2,756	$ 2,221	24%
As a percentage of net revenues	12%	12%		11%	13%	

General and administrative expenses are comprised primarily of salaries for administrative and corporate services personnel, legal and other professional fees. Such expenses increased $351,000 for the three months ended March 31, 2005 over the same period in the prior year as a result of increases in salaries and benefits expense of $143,000 in connection with the employee performance reviews in October 2004, $102,000 in charitable contribution for tsunami disaster relief, $77,000 in low value office equipment purchases for office equipment replacements and $75,000 in accounting services for work related to internal control documentation and compliance. These increases were partially offset by a reduction in depreciation expense of $40,000 as a result of assets reaching depreciable life.

General and administrative expenses increased $535,000 during the six months ended March 31, 2005 as compared to the same period in the prior year as a result of increases in salaries and benefits expense of $256,000 in connection with the employee performance reviews in October 2004, $102,000 in charitable contribution for tsunami disaster relief, $113,000 in low value office equipment purchases for office equipment replacements and $105,000 in accounting services for work related to internal control documentation and compliance. These increases were offset by a reduction in allocated building expense of $101,000 mainly as a result of reduced allocation of rental and other costs due to the expiration of a portion of the lease at our corporate facility and in depreciation expense of $81,000 as a result of assets reaching depreciable life.

Amortization of Intangibles.

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
Amortization of intangibles	$ 828	$ 1,318	(37%)	$ 1,656	$ 1,469	13%
As a percentage of net revenues	6%	13%		6%	8%	

Amortization of intangibles relate to acquired technology, workforce and patents. Amortization of intangibles decreased $490,000 for the three months ended March 31, 2005 over the same period in the prior year reflecting the net effect of a reduction in amortization of contract backlog related to the IBM network processor of $578,000 and

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a reduction of $67,000 in amortization of previously capitalized intangible assets as they reached their estimated useful lives; offset by an increase in amortization of $155,000 related to pattern matching technology acquired in September 2004.

Amortization of intangibles increased $187,000 for the six months ended March 31, 2005 over the same period in the prior year mainly as a result of amortization related to acquired pattern matching and other technologies of $338,000 offset by a reduction of $161,000 in amortization of previously capitalized intangible assets as they reached their estimated useful lives.

Purchased In-Process Research and Development.

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
Purchased in-process research & development	$ -	$ -	-	$ -	$ 3,337	(100%)
As a percentage of net revenues	-	-		-	19%	

Purchased in-process research and development during the six months ended March 31, 2004 related to the purchase of certain assets and intellectual property for programmable network processors designed for network traffic related to the IBM network processor product line. The allocated amount of $3.3 million, related to two projects, was determined by management based on established valuation techniques in the semiconductor industry and was expensed upon acquisition because technological feasibility had not been established and no alternative future uses exist. The acquired technology includes development work on the next generation network processor (increasing speed and density while reducing die size) which was approximately 85% complete and estimated to be

completed in early 2006 at an estimated cost of $5 million, and future development of the network processor (with further increase in speed) which was approximately 15% complete and estimated to be completed in late 2006 at an estimated cost of $4 million. The fair value of the projects containing in-process technology in development was determined using the income approach, which discounts expected future cash flows to present value. The discount rates used in the present value calculations were derived from a weighted-average cost of capital analysis adjusted to reflect additional risks inherent in the development life cycle including the failure to achieve technical viability, rapid changes in customer markets and required standards for new products as well as potential competition in the market for such products. Failure to bring these products to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on our business and operating results.

Interest and Other Income, net.

(dollars in thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004	Year-over-Year Change	Six Months Ended March 31, 2005	Six Months Ended March 31, 2004	Year-over-Year Change
Interest & other income, net	$ 267	$ 109	145%	$ 456	$ 211	116%
As a percentage of net revenues	2%	1%		2%	1%	

Interest and other income, net, increased $158,000 during the three months ended March 31, 2005 and $245,000 during the six months ended March 31, 2005 as compared to the same respective periods in the prior fiscal year. The increase was primarily a result of a higher average cash balance during the periods as a result of additional cash generated from the private financing completed in February 2004 as well as a shift in the investment mix to higher average yield short-term investments with the purchase of commercial paper and municipal bonds.

Income Taxes. In fiscal 2002, we recorded a valuation allowance of $9.8 million to reduce the carrying value of our deferred tax assets and in fiscal 2003, we recognized a tax benefit of $1.8 million related to carry back of net operating losses to prior years. As a result of continuing losses over a longer period than previously expected, we have not

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recognized tax benefits for the three and six months ended March 31, 2005 and 2004. We maintain a full valuation allowance against deferred tax assets as we believe that it is more likely than not that the Company will not realize the benefits of the deferred tax assets. We continue to consider future taxable income and ongoing prudent and feasible tax planning strategies in assessing the valuation allowance. The provision for income taxes for the quarter and six months ended March 31, 2005 primarily reflect taxes on the Company' s non-U.S. operations.

Liquidity and Capital Resources

A summary of the sources and uses of cash and cash equivalents is as follows:

	Six Months Ended March 31,	
	2005	2004
	(in thousands)	
Net cash provided by (used in) operating activities	$ 992	$ (6,058)
Net cash provided by (used in) investing activities	10,697	(45,503)
Net cash provided by financing activities	970	33,411
Net increase (decrease) in cash and cash equivalents	$ 12,659	$ (18,150)

Net cash provided by operating activities of $992,000 for the six months ended March 31, 2005 was the result of net loss of $1.4 million as adjusted for non-cash items, which include depreciation costs of $477,000 related to property and equipment and amortization of intangibles of $1.7 million as well as a decrease in inventory of $160,000 resulting from the timing of purchase receipts and customer shipments, in other assets of $259,000 as a result of a decrease in software licenses and an increase in accounts payable and accrued and other current liabilities of $1.0 million reflecting the timing in payments of trade payables and increases in deferred income and revenues, related to the timing of maintenance contract purchases amortizable over the service term and distributor sell-through

of purchased processors, offset by a reduction in accrued vacant facility lease cost in accordance with scheduled amortization. These increases were offset by an increase in accounts receivable of $876,000 and in prepaid expenses and in other current assets of $272,000 mainly as a result of insurance policy renewals during the period.

Net cash used in operating activities of $6.1 million for the six months ended March 31, 2004 was the result of net loss of $7.7 million as adjusted for non-cash items, which include purchased in-process research and development of $3.3 million, depreciation of fixed assets of $670,000, amortization of intangibles related to acquired technologies of $1.5 million, of which $1.3 million represents amortization of the acquired backlog and technology related to the IBM network processor product line, amortization of deferred stock compensation of $87,000 and loss on disposal of leasehold improvements of $175,000 related to an expired lease, as well as a decrease in other assets of $433,000 and an increase in accounts payable of $500,000. These adjustments were offset by an increase in accounts receivable of $1.4 million, inventories of $734,000 and in prepaid expenses and other current assets of $831,000, related to prepaid insurance and engineering and maintenance tools. Additionally, accrued expenses and other current liabilities decreased by approximately $2.1 million as a result of the payment of previously-accrued engineering costs.

Net cash provided by investing activities of $10.7 million for the six months ended March 31, 2005 primarily reflects the net sale of short-term investments of $11.3 million, as the Company shifted its portfolio mix from municipal bonds to higher interest-yielding commercial paper, offset by the purchase of property and equipment of $553,000 to replace older office equipment and acquire office equipment for headcount additions. Net cash used in investing activities of $45.5 million for the six months ended March 31, 2004 reflects the purchase of certain assets and intellectual property related to the IBM network processor product line for $15.7 million, the purchase of short-term investments of $29.4 million utilizing the proceeds from the private placement financing and the purchase of property and equipment of $347,000.

Net cash provided by financing activities for the six months ended March 31, 2005 was $970,000 and was comprised of cash proceeds from the issuance of common stock for stock option exercises and employee stock purchase plan purchases which aggregated $1.3 million, offset by installment payments on acquired software licenses of $352,000. The net cash provided by financing activities during the six months ended March 31, 2004 is mainly attributable to net proceeds from the private placement financing of $30.9 million as well as cash proceeds from the

issuance of common stock for stock option exercises and employee stock purchase plan purchases aggregating $2.4 million.

The Company' s inventory balance decreased by $160,000 to $1.9 million at March 31, 2005 as compared to $2.1 million as of September 30, 2004. The decrease in inventory is a result of the timing of inventory purchases relative to manufacturer lead-time coupled with anticipated shipment schedules to fill customer orders for the succeeding quarter. The Company' s annualized inventory turns in the quarter ended March 31, 2005 was 7.2 times as compared to 8.9 times in the quarter ended September 30, 2004. The Company' s accounts receivable balance, which is contingent upon the timing of product shipment within the respective periods, increased $876,000 to $6.5 million, as of March 31, 2005, reflecting higher purchase levels and revenues in March 2005 as compared to September 2004.

The Company uses a number of independent suppliers to manufacture substantially all of its products. As a result, the Company relies on these suppliers to allocate to the Company a sufficient portion of foundry capacity to meet the Company' s needs and deliver sufficient quantities of the Company' s products on a timely basis. These arrangements allow the Company to avoid utilizing its capital resources for manufacturing facilities and work-in-process inventory and to focus substantially all of its resources on the design, development and marketing of its products.

The Company requires substantial working capital to fund its business, particularly to finance accounts receivable and inventory, and for investments in property and equipment. The Company' s need to raise capital in the future will depend on many factors including the rate of sales growth, market acceptance of the Company' s existing and new products, the amount and timing of research and development expenditures, the timing and size of acquisitions of businesses or technologies, the timing of the introduction of new products and the expansion of sales and marketing efforts. We believe that our existing cash resources will fund any anticipated operating losses, purchases of capital equipment and provide adequate working capital for the next twelve months. Our liquidity is affected by many factors including, among others, the extent to which we pursue additional capital expenditures, the level of our product development efforts, and other factors related to the uncertainties of the industry and global economies. Accordingly, there can be no assurance that events in the future will not require us to seek additional capital sooner or, if so required, that such capital will be available at all or on terms acceptable to us.

On February 6, 2004, the Company entered into a securities purchase agreement with certain investors for the private placement of 2.2 million shares of the Company' s common stock at a price of $15.00 per share for aggregate proceeds of $30.9 million, net of expenses of approximately $2.1 million. The shares were issued and paid for on February 6, 2004. The Company intends to apply the net proceeds for working capital and general corporate purposes, as well as for strategic purposes in connection with selected acquisitions that may be considered in the future to expand its product and service offerings.

On April 25, 2005, the Company' s Board of Directors authorized a stock repurchase program whereby the Company may repurchase up to $10 million in value of the Company' s common stock from time to time through open market and privately negotiated transactions. The expiration date of the program is April 25, 2006.

The Company occupies its facilities under several non-cancelable operating leases that expire at various dates through April 2009, and which contain renewal options. Additionally, contractual obligations were also entered into related to non-recurring engineering services and inventory purchases. Payment obligations for such commitments as of March 31, 2005 are as follows:

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		Payments Due By Period			
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**After 5 years**
		(in thousands)			
Operating lease commitments	$ 3,939	$ 1,751	$ 1,985	$ 203	$ -
Inventory purchases	5,365	5,365	-	-	-
Non-recurring engineering expense	1,821	1,821	-	-	-
Totals	$ 11,125	$ 8,937	$ 1,985	$ 203	$ -

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company' s financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that may be material to investors.

Guarantees

In November 2002, the FASB issued FASB Interpretation No. 45 ("FIN 45"), "Guarantor' s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 requires that a liability be recorded in the guarantor' s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity' s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. Agreements that we have determined to be within the scope of FIN 45 include hardware and software license warranties, indemnification arrangements with officers and directors and indemnification arrangements with customers with respect to intellectual property. To date, the Company has not incurred material costs in relation to any of the above guarantees and, accordingly, adoption of this standard did not have a material impact on its financial position, results of operations or cash flows.

As permitted under Delaware law, the Company has agreements that provide indemnification of officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company' s request

in such capacity. The indemnification period is effective for the officer' s or director' s lifetime. The maximum potential amount of future payments that the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid. All of the indemnification agreements were grandfathered under the provisions of FIN 45 as they were in effect prior to December 31, 2002. As a result of the insurance policy coverage, the Company believes the estimated fair value of the potential liability under these agreements is minimal. Accordingly, the Company has not recorded any liabilities for these agreements as of March 31, 2005.

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party, generally business partners or customers, for losses suffered or incurred in connection with patent, copyright or other intellectual property infringement claims by any third party with respect to the Company' s products. The term of these indemnification agreements is generally perpetual, effective after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. To date, the Company has not incurred costs to defend lawsuits or settle claims related to these indemnification agreements. Accordingly, the Company has not recorded any liabilities for these agreements as of March 31, 2005. However, the Company may, in the future, record charges related to indemnification obligations and, depending upon the nature of any such lawsuit or claim, the estimated fair value of such indemnification obligations may be material.

The Company warrants that its hardware products are free from defects in material and workmanship under normal use and service and that its hardware and software products will perform in all material respects in

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accordance with the standard published specifications in effect at the time of delivery of the licensed products to the customer. The warranty periods generally range from three months to one year for software and one year for hardware. Additionally, the Company warrants that its maintenance services will be performed consistent with generally accepted industry standards through completion of the agreed upon services. The Company' s policy is to provide for the estimated cost of product and service warranties based on specific warranty claims and claim history as a charge to cost of revenues. To date, the Company has not incurred significant expense under its product or service warranties. As a result, the Company has not recorded an accrual related to product or warranty services as of March 31, 2005. The Company assesses the need for a warranty accrual every quarter. There is no assurance that a warranty accrual will not be necessary in the future.

Other Commitments

In connection with the purchase of a pattern matching technology in September 2004, the Company has potential obligations aggregating $900,000, the payments for which are contingent upon achievement of certain development milestones. Such payments, if any, are due within fiscal 2005. As of March 31, 2005, none of the development milestones have been met.

Trends, Risks and Uncertainties

In future periods, Hifn' s business, financial condition and results of operations may be affected by many factors including, but not limited to, the following:

Our Business Depends Upon The Development Of The Packet Processor Market.

Our prospects are dependent upon the acceptance of packet processors as an alternative to other technology traditionally utilized by network and storage equipment vendors. Many of our current and potential customers have substantial technological capabilities and financial resources and currently develop internally the application specific integrated circuit components and program the general purpose microprocessors utilized in their products as an alternative to our packet processors. These customers may in the future continue to rely on these solutions or may determine to develop or acquire components, technologies or packet processors that are similar to, or that may be substituted for, our products. In order to be successful, we must anticipate market trends and the price, performance and functionality requirements of such network and storage equipment vendors and must successfully develop and manufacture products that meet their requirements. In addition, we must make products available to these large customers on a timely basis and at competitive prices. If orders from customers are cancelled, decreased or delayed, or if we fail to obtain significant orders from new customers, or any significant customer delays or fails to pay, our business, financial condition and results of operations could suffer.

Our Business Depends Upon The Continued Growth of the Network Equipment and Storage Equipment Markets And Our

Penetration Of The Virtual Private Network, iSCSI and Network Processor Markets.

Our success is largely dependent upon continued growth in the market for network security equipment, such as routers, remote access concentrators, switches, broadband access equipment, security gateways, firewalls and network interface cards. Our success also depends upon storage equipment vendors incorporating our packet processors into their systems. We want to be a leading supplier of packet processors that implement the network security protocols necessary to support the deployment of virtual private networks. Additionally, we have entered into the network processor market and developed products that we anticipate fulfills the need for security in the iSCSI market.

These markets, which are either emerging or evolving, may not grow or be material. Alternatively, if they do emerge or continue to grow, our products may not successfully serve this market. Our ability to generate significant revenue in the network and storage equipment, virtual private network, network processor and iSCSI markets will depend upon, among other things, the following:

Capital spending levels;

Additions to, changes in or lack of industry standards;

Our ability to demonstrate the benefits of our technology to distributors, original equipment manufacturers and end users;

The increased use of the Internet by businesses as replacements for, or enhancements to, their private networks; and

The adoption of security as a necessary feature in iSCSI.

We are unable to determine the rate or extent to which the network equipment and storage markets will grow, if at all. Additionally, if we may be unable to penetrate the virtual private network, network processor or iSCSI markets, or these markets may fail to develop. , our business, financial condition and results of operations could suffer. Any decrease in the growth of the network or storage equipment market, a decline in demand for our products or our inability to penetrate new markets could harm our business, financial condition and results of operations.

Because We Depend Upon A Small Number Of Customers, If Our Sales To Any Of These Customers Decline, Our Business, Financial Condition and Results of Operations May Suffer.

Cisco Systems, Inc. (“Cisco”), an OEM producer of network equipment, comprised 46%, 46% and 41% of our net revenues for the three and six months ended March 31, 2005 and the year ended September 30, 2004, respectively. Quantum Corporation (“Quantum”), through its manufacturing subcontractor, accounted for approximately 14%, 13% and 14% of our net revenues during the three and six months ended March 31, 2005 and the year ended September 30, 2004, respectively. Huawei Technologies, Inc. (“Huawei”), an OEM producer of network equipment, comprised 12%, 11% and 14% of our net revenues for the three and six months ended March 31, 2005 and the year ended September 30, 2004, respectively.

Cisco, Quantum and Huawei are not under any binding obligation to order from us. If our sales to Cisco, Quantum or Huawei decline, our business, financial condition and results of operations could suffer. We expect that our most significant customers in the future could be different from our largest customers today for a number of reasons, including customers' deployment schedules and budget considerations. As a result, we believe we may experience significant fluctuations in our results of operations on a quarterly and annual basis.

Limited numbers of network and storage equipment vendors account for a majority of packet processor purchases in their respective markets. In particular, the market for network equipment that would include packet processors, such as routers, remote access concentrators and firewalls, is dominated by a few large vendors, including Cisco Systems, Inc., Nortel Networks, Inc. and 3Com Corporation. As a result, our future success will depend upon our ability to establish and maintain relationships with these companies. If these network equipment vendors do not incorporate our packet processors into their products, our business, financial condition and results of operations could suffer.

Our Operating Results May Fluctuate Significantly.

Our operating results have fluctuated significantly in the past and we expect that they will continue to fluctuate in the future. This fluctuation is a result of a variety of factors including the following:

General business conditions in our markets as well as global economic uncertainty;

Increases or reductions in demand for our customers' products;

The timing and volume of orders we receive from our customers;

Cancellations or delays of customer product orders;

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Acquisitions or mergers involving us, our competitors or customers;

Any new product introductions by us or our competitors;

Our suppliers increasing costs or changing the delivery of products to us;

Increased competition or reductions in the prices that we are able to charge;

The variety of the products that we sell as well as seasonal demand for our products; and

The availability of manufacturing capacity necessary to make our products.

The Length Of Time It Takes To Develop Our Products And Make A Sale To Our Customers May Impair Our Operating Results.

Our customers typically take a long time to evaluate our products. In fact, it usually takes our customers 3 to 6 months or more to test our products with an additional 9 to 18 months or more before they commence significant production of equipment incorporating our products. As a result of this lengthy sales cycle, we may experience a delay between increasing expenses for research and development and sales and marketing efforts on the one hand, and the generation of higher revenues, if any, on the other hand. In addition, the delays inherent in such a lengthy sales cycle raise additional risks of customer decisions to cancel or change product plans, which could result in the loss of anticipated sales. Our business, financial condition and results of operations could suffer if customers reduce or delay orders or choose not to release products using our technology.

We Depend Upon Independent Manufacturers And Limited Sources Of Supply.

We rely on subcontractors to manufacture, assemble and test our packet processors. We currently subcontract our semiconductor manufacturing to Atmel Corporation, Toshiba Corporation, Philips Semiconductor and IBM. Since we depend upon independent manufacturers, we do not directly control product delivery schedules or product quality. None of our products are manufactured by more than one supplier. Since the semiconductor industry is highly cyclical, foundry capacity has been very limited at times in the past and may become limited in the future.

We depend on our suppliers to deliver sufficient quantities of finished product to us in a timely manner. Since we place orders on a purchase order basis and do not have long-term volume purchase agreements with any of our suppliers, our suppliers may allocate production capacity to other products while reducing deliveries to us on short notice. In the past, one of our suppliers delayed the delivery of one of our products. As a result, we switched production of the product to a new manufacturer that caused a 3-month delay in shipments to customers. We have also experienced yield and test anomalies on a different product manufactured by another subcontractor that could have interrupted our customer shipments. In this case, the manufacturer was able to correct the problem in a timely manner and customer shipments were not affected. The delay and expense associated with qualifying a new supplier or foundry and commencing volume production can result in lost revenue, reduced operating margins and possible harm to customer relationships. The steps required for a new manufacturer to begin production of a semiconductor product include:

Adapting our product design, if necessary, to the new manufacturer's process;

Creating a new mask set to manufacture the product;

Having the new manufacturer prepare sample products so we can verify the product specification; and

Providing sample products to customers for qualification.

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In general, it takes from 3 to 6 months for a new manufacturer to begin full-scale production of one of our products. We could have similar or more protracted problems in the future with existing or new suppliers.

Toshiba Corporation manufactures products for us in plants located in Asia. To date, the financial and stock market dislocations that have occurred in the Asian financial markets in the past have not harmed our business. However, present or future dislocations or other international business risks, such as currency exchange fluctuations or recessions, could force us to seek new suppliers. We must place orders approximately 20 to 23 weeks in advance of expected delivery. This limits our ability to react to fluctuations in demand for our products, and could cause us to have an excess or a shortage of inventory of a particular product. In addition, if global semiconductor manufacturing capacity fails to increase in line with demand, foundries could allocate available capacity to larger customers or customers with long-term supply contracts. If we cannot obtain adequate foundry capacity at acceptable prices, or our supply is interrupted or delayed, our product revenues could decrease or our cost of revenues could increase. This could harm our business, financial condition and results of operations.

We regularly consider using smaller semiconductor dimensions for each of our products in order to reduce costs. We have begun to decrease the dimensions in our new product designs, and believe that we must do so to remain competitive. We may have difficulty decreasing the dimensions of our products. In the future, we may change our supply arrangements to assume more product manufacturing responsibilities. We may subcontract for wafer manufacturing, assembly and test rather than purchase finished products. However, there are additional risks associated with manufacturing, including variances in production yields, the ability to obtain adequate test and assembly capacity at reasonable cost and other general risks associated with the manufacture of semiconductors. We may also enter into volume purchase agreements that would require us to commit to minimum levels of purchases and which may require up-front investments. If we fail to effectively assume greater manufacturing responsibilities or manage volume purchase arrangements, our business, financial condition and results of operations will suffer.

We Face Risks Associated With Acquisitions.

We continually evaluate strategic acquisitions of businesses and technologies that would complement our product offerings or enhance our market coverage or technological capabilities and may make additional acquisitions in the future. Future acquisitions could be effected without stockholder approval, and could cause us to dilute shareholder equity, incur debt and contingent liabilities and amortize acquisition expenses related to intangible assets, any of which could harm our operating results and/or the price of our Common Stock. Acquisitions entail numerous risks, including:

Difficulties in assimilating acquired operations, technologies and products;

Diversion of management's attention from other business concerns;

Risks of entering markets in which we have little or no prior experience; and

Loss of key employees of acquired organizations.

We may not be able to successfully integrate businesses, products, technologies or personnel that we acquire. If we fail to do so, our business, financial condition and results of operations could suffer.

We Face Risks Associated With The Integration Of The IBM Network Processor Product Line Into Our Business.

During the fiscal quarter ended December 31, 2003, we acquired certain assets and intellectual property related to the IBM network processor product line. Our success in integrating these assets into our business will depend on our ability to merge the acquired assets into our ongoing operations, including maintaining a continuing relationship with IBM' s established customer base and our third party supplier, in this case, IBM. Without the successful integration of this significant asset acquisition, there can be no assurance that we will be able to maintain the revenue and profit performance levels experienced by IBM. If we fail to integrate these products into our operations successfully, our business, financial condition and results of operations could suffer.

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Additionally, prior to our acquisition of these assets, we understand IBM informed its customers that it was discontinuing selected research and development activities in connection with the assets and would not be developing any related follow-on products with respect to the products associated with the acquired assets. As a result of such announcement, there can be no assurance that the established customer base will continue to purchase the products based on the acquired assets from us and maintain their relationship with us in the future for follow-on products. If we fail to maintain the established customer base, we may not be able to maintain the revenue and profit performance levels that IBM maintained with respect to these products. Loss of the established customer base could negatively impact our results of operations, business and financial condition.

We Will Be Subject To And Are Currently Undergoing Procedures Related To Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 And May Not Be Able To Satisfy Regulatory Requirements Relating To Internal Controls Over Financial Reporting Or May Encounter Difficulties In Implementing Any New Or Improved Internal Controls.

As required by Section 404 of the Sarbanes-Oxley Act, we are conducting a review of all of our internal control processes and procedures. In our review, we have identified areas that may potentially require that we modify or strengthen controls over processes to improve internal controls and we intend to continue to evaluate and, where necessary, effect modifications. Our areas of focus for review include, but are not limited to, our financial system and segregation of duties. We made substantial progress in our review process and will continue to perform our review and testing. While the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, we cannot assure that our system of controls will succeed in achieving its stated goals under all conditions. Any failure to implement required new or improved controls, or difficulties encountered in the implementation of such new or improved controls, could have implications on our consolidated operating results or could result in a material weakness that would be required to be reported in the Company' s Form 10-K.

We Face Order And Shipment Uncertainties.

We generally make our sales under individual purchase orders that may be canceled or deferred by customers on short notice without significant penalty, if any. Cancellation or deferral of product orders could cause us to hold excess inventory, which could harm our profit margins and restrict our ability to fund our operations. During fiscal 2001, we wrote off excess inventory of $3.4 million as a result of a significant decrease in forecasted demand for our products. We recognize revenue upon shipment of products to our customers. Revenue from products sold to

distributors are deferred until the distributor sells the products to a third party. An unanticipated level of returns could harm our business, financial condition and results of operations.

We Face Risks Associated With Evolving Industry Standards And Rapid Technological Change.

The markets in which we compete are characterized by rapidly changing technology, frequent product introductions and evolving industry standards. Our performance depends on a number of factors, including our ability to do the following:

- Properly identify emerging target markets and related technological trends;
- Develop and maintain competitive products;
- Develop end-to-end, ubiquitous systems solutions;
- Develop, or partner with providers of, security services processors;
- Develop both hardware and software security services solutions;
- Enhance our products by adding innovative features that differentiate our products from those of competitors;
- Bring products to market on a timely basis at competitive prices; and

Respond effectively to new technological changes or new product announcements by others.

Our past success has been dependent in part upon our ability to develop products that have been selected for design into new products of leading equipment manufacturers. However, the development of our packet processors is complex and, from time to time, we have experienced delays in completing the development and introduction of new products. We may not be able to adhere to our new product design and introduction schedules and our products may not be accepted in the market at favorable prices, if at all.

In evaluating new product decisions, we must anticipate future demand for product features and performance characteristics, as well as available supporting technologies, manufacturing capacity, competitive product offerings and industry standards. We must also continue to make significant investments in research and development in order to continue to enhance the performance and functionality of our products to keep pace with competitive products and customer demands for improved performance, features and functionality. The technical innovations required for us to remain competitive are complicated and require a significant amount of time and money. During fiscal 2004, we acquired certain technology for embedded processors, pattern matching and network processors. We may experience substantial difficulty in introducing new products, such as new products containing the acquired technologies and we may be unable to offer enhancements to existing products on a timely or cost-effective basis, if at all. For instance, the performance of our encryption/compression and public key processors depends upon the integrity of our security technology. If any significant advances in overcoming cryptographic systems are made, then the security of our encryption/compression and public key processors will be reduced or eliminated unless we are able to develop further technical innovations that adequately enhance the security of these products. Our inability to develop and introduce new products or enhancements directed at new industry standards could harm our business, financial condition and results of operations.

Our Markets Are Highly Competitive.

We compete in markets that are intensely competitive and are expected to become increasingly competitive as current competitors expand their product offerings and new competitors enter the market. The markets that we compete in are subject to frequent product introductions with improved price-performance characteristics, rapid technological change, and the continued emergence of new industry standards. Our products compete with offerings from companies such as Analog Devices, Inc., SafeNet, Inc., IBM, Broadcom Corporation, Motorola, Inc., Cavium Networks, Freescale Technologies, Inc., Intel Corporation, Agere Systems and Applied Micro Circuits Corporation. Hifn was a wholly-owned subsidiary of Stac, Inc. until Hifn' s spin-off from Stac in 1996 upon which Stac assigned two license agreements entered into with IBM in 1994 in which Stac granted IBM the right to use, but not sublicense, our patented compression technology in IBM hardware and software products. Stac also assigned to us its license agreement with Microsoft Corporation ("Microsoft") in 1994 whereby Stac granted Microsoft the right to use, but not sublicense, our compression technology in their software products. We expect significant future competition from major domestic and international semiconductor suppliers. Several established electronics and semiconductor suppliers have recently entered, or expressed an interest to enter, the network equipment market. We also may face competition from suppliers of products based on new or emerging technologies. Furthermore, many of our existing and potential customers internally develop solutions which attempt to perform all or a portion of the functions performed by our products.

A key element of our packet processor architecture is our encryption technology. Until recently, in order to export our encryption-related products, the U.S. Department of Commerce required us to obtain a license. Foreign competitors that were not subject to similar requirements have an advantage over us in their ability to establish existing markets for their products and rapidly respond to the requests of customers in the global market. Although the export restriction has been liberalized, we may not be successful in entering or competing in the foreign encryption markets. See "Our Products Are Subject To Export Restrictions."

Many of our current and prospective competitors offer broader product lines and have significantly greater financial, technical, manufacturing and marketing resources than us. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or to devote greater resources to promote the sale of their products. In particular, companies such as Intel Corporation, Lucent Technologies Inc., Motorola, Inc., National Semiconductor Corporation and Texas Instruments Incorporated have a significant advantage over us given their relationships with many of our customers, their extensive marketing power and name recognition and their much greater financial resources. In addition, current and potential competitors may decide to consolidate, lower the prices of their products or bundle their products with other products. Any of the above would significantly and negatively impact our ability to compete and obtain or maintain market share. If we are unable to successfully compete against our competitors, our business, results of operations and financial condition will suffer.

We believe that the important competitive factors in our markets are the following:

Performance;

Price;

The time that is required to develop a new product or enhancements to existing products;

The ability to achieve product acceptance with major network and storage equipment vendors;

The support that exists for new network and storage standards;

Features and functionality;

Adaptability of products to specific applications;

Reliability; and

Technical service and support as well as effective intellectual property protection.

If we are unable to successfully develop and market products that compete with those of other suppliers, our business, financial condition and results of operations could be harmed. In addition, we must compete for the services of qualified distributors and sales representatives. To the extent that our competitors offer distributors or sales representatives more favorable terms, these distributors and sales representatives may decline to carry, or discontinue carrying, our products. Our business, financial condition and results of operations could be harmed by any failure to maintain and expand our distribution network.

Our Success Depends Upon Protecting Our Intellectual Property.

Our proprietary technology is critical to our future success. We rely in part on patent, trade, trademark, mask work and copyright law to protect our intellectual property. We own twenty-two (22) United States patents and six foreign patents. Our issued patents and patent applications primarily cover various aspects of our compression, flow classification, bandwidth management, cryptographic packet processing, rate shaping and pattern matching technologies and have expiration dates ranging from 2006 to 2022. We also have four pending patent applications in the United States and a total of seventeen (17) in Europe, Asia and Australia covering flow classification, cryptographic packet processing, and pattern matching. Patents may not be issued under our current or future patent applications, and the patents issued under such patent applications could be invalidated, circumvented or challenged. In addition, third parties could make infringement claims against us in the future. Such infringement claims could result in costly litigation. We may not prevail in any such litigation or be able to license any valid and infringed patents from third parties on commercially reasonable terms, if at all. Regardless of the outcome, an infringement claim would likely result in substantial cost and diversion of our resources. Any infringement claim or other litigation against us or by us could harm our business, financial condition and results of operations. The patents issued to us may not be adequate to protect our proprietary rights, to deter misappropriation or to prevent an unauthorized third party from copying our technology, designing around the patents we own or otherwise obtaining and using our products, designs or other information. In addition, others could develop technologies that are similar or superior to our technology.

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We also claim copyright protection for certain proprietary software and documentation. We attempt to protect our trade secrets and other proprietary information through agreements with our customers, employees and consultants, and through other security measures. However, our efforts may not be successful. Furthermore, the laws of certain countries in which our products are or may be manufactured or sold may not protect our products and intellectual property.

Network And Storage Equipment Prices Typically Decrease.

Average selling prices in the networking, storage and semiconductor industries have rapidly declined due to many factors, including:

- Rapidly changing technologies;
- Price-performance enhancements; and
- Product obsolescence.

The decline in the average selling prices of our products may cause substantial fluctuations in our operating results. We anticipate that the average selling prices of our products will decrease in the future due to product introductions by our competitors, price pressures from significant customers and other factors. Therefore, we must continue to develop and introduce new products that incorporate features which we can sell at higher prices. If we fail to do so, our revenues and gross margins could decline, which would harm our business, financial condition and results of operations.

We Face Product Return, Product Liability And Product Defect Risks.

Complex products such as ours frequently contain errors, defects and bugs when first introduced or as new versions are released. We have discovered such errors, defects and bugs in the past. Delivery of products with production defects or reliability, quality or compatibility problems could hinder market acceptance of our products. This could damage our reputation and harm our ability to attract and retain customers. Errors, defects or bugs could also cause interruptions, delays or a cessation of sales to our customers. We would have to expend significant capital and resources to remedy these problems. Errors, defects or bugs could be discovered in our new products after we begin commercial production of them, despite testing by us and our suppliers and customers. This could result in additional development costs, loss of, or delays in, market acceptance, diversion of technical and other resources from our other development efforts, claims by our customers or others against us or the loss of credibility with our current and prospective customers. Any such event would harm our business, financial condition and results of operations.

We Depend Upon Key Personnel.

Our success greatly depends on the continued contributions of our key management and other personnel, many of whom would be difficult to replace. We do not have employment contracts with any of our key personnel, nor do we maintain any key man life insurance on any of our personnel. It may be difficult for us to integrate new members of our management team. We must also attract and retain experienced and highly skilled engineering, sales and marketing and managerial personnel. Competition for such personnel has, in the past, been intense in the geographic areas and market segments in which we compete, and we may not be successful in hiring and retaining such people. If we lose the services of any key personnel, or cannot attract or retain qualified personnel, particularly engineers, our business, financial condition and results of operations could suffer. In addition, companies in technology industries whose employees accept positions with competitors have in the past claimed that their competitors have engaged in unfair competition or hiring practices. We could receive such claims in the future as we seek to hire qualified personnel. These claims could result in material litigation. We could incur substantial costs in defending against any such claims, regardless of their merits.

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The Cyclical Nature Of The Semiconductor Industry May Harm Our Business.

The semiconductor industry has experienced significant downturns and wide fluctuations in supply and demand. The industry has also experienced significant fluctuations in anticipation of changes in general economic conditions. This has caused significant variances in product demand, production capacity and rapid erosion of average selling prices. Industry-wide fluctuations in the future could harm our business, financial condition and results of operations.

We Face Risks Associated With Our International Business Activities.

We sell most of our products to customers in the United States. If our international sales increase, particularly in light of decreased export restrictions, we may encounter risks inherent in international operations. All of our international sales to date are denominated in U.S. dollars. As a result, if the value of the U.S. dollar increases relative to foreign currencies, our products could become less competitive in international markets. We also obtain some of our manufacturing, assembly and test services from suppliers located outside the United States. International business activities could be limited or disrupted by any of the following:

- The imposition of governmental controls;
- Export license/technical review requirements;
- Restrictions on the export of technology;
- Currency exchange fluctuations;
- Political instability;
- Financial and stock market dislocations;
- Military and related activities;
- Trade restrictions; and
- Changes in tariffs.

Demand for our products also could be harmed by seasonality of international sales and economic conditions in our primary overseas markets. These international factors could harm future sales of our products to international customers and our business, financial condition and results of operations in general.

The Company has established a development facility in China. The facility faces some of the same risks with respect to international business activities as referenced above, including, without limitation, the imposition of governmental controls, currency exchange fluctuations and political instability.

Our Products Are Subject To Export Restrictions.

The encryption algorithms embedded in our products are a key element of our packet processor architecture. These products are subject to U.S. Department of Commerce export control restrictions. Our network equipment customers may only export products incorporating encryption technology if they obtain a one-time technical review. These U.S. export laws also prohibit the export of encryption products to a number of countries deemed by the U.S. to be hostile. Many foreign countries also restrict exports to many of these countries deemed to be "terrorist-supporting" states by the U.S. government. Because the restrictions on exports of encryption products have been liberalized, we, along with our network equipment customers have an opportunity to effectively compete with our foreign competitors. The existence of these restrictions until recently may have enabled foreign competitors facing less stringent controls on their products to become more established and, therefore, more competitive in the global market than our network equipment customers. In addition, the list of products and countries for which export

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approval is required, and the regulatory policies with respect thereto, could be revised, and laws limiting the domestic use of encryption could be enacted. While the U.S. government now allows U.S. companies to assume that exports to non-government end-users will be approved within 30 days of official registration with the Department of Commerce, the sale of our packet processors could be harmed by the failure of our network equipment customers to obtain the required approvals or by the costs of compliance.

Our Stock Price May Be Volatile.

The market price of our Common Stock has fluctuated in the past and is likely to fluctuate in the future. In addition, the securities markets have experienced significant price and volume fluctuations and the market prices of the securities of technology-related companies including networking, storage and semiconductor companies have been especially volatile. Such fluctuations can result from:

- Quarterly variations in operating results;
- Announcements of new products by us or our competitors;
- The gain or loss of significant customers;
- Changes in analysts' estimates;
- Short-selling of our Common Stock; and
- Events affecting other companies that investors deem to be comparable to us.

The Common Stock Sold In Our Private Offering Increased The Supply Of Our Common Stock On The Public Market, Which May Cause Our Stock Price To Decline.

On April 9, 2004, the Registration Statement on Form S-3 relating to the sale of 2,200,000 shares of our Common Stock in a private equity offering on February 6, 2004 was declared effective. The shares of Common Stock becoming eligible for immediate and unrestricted resale into the public market at any time could adversely affect the market price of our Common Stock and the presence of these additional shares of Common Stock in the public market may further depress our stock price.

If We Determine That Our Long-Lived Assets Have Been Impaired Or That Our Goodwill Has Been Further Impaired Our Financial Condition and Results of Operations May Suffer.

We perform impairment analyses of goodwill and long-lived and intangible assets on an annual basis. During fiscal 2003 and 2002, we determined that impairment had been realized on certain developed technology and goodwill, resulting in recognition of impairment charges of $3.9 million and $27.4 million, respectively. Pursuant to SFAS 142, "Goodwill and Other Intangible Assets," we will continue to perform an annual impairment test and if, as a result of this analysis, we determine that there has been an impairment of our goodwill and other long-lived and intangible assets, asset impairment charges will be recognized. Approximately $1.0 million of goodwill remains as of March 31, 2005. If we determine that our long-lived assets have been impaired or that our goodwill has been further impaired, our financial condition and results of operations may suffer.

We Have Been Engaged in Securities Class-Action Lawsuits.

In the past, the Company has been engaged in securities class-action lawsuits. During fiscal 2003, we completed the settlement terms of a class action complaint and had shareholder derivative actions dismissed. As of March 31, 2005, there were no outstanding claims against us nor do we have any outstanding obligations related to claims or lawsuits. There can be no assurance there will not be any actions against us in the future. Any such actions may have a material adverse effect on our financial condition and results of operations.

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Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R ("SFAS No. 123R"), "Share-Based Payment," and amendment to Statement of Financial Accounting Standards No. 123 ("SFAS No. 123"), "Accounting for Stock-Based Compensation" and Statement on Financial Accounting Standards No. 95, "Statement of Cash Flows." The revised standard addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company' s equity instruments or that may be settled by the issuance of such equity instruments. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB 25. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. The effective date for SFAS No. 123R, as amended on April 14, 2005, is for annual periods beginning after June 15, 2005. The Company has not yet determined which fair-value method and transitional provision it will follow. Currently, we disclose the pro forma net income (loss) and related pro forma income (loss) per share information in accordance with SFAS 123 and Statement on Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation Costs−Transition and Disclosure." The adoption of SFAS No. 123R will have a material effect on our results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk – The Company does not use derivative financial instruments in its investment portfolio. The Company's investment portfolio is generally comprised of commercial paper. The Company places investments in instruments that meet high credit quality standards. These securities are subject to interest rate risk, and could decline in value if interest rates fluctuate. Due to the short duration and conservative nature of the Company's investment portfolio, the Company does not expect any material loss with respect to its investment portfolio. A 10% change in interest rates at March 31, 2005 would not have a material effect on the Company's pre-tax earnings and the fair value of its investments.

Foreign Currency Exchange Rate Risk – All of the Company's sales, cost of manufacturing and marketing are transacted in US dollars. Accordingly, the Company's results of operations are not subject to foreign exchange rate fluctuations. Gains and losses from such fluctuations have not been incurred by the Company to date.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Act of 1934, as amended, are effective to ensure that information required to be disclosed in this Quarterly Report on Form 10-Q is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting that was identified in connection with our evaluation of disclosure controls and procedures 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.

PART II − OTHER INFORMATION

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

The Company held its Annual Meeting of Stockholders on February 17, 2005. At the meeting, the following proposals received the votes listed below:

Proposal I: Election of Class III Directors for three-year terms expiring 2008.

	Votes for:	Votes withheld:
Albert Sisto	13,149,356	92,272
Douglas Whiting	12,695,808	550,820

The Company' s Board of Directors is currently comprised of six members who are divided into three classes with overlapping three-year terms. The term for Class I director (Christopher G. Kenber) will expire at the meeting of stockholders to be held in 2006. The term for Class II directors (Dennis DeCoste, Taher Elgamal and Robert Johnson) will expire at the meeting of stockholders to be held in 2007.

Proposal II: Approval of an amendment to the Company' s 2001 Nonstatutory Stock Option Plan to provide for an increase in the number of shares of common stock available for issuance thereunder by 500,000 shares to 2,500,000 shares.

Votes for:	2,589,338
Votes against:	5,819,808
Abstentions:	7,838

Proposal III: Approval of ratification of the appointment of PricewaterhouseCoopers LLP as independent auditors of the Company for the fiscal year ending September 30, 2005.

Votes for:	13,202,726
Votes against:	28,933
Abstentions:	14,969

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Item 5. Other Information

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the "Act"), we are required to disclose the non-audit services approved by our Audit Committee to be performed by PricewaterhouseCoopers LLP, our external accountants. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee approved the engagement of PricewaterhouseCoopers LLP for work related to the Act' s Section 404 certification requirements.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit Index

Exhibit Number	Description
3.1*	Form of Third Amended and Restated Certificate of Incorporation of hi/fn, inc.
3.2*	Amended and Restated Bylaws of hi/fn, inc.
31.1	Certification of Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

31.2	Certification of Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

None.

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* Incorporated by reference from Registrant's Registration Statement on Form 10 (File No. 0-24765) filed with the SEC on August 7, 1998 as amended.

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SIGNATURES

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

hi/fn, inc.
(Registrant)

By: /s/ William R. Walker
____

Date: April 29, 2005

William R. Walker
Vice President, Finance, Chief Financial Officer and Secretary
(principal financial and accounting officer)

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EXHIBIT 31.1

CERTIFICATION PURSUANT TOSECTION
302 (a) OF
THE SARBANES-OXLEY ACT OF 2002

I, Christopher G. Kenber, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Hifn, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter (the registrant' s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting; and

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of the registrant' s board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonable likely to adversely affect the registrant' s ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal controls over financial reporting.

Date: April 29, 2005

/s/ Christopher G. Kenber
____

Christopher G. Kenber
Chairman, President and CEO

EXHIBIT 31.2

CERTIFICATION PURSUANT TOSECTION
302 (a) OF
THE SARBANES-OXLEY ACT OF 2002

I, William R. Walker, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Hifn, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter (the registrant' s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting; and

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal controls over financial reporting, to the registrant' s auditors and the audit committee of the registrant' s board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonable likely to adversely affect the registrant' s ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal controls over financial reporting.

Date: April 29, 2005

/s/ William R. Walker
____
William R. Walker
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Christopher G. Kenber, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of hi/fn, inc. on Form 10-Q for the three months ended March 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of hi/fn, inc.

Date: April 29, 2005

By: /s/ Christopher G. Kenber
____
Name: Christopher G. Kenber
Title: Chief Executive Officer

EXHIBIT 32.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, William R. Walker, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of hi/fn, inc. on Form 10-Q for the three months ended March 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of hi/fn, inc.

By: /s/ William R. Walker
____

Date: April 29, 2005

Name: William R. Walker
Title: Chief Financial Officer