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HARRIS & HARRIS GROUP INC /NY/  
Form 10-Q  
November 12, 2004

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 quarterly period ended September 30, 2004

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: 0-11576

HARRIS & HARRIS GROUP, INC.

-----  
(Exact name of registrant as specified in its charter)

New York 13-3119827

-----  
(State or other jurisdiction of (IRS Employer Identification No.)  
incorporation or organization)

111 West 57th Street, New York, New York 10019

-----  
(Address of Principal Executive Offices) (Zip Code)

(212) 582-0900

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No  
-----

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

Yes No X  
-----

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class Outstanding at November 12, 2004  
-----  
Common Stock, \$0.01 par value per share 17,248,845 shares

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Harris & Harris Group, Inc.  
Form 10-Q, September 30, 2004

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PART I. FINANCIAL INFORMATION

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### Item 1. Consolidated Financial Statements

The information furnished in the accompanying consolidated financial statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim period presented.

Harris & Harris Group, Inc. (the "Company," "us," "our" and "we"), is an internally managed venture capital company that has elected to be treated as a business development company under the Investment Company Act of 1940. Certain information and disclosures normally included in the consolidated financial statements in accordance with Generally Accepted Accounting Principles have been condensed or omitted as permitted by Regulation S-X and Regulation S-K. It is suggested that the accompanying consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2003, contained in our 2003 Annual Report.

On September 25, 1997, our Board of Directors approved a proposal to seek out qualification as a Regulated Investment Company ("RIC") under Subchapter M of the Internal Revenue Code (the "Code"). At that time, we were taxable under Subchapter C of the Code (a "C Corporation"). In order to qualify as a RIC, we must, in general (1) annually derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and similar sources; (2) quarterly meet certain investment diversification requirements; and (3) annually distribute at least 90% of our investment company taxable income as a dividend. In addition to the requirement that we must annually distribute at least 90% of our investment company taxable income, we may either distribute or retain our taxable net capital gains from investments, but any net capital gains not distributed could be subject to corporate level tax. Further, we could be subject to a 4% excise tax to the extent we fail to distribute at least 98% of our annual investment company taxable income and would be subject to income tax to the extent we fail to distribute 100% of our investment company taxable income.

Because of the specialized nature of our investment portfolio and the size of our Company, prior to our recent offerings of additional shares, we were able to satisfy certain diversification requirements under Subchapter M of the Code only if we received a certification from the Securities and Exchange Commission ("SEC") that we are "principally engaged in the furnishing of capital to other corporations that are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available."

On June 15, 2004, we received SEC certification for 2003, permitting us to qualify for RIC treatment for 2003 (as we had for the years 1999 through 2002). Although the SEC certification for 2003 was issued, there can be no assurance that we will qualify for or receive such certification for subsequent years (to the extent we need certification for any subsequent year) or that we will actually qualify for Subchapter M treatment in any subsequent year.

In addition, under certain circumstances, even if we qualified for Subchapter M treatment in a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC.

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CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

ASSETS

|  | September 30, 2004<br>(Unaudited) | December 31, 2003 |
|--|-----------------------------------|-------------------|
| Investments, at value<br>(Cost: \$78,938,861 at 9/30/04,<br>\$44,603,778 at 12/31/03)..... | \$78,613,954                      | \$42,227,062      |
| Cash and cash equivalents.....   | 290,641                           | 425,574           |
| Restricted funds (Note 5).....   | 1,393,093                         | 1,212,078         |
| Interest receivable.....   | 184,325                           | 450               |
| Income tax receivable.....   | 9,532                             | 17,375            |
| Prepaid expenses.....  | 25,669                            | 6,841             |
| Other assets, net of reserve<br>of \$255,486 at 9/30/04.....                               | 240,422                           | 225,748           |
|  | -----                             | -----             |
| Total assets.....  | \$80,757,636                      | \$44,115,128      |
|  | =====                             | =====             |

LIABILITIES & NET ASSETS

|  |              |              |
|--|--------------|--------------|
| Accounts payable and accrued<br>liabilities..... | \$ 2,565,303 | \$ 2,723,398 |
| Accrued profit sharing (Note 3).....             | 336,820      | 0            |
| Deferred rent.....                               | 34,922       | 39,648       |
| Deferred income tax liability<br>(Note 6).....   | 1,315,579    | 669,344      |
|  | -----        | -----        |
| Total liabilities.....                           | 4,252,624    | 3,432,390    |
|  | -----        | -----        |
| Net assets.....                                  | \$76,505,012 | \$40,682,738 |
|  | =====        | =====        |

Net assets are comprised of:

|   |             |             |
|---|-------------|-------------|
| Preferred stock, \$0.10 par value,<br>2,000,000 shares authorized;<br>none issued.....  | \$ 0        | \$ 0        |
| Common stock, \$0.01 par value,<br>25,000,000 shares authorized;<br>19,077,585 issued at 9/30/04<br>and 15,627,585 at 12/31/03.....                       | 190,776     | 156,276     |
| Additional paid in capital (Note 4) ..  | 85,657,650  | 49,564,475  |
| Accumulated net realized loss.....  | (4,121,822) | (2,410,847) |
| Accumulated unrealized depreciation<br>of investments, including<br>deferred tax liability of<br>\$1,491,153 at 9/30/04 and<br>\$844,918 at 12/31/03..... | (1,816,061) | (3,221,635) |
| Treasury stock, at cost (1,828,740<br>shares at 9/30/04 and 12/31/03)....   | (3,405,531) | (3,405,531) |

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|   |              |              |
|---|--------------|--------------|
|   | -----        | -----        |
| Net assets.....                               | \$76,505,012 | \$40,682,738 |
|   | =====        | =====        |
| Shares outstanding.....                       | 17,248,845   | 13,798,845   |
|   | =====        | =====        |
| Net asset value per outstanding<br>share..... | \$ 4.44      | \$ 2.95      |
|   | =====        | =====        |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

|  | Three Months Ended |                | Nin       |
|--|--------------------|----------------|-----------|
|  | Sept. 30, 2004     | Sept. 30, 2003 | Sept. 30, |
| Investment income:                           |                    |                |           |
| Interest from:                               |                    |                |           |
| Fixed-income securities.....                 | \$ 235,778         | \$ 25,910      | \$ 365    |
| Portfolio companies.....                     | 17,803             | 0              | 23        |
| Other income.....                            | 0                  | 4,702          |           |
|  | -----              | -----          | -----     |
| Total investment income.....                 | 253,581            | 30,612         | 389       |
| Expenses:                                    |                    |                |           |
| Profit-sharing (Note 3).....                 | 336,820            | 0              | 336       |
| Salaries and benefits.....                   | 419,384            | 360,116        | 1,384     |
| Administration and operations.....           | 129,649            | 85,536         | 475       |
| Professional fees.....                       | 231,144            | 59,277         | 389       |
| Rent.....                                    | 38,860             | 49,885         | 111       |
| Directors' fees and expenses.....            | 63,188             | 31,250         | 156       |
| Depreciation.....                            | 10,958             | 11,408         | 29        |
| Bank custody fees.....                       | 2,351              | 1,499          | 8         |
| Interest expense.....                        | 0                  | 3,987          |           |
|  | -----              | -----          | -----     |
| Total expenses.....                          | 1,232,354          | 602,958        | 2,892     |
| Operating loss before income taxes.....      | (978,773)          | (572,346)      | (2,503)   |
| Net operating loss.....                      | (978,773)          | (572,346)      | (2,503)   |
| Net realized (loss) gain on investments:     |                    |                |           |
| Realized (loss) gain on investments.....     | 2,704              | (1,003,919)    | 798       |
|  | -----              | -----          | -----     |
| Total realized (loss) gain.....              | 2,704              | (1,003,919)    | 798       |
| Income tax benefit (provision) (Note 6)..... | 1,482              | 3,500          | (6        |
|  | -----              | -----          | -----     |
| Net realized (loss) gain on investments..... | 4,186              | (1,000,419)    | 792       |
| Net realized loss.....                       | (974,587)          | (1,572,765)    | (1,710)   |

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|  |              |                |          |
|--|--------------|----------------|----------|
| Net increase (decrease) in unrealized appreciation on investments:     |              |                |          |
| Increase as a result of investment sales.....                          | 0            | 1,000,001      | 915      |
| Decrease as a result of investment sales.....                          | 0            | 0              |          |
| Increase on investments held.....                                      | 3,172,633    | 67,982         | 3,212    |
| Decrease on investments held.....                                      | (440,690)    | (765,516)      | (2,075)  |
|  | -----        | -----          | -----    |
| Net change in unrealized appreciation on investments.....              | 2,731,943    | 302,467        | 2,051    |
| Income tax (expense) benefit (Note 6).....                             | (646,235)    | 0              | (646)    |
|  | -----        | -----          | -----    |
| Net increase (decrease) in unrealized appreciation on investments..... | 2,085,708    | 302,467        | 1,405    |
|  | -----        | -----          | -----    |
| Net (decrease) increase in net assets resulting from operations:       |              |                |          |
| Total.....   | \$ 1,111,121 | \$ (1,270,298) | \$ (305) |
|  | =====        | =====          | =====    |
| Per outstanding share.....   | \$ .06       | \$ (.11)       | \$       |
|  | =====        | =====          | =====    |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | Nine Months Ended<br>Sept. 30, 2004 | Nine Months Ended<br>Sept. 30, 2003 |
|---|-------------------------------------|-------------------------------------|
| Cash flows from operating activities:   |                                     |                                     |
| Net (decrease) in net assets resulting from operations.....   | \$ (305,401)                        | \$ (3,030,134)                      |
| Adjustments to reconcile net decrease in net assets resulting from operations to net cash used in operating activities: |                                     |                                     |
| Realized and unrealized (loss) gain on investments.....   | (2,850,482)                         | 1,132,517                           |
| Depreciation.....   | 29,906                              | 31,538                              |
| Deferred income taxes.....  | 646,235                             | 0                                   |
| Changes in assets and liabilities:  |                                     |                                     |
| Restricted funds.....   | (181,015)                           | (342,107)                           |
| Receivable from portfolio company....   | 0                                   | 786,492                             |
| Funds in escrow.....  | 0                                   | 750,000                             |
| Interest receivable.....  | (183,875)                           | (153)                               |
| Income tax receivable.....  | 7,843                               | (83,595)                            |
| Prepaid expenses.....   | (18,828)                            | 72,692                              |
| Other assets.....   | 5,514                               | (40,927)                            |
| Accounts payable and accrued liabilities.....   | (158,095)                           | 394,485                             |
| Payable to broker for unsettled trade.  | 0                                   | (5,696,725)                         |

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|  |              |               |
|--|--------------|---------------|
| Accrued profit sharing.....  | 336,820      | (15,233)      |
| Current income tax liability.....  | 0            | (857,656)     |
| Deferred rent.....   | (4,726)      | 35,826        |
|  | -----        | -----         |
| Net cash used in operating activities.   | (2,676,104)  | (6,862,980)   |
| Cash flows from investing activities:  |              |               |
| Net (purchase) sale of short-term<br>investments and marketable<br>securities..... | (24,578,644) | (2,975,719)   |
| Proceeds from investments.....   | 2,515,386    | 26,791        |
| Investment in private placements<br>and loans.....                                 | (11,473,651) | (3,331,118)   |
| Purchase of fixed assets.....  | (49,595)     | (195,725)     |
|  | -----        | -----         |
| Net cash (used in) provided by<br>investing activities.....                        | (33,586,504) | (6,475,771)   |
| Cash flows from financing activities:  |              |               |
| Proceeds from note payable.....  | 0            | 7,609,500     |
| Proceeds from public offering, net....   | 36,127,675   | 0             |
| Collection on notes receivable.....  | 0            | 1,500         |
|  | -----        | -----         |
| Net cash provided by financing<br>activities.....                                  | 36,127,675   | 7,611,000     |
|  | -----        | -----         |
| Net increase (decrease) in cash and<br>cash equivalents:                           |              |               |
| Cash and cash equivalents at<br>beginning of the period.....                       | 425,574      | 5,967,356     |
| Cash and cash equivalents at<br>end of the period.....                             | 290,641      | 239,605       |
|  | -----        | -----         |
| Net decrease in cash and cash<br>equivalents.....                                  | \$(134,933)  | \$(5,727,751) |
|  | =====        | =====         |
| Supplemental disclosures of cash flow information:                                 |              |               |
| Income taxes paid.....   | \$ 0         | \$ 575,100    |
| Interest paid.....   | \$ 0         | \$ 15,441     |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS  
(Unaudited)

|                       | Three Months Ended |                | Nine Months Ended |                |
|-----------------------|--------------------|----------------|-------------------|----------------|
|                       | Sept. 30, 2004     | Sept. 30, 2003 | Sept. 30, 2004    | Sept. 30, 2003 |
| Changes in net assets |                    |                |                   |                |

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|                         |               |               |                |                |
|-------------------------|---------------|---------------|----------------|----------------|
| from operations:        |               |               |                |                |
| Net operating loss..... | \$ (978,773)  | \$ (572,346)  | \$ (2,503,222) | \$ (1,883,795) |
| Net realized gain       |               |               |                |                |
| (loss) on               |               |               |                |                |
| investments.....        | 4,186         | (1,000,419)   | 792,247        | (989,169)      |
| Net increase in         |               |               |                |                |
| unrealized              |               |               |                |                |
| appreciation on         |               |               |                |                |
| investments as a        |               |               |                |                |
| result of sales.....    | 0             | 1,000,001     | 915,118        | 981,970        |
| Net increase            |               |               |                |                |
| (decrease) in           |               |               |                |                |
| unrealized              |               |               |                |                |
| appreciation on         |               |               |                |                |
| investments held.....   | 2,085,708     | (697,534)     | 490,456        | (1,139,140)    |
|                         | -----         | -----         | -----          | -----          |
| Net increase            |               |               |                |                |
| (decrease) in net       |               |               |                |                |
| assets resulting        |               |               |                |                |
| from operations.....    | 1,111,121     | (1,270,298)   | (305,401)      | (3,030,134)    |
| Changes in net assets   |               |               |                |                |
| from capital stock      |               |               |                |                |
| transactions:           |               |               |                |                |
| Proceeds from sale      |               |               |                |                |
| of common stock.....    | 34,500        | 0             | 34,500         | 0              |
| Additional paid in      |               |               |                |                |
| capital on common       |               |               |                |                |
| stock issued.....       | 36,093,175    | 0             | 36,093,175     | 0              |
|                         | -----         | -----         | -----          | -----          |
| Net increase in         |               |               |                |                |
| net assets              |               |               |                |                |
| resulting from          |               |               |                |                |
| capital stock           |               |               |                |                |
| transactions.....       | 36,127,675    | 0             | 36,127,675     | 0              |
|                         | -----         | -----         | -----          | -----          |
| Net increase (decrease) |               |               |                |                |
| in net assets.....      | 37,238,796    | (1,270,298)   | 35,822,274     | (3,030,134)    |
| Net assets:             |               |               |                |                |
| Beginning of            |               |               |                |                |
| the period.....         | 39,266,216    | 25,496,210    | 40,682,738     | 27,256,046     |
|                         | -----         | -----         | -----          | -----          |
| End of the period.....  | \$ 76,505,012 | \$ 24,225,912 | \$ 76,505,012  | \$ 24,225,912  |
|                         | =====         | =====         | =====          | =====          |

The accompanying notes are an integral part of these consolidated financial statements.



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|  | Method of<br>Valuation (3) | Shares/<br>Principal | Value      |
|--|----------------------------|----------------------|------------|
| Investments in Unaffiliated Companies<br>(8) (9) (10) -- 12.2% of total investments  |                            |                      |            |
| Private Placement Portfolio (Illiquid) --<br>12.2% of total investments  |                            |                      |            |
| AlphaSimplex Group, LLC (2) (5) --<br>Investment management company headed by<br>Dr. Andrew W. Lo, holder of the Harris &<br>Harris Group Chair at MIT   |                            |                      |            |
| Limited Liability Company Interest.....  | (C)                        | --                   | \$ 125,000 |
| Continuum Photonics, Inc. (1) (2) (5) (6) --<br>Develops optical networking components by<br>merging cutting-edge materials, MEMS and<br>electronics technologies -- 4.23% of fully<br>diluted equity              |                            |                      |            |
| Series B Convertible Preferred Stock.....  | (C)                        | 2,000,000            | 776,119    |
| Series C Convertible Preferred Stock.....  | (C)                        | 2,689,103            | 839,000    |
|  |                            |                      | -----      |
|  |                            |                      | 1,615,119  |
| Crystal IS, Inc. (1) (2) (4) (6) -- Develops<br>a technology to grow aluminum<br>nitride single-crystal boules --<br>1.81% of fully diluted equity   |                            |                      |            |
| Series A Convertible Preferred Stock.....  | (A)                        | 5,482                | 199,983    |
| Exponential Business Development Company (1) (2) --<br>Venture capital partnership focused on<br>early stage companies   |                            |                      |            |
| Limited Partnership Interest.....  | (B)                        | --                   | 0          |
| Heartware, Inc. (1) (2) (5) (6) -- Develops<br>ventricular assist devices -- 0% of<br>fully diluted equity   |                            |                      |            |
| Series A-2 Non-Voting Preferred Stock.....   | (B)                        | 47,620               | 0          |
| Molecular Imprints, Inc. (1) (2) (4) (5) --<br>Develops nanoimprint lithography capital<br>equipment -- 2.09% of fully diluted equity  |                            |                      |            |
| Series B Convertible Preferred Stock.....  | (A)                        | 1,333,333            | 2,000,000  |
| Nanosys, Inc. (1) (2) (5) (6) -- Develops<br>nanotechnology-enabled systems incorporating<br>novel and patent-protected zero and one-<br>dimensional nanometer-scale materials --<br>1.58% of fully diluted equity |                            |                      |            |
| Series C Convertible Preferred Stock.....  | (A)                        | 803,428              | 1,500,000  |
| Nantero, Inc. (1) (2) (5) (6) -- Develops a<br>high-density, nonvolatile, random access<br>memory chip, using nanotechnology -- 3.35%<br>of fully diluted equity   |                            |                      |            |
| Series A Convertible Preferred Stock.....  | (C)                        | 345,070              | 538,309    |
| Series B Convertible Preferred Stock.....  | (C)                        | 207,051              | 323,000    |
|  |                            |                      | -----      |
|  |                            |                      | 861,309    |

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|   |           |       |           |
|---|-----------|-------|-----------|
| NeoPhotonics Corporation (1) (2) (5) (6) (12) --  |           |       |           |
| Develops and manufactures planar optical devices and components using nanomaterials -- deposition technology -- 3.49% of fully diluted equity |           |       |           |
| Common Stock (C)  | 60,580    | 9,105 |           |
| Series 1 Convertible Preferred Stock.....(A)  | 1,831,256 |       | 2,014,677 |
| Warrants at \$0.15 expiring 3/12/11.....(C)   | 30,426    |       | 304       |
|   |           |       | -----     |
|   |           |       | 2,024,086 |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2004  
(UNAUDITED)

|  | Method of Valuation (3) | Shares/Principal | Value        |
|--|-------------------------|------------------|--------------|
| Investments in Unaffiliated Companies<br>(8) (9) (10) -- 12.2% of total investments (cont.)                                      |                         |                  |              |
| Private Placement Portfolio (Illiquid) --<br>12.2% of total investments (cont.)  |                         |                  |              |
| Optiva, Inc. (1) (2) (6) -- Develops and commercializes nanomaterials for advanced applications -- 1.74% of fully diluted equity |                         |                  |              |
| Series C Convertible Preferred Stock.....(B)   |                         | 1,249,999        | \$ 625,000   |
| Secured Convertible Bridge Note with 50% Preferred Stock Warrant coverage.....(A)  |                         | 401,536          | 408,752      |
|  |                         |                  | -----        |
|  |                         |                  | 1,033,752    |
| Starfire Systems, Inc. (1) (2) (4) (5) (6) --<br>Develops and produces ceramic-forming polymers -- 1.80% of fully diluted equity |                         |                  |              |
| Common Stock.....(A)   |                         | 125,000          | 50,000       |
| Series A-1 Convertible Preferred Stock.....(A)   |                         | 200,000          | 200,000      |
|  |                         |                  | -----        |
|  |                         |                  | 250,000      |
| Total Unaffiliated Private Placement Portfolio (cost: \$10,316,632).....   |                         |                  | \$ 9,609,249 |
|  |                         |                  | -----        |
| Total Investments in Unaffiliated Companies (cost: \$10,316,632).....  |                         |                  | \$ 9,609,249 |
|  |                         |                  | -----        |

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The accompanying notes are an integral part of  
these consolidated financial statements.

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### CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2004 (UNAUDITED)

|   | Method of<br>Valuation (3) | Shares/<br>Principal | Value       |
|---|----------------------------|----------------------|-------------|
| Investments in Non-Controlled Affiliated<br>Companies (8) (9) (11) -- 22.2% of total<br>investments   |                            |                      |             |
| Publicly Traded Portfolio -- 12.7% of total<br>investments  |                            |                      |             |
| NeuroMetrix, Inc. (1) (2) (13) -- Develops and<br>sells medical devices for monitoring<br>neuromuscular disorders -- 8.65% of fully<br>diluted equity                           |                            |                      |             |
| Common Stock.....   | (D)                        | 1,137,570            | \$9,998,103 |
|   |                            |                      | -----       |
| Total Publicly Traded Portfolio (cost: \$4,411,373).....  |                            |                      | \$9,998,103 |
|   |                            |                      | -----       |
| Private Placement Portfolio (Illiquid) -- 9.5% of total investments   |                            |                      |             |
| Agile Materials & Technologies, Inc. (1) (2) (6)<br>-- Develops and sells variable integrated<br>passive RF electronic equipment components --<br>8.15% of fully diluted equity |                            |                      |             |
| Series A Convertible Preferred Stock.....   | (B)                        | 3,732,736            | \$ 110,700  |
| Convertible Bridge Note with 20% warrants.....  | (B)                        | \$301,273            | 310,650     |
|   |                            |                      | -----       |
|   |                            |                      | 421,350     |
| Chlorogen, Inc. (1) (2) (5) (6) -- Develops<br>patented chloroplast technology to<br>produce plant-made proteins -- 9.74%<br>of fully diluted equity                            |                            |                      |             |
| Series A Convertible Preferred Stock.....   | (A)                        | 4,478,038            | 785,000     |
| CSwitch, Inc. (1) (2) (4) (5) (6) -- Develops<br>next-generation, system-on-a-chip<br>solutions for communications-based<br>platforms -- 5.66% of fully diluted equity          |                            |                      |             |
| Series A Convertible Preferred Stock.....   | (A)                        | 1,000,000            | 1,000,000   |
| Experion Systems, Inc. (1) (2) (7) -- Develops<br>and sells software to credit unions -- 12.49%<br>of fully diluted equity  |                            |                      |             |
| Series A Convertible Preferred Stock.....   | (B)                        | 294,118              | 0           |
| Series B Convertible Preferred Stock.....   | (B)                        | 35,294               | 0           |

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|   |            |           |
|---|------------|-----------|
| Series C Convertible Preferred Stock.....(B)  | 222,184    | 0         |
| Series D Convertible Preferred Stock.....(B)  | 64,501     | 363,786   |
|   |            | -----     |
|   |            | 363,786   |
| NanoGram Corporation (1) (2) (5) (6) -- Develops a broad suite of intellectual property utilizing nanotechnology -- 7.29% of fully diluted equity   |            |           |
| Series I Convertible Preferred Stock.....(A)  | 63,210     | 21,672    |
| Series II Convertible Preferred Stock.....(A)   | 1,250,904  | 1,000,723 |
|   |            | -----     |
|   |            | 1,022,395 |
| NanoOpto Corporation (1) (2) (6) -- Develops high performance, integrated optical communications sub-components on a chip by utilizing patented nano-manufacturing technology -- 11.92% of fully diluted equity |            |           |
| Series A-1 Convertible Preferred Stock.....(C)  | 267,857    | 47,567    |
| Series B Convertible Preferred Stock.....(C)  | 3,819,935  | 1,625,000 |
|   |            | -----     |
|   |            | 1,672,567 |
| Nanopharma Corp. (1) (2) (6) -- Develops advanced nanoscopic drug delivery vehicles and systems -- 14.32% of fully diluted equity   |            |           |
| Series A Convertible Preferred Stock.....(A)  | 684,516    | 700,000   |
| Subordinated Convertible Bridge Note.....(A)  | \$ 150,000 | 153,370   |
|   |            | -----     |
|   |            | 853,370   |
| Nanotechnologies, Inc. (1) (2) (5) (6) -- Develops high-performance nanoscale materials for industry -- 6.48% of fully diluted equity   |            |           |
| Series B Convertible Preferred Stock.....(B)  | 1,538,837  | 553,982   |
| Series C Convertible Preferred Stock.....(B)  | 235,720    | 84,859    |
|   |            | -----     |
|   |            | 638,841   |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2004  
(UNAUDITED)

|  | Method of<br>Valuation (3) | Shares/<br>Principal | Value |
|--|----------------------------|----------------------|-------|
| Questech Corporation (1) (2) (5) -- Manufactures and markets proprietary metal decorative tiles -- 6.73% of fully diluted equity |                            |                      |       |

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|  |             |              |
|--|-------------|--------------|
| Common Stock.....(C)   | 646,954     | \$ 724,588   |
| Warrants at \$5.00 expiring 10/25/04.....(C)   | 1,966       | 0            |
| Warrants at \$1.50 expiring 11/16/05.....(C)   | 1,250       | 0            |
| Warrants at \$1.50 expiring 08/03/06.....(C)   | 8,500       | 0            |
| Warrants at \$1.50 expiring 11/21/07.....(C)   | 3,750       | 0            |
| Warrants at \$1.50 expiring 11/19/08.....(C)   | 5,000       | 0            |
|  |             | -----        |
|  |             | 724,588      |
|  |             | -----        |
| Total Non-Controlled Private Placement Portfolio (cost: \$12,510,313).....               |             | \$ 7,481,897 |
|  |             | -----        |
| Total Investments in Non-Controlled Affiliated Companies (cost: \$16,921,686).           |             | \$17,480,000 |
|  |             | -----        |
| U.S. Government and Agency Obligations -- 65.5% of total investments                     |             |              |
| U.S. Treasury Bills -- due date 10/07/04.....(J)   | \$2,500,000 | \$2,499,400  |
| U.S. Treasury Bills -- due date 10/28/04.....(J)   | 2,700,000   | 2,697,057    |
| U.S. Treasury Bills -- due date 01/06/05.....(J)   | 2,500,000   | 2,488,275    |
| U.S. Treasury Notes -- due date 04/30/05,<br>coupon 1.625%.....(H)                       | 2,692,000   | 2,685,889    |
| U.S. Treasury Notes -- due date 06/30/05,<br>coupon 1.125%.....(H)                       | 21,500,000  | 21,348,855   |
| U.S. Treasury Notes -- due date 02/28/06,<br>coupon 1.625%.....(H)                       | 2,428,000   | 2,403,234    |
| U.S. Treasury Notes -- due date 06/30/06,<br>coupon 2.75%.....(H)                        | 10,000,000  | 10,041,400   |
| U.S. Treasury Notes -- due date 02/15/07,<br>coupon 2.25%.....(H)                        | 2,428,000   | 2,402,118    |
| U.S. Treasury Notes -- due date 05/15/08,<br>coupon 2.625%.....(H)                       | 2,433,000   | 2,397,357    |
| U.S. Treasury Notes -- due date 03/15/09,<br>coupon 2.625%.....(H)                       | 2,631,000   | 2,561,120    |
|  |             | -----        |
| Total Investments in U.S. Government and Agency<br>Obligations (cost: \$51,700,543)..... |             | \$51,524,705 |
|  |             | -----        |
| Total Investments -- 100% (cost: \$78,938,861).....                                      |             | \$78,613,954 |
|  |             | =====        |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2004

Notes to Consolidated Schedule of Investments

- (1) Represents a non-income producing security. Equity investments that have not paid dividends within the last 12 months are considered to be non-income producing.
- (2) Legal restrictions on sale of investment.

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- (3) See Footnote to Schedule of Investments for a description of the Asset Valuation Policy Guidelines.
- (4) Initial investment was made during 2004.
- (5) No changes in valuation occurred in these investments during the three months ended September 30, 2004.
- (6) These investments are development stage companies. A development stage company is defined as a company that is devoting substantially all of its efforts to establishing a new business, and either it has not yet commenced its planned principal operations, or it has commenced such operations but has not realized significant revenue from them.
- (7) Experion Systems, Inc. was previously named MyPersonalAdvocate.com, Inc.
- (8) Investments in unaffiliated companies consist of investments in which we own less than 5% of the portfolio company. Investments in non-controlled affiliated companies consist of investments in which we own more than 5% but less than 25% of the portfolio company. Investments in controlled affiliated companies consist of investments in which we own more than 25% of the portfolio company.
- (9) The percentage ownership of each portfolio company disclosed in the Consolidated Schedule of Investments expresses the potential equity interest in each such portfolio company. The calculated percentage represents the amount of the issuer's equity securities we own or can acquire as a percentage of the issuer's total outstanding equity securities plus equity securities reserved for issued and outstanding warrants, convertible securities and all authorized stock options, both granted and ungranted.
- (10) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is \$10,316,632. The gross unrealized appreciation based on the tax cost for these securities is \$166,498. The gross unrealized depreciation based on the tax cost for these securities is \$873,881.
- (11) The aggregate cost for federal income tax purposes of investments in non-controlled affiliated companies is \$16,921,686. The gross unrealized appreciation based on the tax cost for these securities is \$5,586,730. The gross unrealized depreciation based on the tax cost for these securities is \$5,028,416.
- (12) NeoPhotonics filed for bankruptcy on November 17, 2003. We sold our investment in its Series D Preferred Stock in January 2004. NeoPhotonics emerged from bankruptcy, as a newly reorganized company, after obtaining financing from us and other investors.
- (13) The Company's 1,137,570 share holding in NeuroMetrix, Inc. (National Market Symbol: NURO), before a lock-up discount, at the September 30, 2004, market price per share of \$10.00, was \$11,375,700. The lock-up expires on January 18, 2005. On November 4, 2004, the market price per share of NeuroMetrix was \$9.21.

The accompanying notes are an integral part of

these consolidated financial statements.

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FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS

ASSET VALUATION POLICY GUIDELINES

Our investments can be classified into five broad categories for valuation purposes:

- 1) EQUITY-RELATED SECURITIES
- 2) INVESTMENTS IN INTELLECTUAL PROPERTY OR PATENTS OR RESEARCH AND DEVELOPMENT IN TECHNOLOGY OR PRODUCT DEVELOPMENT
- 3) LONG-TERM FIXED-INCOME SECURITIES
- 4) SHORT-TERM FIXED-INCOME INVESTMENTS
- 5) ALL OTHER INVESTMENTS

The Investment Company Act of 1940 (the "1940 Act") requires periodic valuation of each investment in our portfolio to determine our net asset value. Under the 1940 Act, unrestricted securities with readily available market quotations are to be valued at the current market value; all other assets must be valued at "fair value" as determined in good faith by or under the direction of the Board of Directors.

Our Board of Directors is responsible for (1) determining overall valuation guidelines and (2) ensuring that our investments are valued within the prescribed guidelines.

Our Valuation Committee, comprised of at least three or more independent Board members, is responsible for reviewing and approving the valuation of our assets within the guidelines established by the Board of Directors. The Valuation Committee receives information and recommendations from management.

Fair value is generally defined as the amount that an investment could be sold for in an orderly disposition over a reasonable time. Generally, to increase objectivity in valuing our assets, external measures of value, such as public markets or third-party transactions, are utilized whenever possible. Valuation is not based on long-term work-out value, nor immediate liquidation value, nor incremental value for potential changes that may take place in the future.

The values assigned to these investments are based on available information and do not necessarily represent amounts that might ultimately be realized, as such amounts depend on future circumstances and cannot reasonably be determined until the individual investments are actually liquidated or become readily marketable.

Our valuation policy with respect to the five broad investment categories is as follows:

EQUITY-RELATED SECURITIES

Equity-related securities are carried at fair value using one or more of the following basic methods of valuation:

A. Cost: The cost method is based on our original cost. This method is generally used in the early stages of a company's development until significant positive or negative events occur subsequent to the date of the original investment that dictate a change to another valuation method. Some examples of these events are:

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(1) a major recapitalization; (2) a major refinancing; (3) a significant third-party transaction; (4) the development of a meaningful public market for a company's common stock; and (5) significant positive or negative changes in a company's business.

B. Analytical Method: The analytical method is generally used to value an investment position when there is no established public or private market in the company's securities or when the factual information available to us dictates that an investment should no longer be valued under either the cost or private market method. This valuation method is inherently imprecise and ultimately the result of reconciling the judgments of our Valuation Committee members, based on the data available to them. The resulting valuation, although stated as a precise number, is necessarily within a range of values that vary depending upon the significance attributed to the various factors being considered. Some of the factors considered may include the financial condition and operating results of the company, the long-term potential of the business of the company, the values of similar securities issued by companies in similar businesses, the proportion of the company's securities we own and the nature of any rights to require the company to register restricted securities under applicable securities laws.

C. Private Market: The private market method uses actual, executed, historical transactions in a company's securities by responsible third parties as a basis for valuation. The private market method may also use, where applicable, unconditional firm offers by responsible third parties as a basis for valuation.

D. Public Market: The public market method is used when there is an established public market for the class of a company's securities held by us or into which our securities are convertible. We discount market value for securities that are subject to significant legal or contractual transfer restrictions. Securities for which market quotations are readily available and which are not subject to substantial legal or contractual and transfer restrictions, are carried at market value as of the time of valuation. Market value for securities traded on securities exchanges or on the Nasdaq National Market is the last reported sales price on the day of valuation. For other securities traded in the over-the-counter market and listed securities for which no sale was reported on that day, market value is the mean of the closing bid price and asked price on that day. This method is the preferred method of valuation when there is an established public market for a company's securities, as that market provides the most objective basis for valuation. If for any reason, the Valuation



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Committee determines that market quotations are not reliable, such securities shall be fair valued by the Valuation Committee in accordance with these valuation procedures.

### INVESTMENTS IN INTELLECTUAL PROPERTY, PATENTS, RESEARCH AND DEVELOPMENT IN TECHNOLOGY OR PRODUCT DEVELOPMENT

Such investments are carried at fair value using the following basic methods of valuation:

E. Cost: The cost method is based on our original cost. This method is generally used in the early stages of commercializing or developing intellectual property or patents or research and development in technology or product development until significant positive or adverse events occur subsequent to the date of the original investment that dictate a change to another valuation method.

F. Analytical Method: The analytical method is used to value an investment after analysis of the best available outside information where the factual information available to us dictates that an investment should no longer be valued under either the cost or private market method. This valuation method is inherently imprecise and ultimately the result of reconciling the judgments of our Valuation Committee members. The resulting valuation, although stated as a precise number, is necessarily within a range of values that vary depending upon the significance attributed to the various factors being considered. Some of the factors considered may include the results of research and development, product development progress, commercial prospects, term of patent, projected markets, and other subjective factors.

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G. Private Market: The private market method uses actual third-party investments in the same or substantially similar intellectual property or patents or research and development in technology or product development as a basis for valuation, using actual executed historical transactions by responsible third parties. The private market method may also use, where applicable, unconditional firm offers by responsible third parties as a basis for valuation.

### LONG-TERM FIXED-INCOME SECURITIES

H. Fixed-Income Securities for which market quotations are readily available are carried at market value as of the time of valuation using the most recent bid quotations when available.

I. Long-Term Fixed-Income Securities for which market quotations are not readily available are carried at fair value as determined in good faith by the Valuation Committee on the basis of available data, which may include credit quality, and interest rate analysis as well as quotations from broker-dealers or, where such quotations are not available, prices from independent pricing services that the Board believes are reasonably reliable and based on reasonable price discovery procedures and data from other

sources.

SHORT-TERM FIXED-INCOME INVESTMENTS

J. Short-Term Fixed-Income Investments are valued in the same manner as long-term fixed income securities until the remaining maturity is 60 days or less, after which time such securities may be valued at amortized cost if there is no concern over payment at maturity.

ALL OTHER INVESTMENTS

K. All Other Investments are reported at fair value as determined in good faith by the Valuation Committee.

For all other investments, the reported values shall reflect the Valuation Committee's judgment of fair values as of the valuation date using the outlined basic methods of valuation or any other method of valuation that the Valuation Committee determines after review and analysis is more appropriate for the particular kind of investment. They do not necessarily represent an amount of money that would be realized if we had to sell such assets in an immediate liquidation. Thus, valuations as of any particular date are not necessarily indicative of amounts that we may ultimately realize as a result of future sales or other dispositions of investments we hold.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1. THE COMPANY

Harris & Harris Group, Inc. (the "Company," "us," "our" and "we"), is a venture capital company operating as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). We operate as an internally managed company whereby our officers and employees, under the general supervision of our Board of Directors, conduct our operations.

We elected to become a BDC on July 26, 1995, after receiving the necessary approvals. From September 30, 1992, until the election of BDC status, we operated as a closed-end, non-diversified investment company under the 1940 Act. Upon commencement of operations as an investment company, we revalued all of our assets and liabilities at fair value as defined in the 1940 Act. Prior to September 30, 1992, we were registered and filed under the reporting requirements of the Securities and Exchange Act of 1934 as an operating company and, while an operating company, operated directly and through subsidiaries.

Harris & Harris Enterprises, Inc. ("Enterprises"), is a 100% wholly owned subsidiary of the Company. Enterprises held a lease for office space until the lease expired on July 31, 2003, which office space it sublet to the Company and an unaffiliated party; is a partner in Harris Partners I, L.P.; and is taxed as a C corporation. Harris Partners I, L.P., is a limited partnership and

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owned, until December 31, 2002, a 20% limited partnership interest in PHZ Capital Partners L.P. Currently, Harris Partners I, L.P., owns our interest in AlphaSimplex Group, LLC. The partners of Harris Partners I, L.P., are Enterprises (sole general partner) and Harris & Harris Group, Inc. (sole limited partner).

We filed for the 1999 tax year to elect treatment as a Regulated Investment Company ("RIC") under Subchapter M of the Internal Revenue Code of 1986 (the "Code") and qualified for the same treatment for 2000-2003. There can be no assurance that we will qualify as a RIC for 2004 and subsequent years or that if we do qualify, we will continue to qualify for subsequent years. In addition, under certain circumstances, even if we qualified for Subchapter M treatment for a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC. As a RIC, we must, among other factors, distribute at least 90% of our investment company taxable income and may either distribute or retain our realized net capital gains on investments.

### NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements:

**Principles of Consolidation.** The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for investment companies and include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Cash and Cash Equivalents.** Cash and cash equivalents include money market instruments with maturities of less than three months.

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**Portfolio Investment Valuations.** Investments are stated at "value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other assets is as determined in good faith by, or under the direction of, the Board of Directors. (See "Asset Valuation Policy Guidelines" in the "Footnote to Consolidated Schedule of Investments.")

**Securities Transactions.** Securities transactions are accounted for on the date the securities are purchased or sold (trade date); dividend income is recorded on the ex-dividend date; and interest income is accrued as earned. Realized gains and losses on investment transactions are determined by specific identification for financial reporting and tax reporting.

**Income Taxes.** Prior to January 1, 1999, we recorded income taxes using the liability method in accordance with the provision of Statement of Financial Accounting Standards No. 109. Accordingly, deferred tax liabilities had been established to reflect temporary differences between the recognition of income and

expenses for financial reporting and tax purposes; the most significant such difference relates to our unrealized appreciation on investments.

The September 30, 2004, consolidated financial statements include a provision for deferred taxes on the remaining net built-in gains as of December 31, 1998, net of the unutilized operating and capital loss carryforwards incurred by us through December 31, 1998.

We pay federal, state and local income taxes on behalf of our wholly owned subsidiary, Harris & Harris Enterprises, which is a C corporation. (See "Note 6. Income Taxes.")

Estimates by Management. The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of September 30, 2004, and December 31, 2003, and the reported amounts of revenues and expenses for the three months ended September 30, 2004, and September 30, 2003. The most significant estimates relate to the fair valuations of certain of our investments. Actual results could differ from these estimates.

#### NOTE 3. EMPLOYEE PROFIT SHARING PLAN

As of January 1, 2003, we implemented the Amended and Restated Harris & Harris Group, Inc. Employee Profit-Sharing Plan, which we refer to as the 2002 Plan.

The 2002 Plan (and its predecessor) provides for profit sharing by our officers and employees equal to 20% of our "qualifying income" for that plan year. For the purposes of the 2002 Plan, qualifying income is defined as net realized income as reflected on our consolidated statements of operations for that year, less nonqualifying gains, if any.

For purposes of the 2002 Plan, our net realized income includes investment income, realized gains and losses, and operating expenses (including taxes paid or payable by us), but is calculated without including dividends paid or distributions made to shareholders, payments under the Plan, unrealized gains and losses, and loss carry-overs from other years. The proportion of net after-tax realized gains attributable to asset values as of September 30, 1997, is considered nonqualifying gain, which reduces qualifying income.

On October 15, 2002, our shareholders approved the performance goals under the 2002 Plan in accordance with Section 162(m) of the Code, effective as of January 1, 2003. The Code generally provides that a public company such as we may not deduct compensation paid to its chief executive officer or to any of its four most highly compensated officers to the extent that the compensation paid to the officer/employee exceeds \$1,000,000 in any tax year, unless payment is made upon the attainment of objective performance goals that are approved by our shareholders.

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Under the 2002 Plan, our net realized income, which we refer to as qualifying income, includes investment income, realized qualifying gains and losses, and operating expenses (including taxes paid or payable by us), but is calculated without including dividends paid or loss carry-overs from other years. As soon as practicable following the year-end audit, the Compensation Committee will determine whether, and if so how much, qualifying income exists for a plan year. Once determined, 90% of the qualifying income will be paid out to 2002 Plan participants pursuant to the distribution percentages set forth in the 2002 Plan. The remaining 10% will be paid out after we have filed our federal tax return for that plan year.

Under the 2002 Plan, awards previously granted to four current Participants (Messrs. Harris and Melsheimer and Ms. Shavin and Ms. Matthews, herein referred to as the "grandfathered participants") will be reduced by 10% with respect to "Non-Tiny Technology Investments" (as defined in the 2002 Plan) and by 25% with respect to "Tiny Technology Investments" (as defined in the 2002 Plan) and will become permanent. These reduced awards are herein referred to as "grandfathered participations." The amount by which the awards are reduced will be allocable and reallocable each year by the Compensation Committee among current and new participants as awards under the 2002 Plan. The grandfathered participations will be honored by us whether or not the grandfathered participant is still employed by us or is still alive (in the event of death, the grandfathered participations will be paid to the grandfathered participant's estate), unless the grandfathered participant is dismissed for cause, in which case all awards, including the grandfathered participations, will be immediately cancelled and forfeited. With regard to new investments and follow-on investments made after the date on which the first new employee begins participating in the 2002 Plan, both current and new participants will be required to be employed by us at the end of a plan year in order to participate in profit-sharing on our investments with respect to that year.

Notwithstanding any provisions of the 2002 Plan, in no event may the aggregate amount of all awards payable for any Plan Year during which we remain a "business development company" within the meaning of the 1940 Act be greater than 20% of our "net income after taxes" within the meaning of Section 57(n)(1)(B) of the 1940 Act. In the event the awards as calculated exceed that amount, the awards will be reduced pro rata.

The 2002 Plan may be modified, amended or terminated by the Compensation Committee at any time. Notwithstanding the foregoing, the grandfathered participations may not be further modified. Nothing in the 2002 Plan will preclude the Compensation Committee from naming additional participants in the 2002 Plan or, except for grandfathered participations, changing the Award Percentage of any Participant (subject to the overall percentage limitations contained in the 2002 Plan). Currently, under the 2002 Plan, the distribution amounts for non-grandfathered investments for each officer and employee are: Charles E. Harris, 7.790%; Mel P. Melsheimer, 3.733%; Douglas W. Jamison, 3.5%; Daniel V. Leff, 3.0%; Helene B. Shavin, 1.524%; and Jacqueline M. Matthews, 0.453%, which together equal 20%. In one case, for a former employee who left other than due to termination for cause, any amount earned will be accrued and may subsequently be paid to the participant.

The grandfathered participations are set forth below:

| Name of Officer/Employee | Grandfathered Participations |                     |
|--------------------------|------------------------------|---------------------|
|                          | Non-Tiny Technology (%)      | Tiny Technology (%) |
| Charles E. Harris        | 12.41100                     | 10.34250            |
| Mel P. Melsheimer        | 3.80970                      | 3.17475             |
| Helene B. Shavin         | 1.37160                      | 1.14300             |
| Jacqueline M. Matthews   | 0.40770                      | 0.33975             |
| TOTAL                    | 18.00000                     | 15.00000            |

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Accordingly, an additional 2% of Qualifying Income with respect to grandfathered Non-Tiny Technology Investments, 5% of Qualifying Income with respect to grandfathered Tiny Technology Investments and the full 20% of Qualifying Income with respect to non-grandfathered investments are available for allocation and reallocation from year to year. Currently, Douglas W. Jamison and Daniel V. Leff are each allocated 0.80% of the Non-Tiny Technology Grandfathered Participations and 2% of the Tiny Technology Grandfathered Participations.

Each quarter, we perform a calculation to determine the accrual for profit-sharing. We calculate 20% of Qualifying Income pursuant to the terms of the plan and estimate the effect on Qualifying Income of selling all the portfolio investments that are valued above cost (i.e., are in an unrealized appreciation position). While the accrual will fluctuate each quarter as a result of changes in Qualifying Income and changes in unrealized appreciation, payments are only made to the extent that Qualifying Income exists. During 2003, we made no accrual for profit sharing.

At September 30, 2004, we have \$336,820 accrued for profit sharing.

#### NOTE 4. CAPITAL TRANSACTIONS

In 1998, the Board of Directors approved that effective January 1, 1998, 50% of all Directors' fees be used to purchase our common stock from us. However, effective March 1, 1999, the Board of Directors approved that Directors may purchase our common stock in the open market, rather than from us.

Since 1998, we have repurchased a total of 1,859,047 of our shares for a total of \$3,496,388, including commissions and expenses, at an average price of \$1.88 per share. These treasury shares were reduced by the purchases made by the Directors. On July 23, 2002, because of our strategic decision to invest in tiny technology, the Board of Directors reaffirmed its commitment not to authorize the purchase of additional shares of stock in the foreseeable future.

On August 1, 2002, we sold 2,954,743 shares of common stock for net proceeds of \$5,927,882; net proceeds of the offering, less offering costs of \$284,412, were \$5,643,470. We have invested all of the net proceeds raised from the offering in accordance with our investment objectives and policies.

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On December 30, 2003, we sold 2,300,000 shares of common stock for net proceeds of \$17,296,000; net proceeds of the offering, less offering costs of \$664,038, were \$16,631,962. We intend to use the net proceeds of the offering, less offering costs, to make new investments in tiny technology as well as follow-on investments in our existing venture capital investments, and for working capital.

For these purposes, from the completion of the offering through September 30, 2004, we have used \$14,408,046 of the \$16,631,962.

In 2004, we registered with the Securities and Exchange Commission for the sale of up to 7,000,000 shares of our common stock from time to time. On July 7, 2004, we sold 3,450,000 common shares for net proceeds of \$36,501,000; net proceeds of the offering, less offering costs of \$373,325, were \$36,127,675. We intend to use the net proceeds of the offering, less offering costs, to make new investments in tiny technology as well as follow-on investments in our existing venture capital investments, and for working capital. An additional 3,550,000 shares may be sold at prices and on terms to be set forth in one or more supplements to the prospectus from time to time.

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As of December 31, 2003, there are no distributable earnings. The difference between the book basis and tax basis components of distributable earnings is primarily attributed to Built-In Gains existing at the time of our qualification as a RIC (see Note 6. "Income Taxes"), nondeductible deferred compensation and net operating losses.

Beginning with the Consolidated Statements of Assets and Liabilities at December 31, 2003, additional paid-in capital and common stock warrants have been combined and are reported as additional paid-in capital. There have been no common stock warrants outstanding since March 2000.

### NOTE 5. EMPLOYEE BENEFITS

On October 19, 1999, Charles E. Harris signed an Employment Agreement with us (disclosed in a Form 8-K filed on October 27, 1999) (the "Employment Agreement"), which superseded an employment agreement that was about to expire on December 31, 1999. The Employment Agreement shall terminate on December 31, 2004 ("Term") subject to either an earlier termination or an extension in accordance with the terms; on January 1, 2000 and on each day thereafter, the Term extends automatically by one day unless at any time we or Mr. Harris, by written notice, decide not to extend the Term, in which case the Term will expire five years from the date of the written notice. On October 14, 2004, Mr. Harris signed an Amended and Restated Employment Agreement with us (disclosed on Form 8-K filed on October 15, 2004) (the "Amended Employment Agreement") for the purpose of changing the termination date to be consistent with his retirement date under the Company's Executive Mandatory Retirement Benefit Plan. According to the Amended Employment Agreement, Mr. Harris's employment shall not be extended beyond December 31, 2008, unless his employment is extended pursuant to the Executive Mandatory Retirement Benefit Plan.

During the period of employment, Mr. Harris shall serve as our Chairman and Chief Executive Officer; be responsible for the

general management of our affairs and all our subsidiaries, reporting directly to our Board of Directors; serve as a member of the Board for the period of which he is and shall from time to time be elected or reelected; and serve, if elected, as our President and as an officer and director of any subsidiary or affiliate of us.

Mr. Harris is to receive compensation under his Employment Agreement in the form of base salary of \$208,315 for 2000 (\$229,778 for 2004), with automatic yearly adjustments to reflect inflation.

In addition, the Board may increase such salary, and consequently decrease it, but not below the level provided for by the automatic adjustments described above. Mr. Harris is also entitled to participate in our Profit-Sharing Plan as well as in all compensation or employee benefit plans or programs, and to receive all benefits, perquisites, and emoluments for which salaried employees are eligible. Under the Employment Agreement, we will furnish Mr. Harris with certain perquisites which include a company car, membership in certain clubs and up to a \$5,000 annual reimbursement for personal, financial or tax advice.

The Employment Agreement provides Mr. Harris with life insurance for the benefit of his designated beneficiaries in the amount of \$2,000,000; provides reimbursement for uninsured medical expenses, not to exceed \$10,000 per annum, adjusted for inflation, over the period of the contract; provides Mr. Harris and his spouse with long-term care insurance; and with disability insurance in the amount of 100% of his base salary. These benefits are for the term of the Employment Agreement.

The Employment Agreement provides for us to adopt a supplemental executive retirement plan (the "SERP") for the benefit of Mr. Harris. Under the SERP, we will cause an amount equal to one-twelfth of Mr. Harris's current annual salary to be credited each month (a "Monthly Credit") to a special account maintained for this purpose on our books for the benefit of Mr. Harris (the "SERP

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Account"). The amounts credited to the SERP Account will be deemed invested or reinvested in such mutual funds or U.S. Government securities as determined by Mr. Harris. The SERP Account will be credited and debited to reflect the deemed investment returns, losses and expenses attributed to such deemed investments and reinvestments. Mr. Harris's benefit under the SERP will equal the balance in the SERP Account and such benefit will always be 100% vested (i.e., not forfeitable). Mr. Harris will determine the form and timing of the distribution of the balance in the SERP Account; provided, however, in the event of the termination of his employment, the balance in the SERP Account will be distributed to Mr. Harris or his beneficiary, as the case may be, in a lump-sum payment within 30 days of such termination. We will establish a rabbi trust for the purpose of accumulating funds to satisfy the obligations incurred by us under the SERP. The restricted funds for the SERP Plan total \$1,393,093 at September 30, 2004. Mr. Harris's rights to benefits pursuant to this SERP will be no greater than those of a general creditor of us.

The Employment Agreement provides severance pay in the event of termination without cause or by constructive discharge and also



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provides for certain death benefits payable to the surviving spouse equal to the executive's base salary for a period of two years.

In addition, Mr. Harris is entitled to receive severance pay pursuant to the severance compensation agreement that he entered into with us, effective August 15, 1990. The severance compensation agreement provides that if, following a change in our control, as defined in the agreement, such individual's employment is terminated by us without cause or by the executive within one year of such change in control, the individual shall be entitled to receive compensation in a lump sum payment equal to 2.99 times the individual's average annualized compensation and payment of other welfare benefits. If Mr. Harris's termination is without cause or is a constructive discharge, the amount payable under the Employment Agreement will be reduced by the amounts paid pursuant to the severance compensation agreement.

As of January 1, 1989, we adopted an employee benefits program covering substantially all of our employees under a 401(k) Plan and Trust Agreement. As of January 1, 1999, we adopted the Harris & Harris Pension Plan and Trust, a money purchase plan which would allow us to stay compliant with the 401(k) top-heavy regulations and deduction limitation regulations. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 which has increased the deduction limits for plans such as the 401(k) Plan. This Act eliminates the need for us to maintain two separate plans. Effective December 31, 2001, the Pension Plan merged into the 401(k) Plan, with the 401(k) Plan being the surviving plan. For the year ended December 31, 2003, the Compensation Committee approved a 100% match. Contributions to the plan are at the discretion of the Compensation Committee.

On June 30, 1994, we adopted a plan to provide medical and dental insurance for retirees, their spouses and dependents who, at the time of their retirement, have ten years of service with us and have attained 50 years of age or have attained 45 years of age and have 15 years of service with us. On February 10, 1997, we amended this plan to include employees who "have seven full years of service and have attained 58 years of age." The coverage is secondary to any government provided or subsequent employer provided health insurance plans. The annual premium cost to us with respect to the entitled retiree shall not exceed \$12,000, subject to an index for inflation. Based upon actuarial estimates, we provided an original reserve of \$176,520 that was charged to operations for the period ending June 30, 1994. As of September 30, 2004, we had a reserve of \$602,801 for the plan. Recent changes to the Medicare program may affect our costs under this plan. In accordance with FASB Staff Position 106-1, our estimates of the obligation under this standard do not reflect these changes. Specific authoritative guidance regarding these changes is pending and when issued, could require us to change previously reported information.

We are making the following disclosures about our plan to provide medical and dental insurance for retirees.

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|   |           |
|---|-----------|
| Projected accumulated postretirement benefit obligation at January 1, 2004    | \$525,288 |
| Service cost  | 47,964    |
| Interest cost   | 23,544    |
|   | -----     |
| Projected accumulated postretirement Benefit obligation at September 30, 2004 | \$596,796 |
|   | =====     |

On March 20, 2003, in order to begin planning for eventual management succession, the Board of Directors voted to establish a mandatory retirement plan for individuals who are employed by us in a bona fide executive or high policy-making position. There are currently two such individuals, the Chairman and CEO, and the President and COO. Under this plan, mandatory retirement will take place effective December 31 of the year in which the eligible individuals attain the age of 65. On an annual basis beginning in the year in which the designated individual attains the age of 65, a committee of the Board consisting of non-interested directors may determine to postpone the mandatory retirement date for that individual for one additional year for our benefit.

Under applicable law prohibiting discrimination in employment on the basis of age, we can impose a mandatory retirement age of 65 for our executives or employees in high policy-making positions only if each employee subject to the mandatory retirement age is entitled to an immediate retirement benefit at retirement age of at least \$44,000 per year. The benefits payable at retirement to Charles E. Harris, our Chairman and Chief Executive Officer, and Mel P. Melsheimer, our President, Chief Operating Officer and Chief Financial Officer, under our existing retirement plans do not equal this threshold. A new plan was established to provide them with the difference between the benefit required under the age discrimination laws and that provided under our existing plans. For Mr. Harris, the expense to us of providing the benefit under this new plan, which prior to October 14, 2004, had been waived by Mr. Harris, is currently estimated to be \$76,597 and is being amortized over the fiscal periods through the year ended December 31, 2008. For Mr. Melsheimer, the expense to us of providing the benefit under this new plan is currently estimated to be \$247,516 and is being amortized over the fiscal periods through the year ended December 31, 2004. This benefit will be unfunded.

NOTE 6. INCOME TAXES

Provided that a proper election is made, a corporation taxable under Subchapter C of the Internal Revenue Code (a "C Corporation") that elects to qualify as a RIC continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC (the "Inclusion Period") from sales of assets that were held by the corporation on the effective date of the RIC election ("C Corporation Assets"), to the extent of any gain built into the assets on such date ("Built-In Gain"). (If the corporation fails to make a proper election, it is taxable on its

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Built-In Gain as of the effective date of its RIC election.) We had Built-In Gains at the time of our qualification as a RIC and made the election to be taxed on any Built-In Gain realized during the Inclusion Period. Prior to 1999, we incurred ordinary and capital losses from operations. After our election of RIC status, those losses remained available to be carried forward to subsequent taxable years. We have previously used loss carryforwards to offset Built-In Gains. As of January 1, 2004, we had \$501,640 of pre-1999 loss carryforwards remaining and \$4,663,457 of unrealized Built-In Gains remaining.

Continued qualification as a RIC requires us to satisfy certain investment asset diversification requirements in future years. Our ability to satisfy those requirements may not be controllable by us. There can be no assurance that we will qualify as a RIC in subsequent years.

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We pay federal, state and local taxes on behalf of our wholly owned subsidiary, Harris & Harris Enterprises, Inc., which is taxed as a C Corporation.

For the three and nine months ended September 30, 2004, and 2003, our income tax provision was allocated among various types of realized and unrealized gain or loss as follows:

|  | Three Months<br>Ended<br>Sept. 30, 2004 | Three Months<br>Ended<br>Sept. 30, 2003 | Nine Months<br>Ended<br>Sept. 30, 2004 | Nine Months<br>Ended<br>Sept. 30, 2003 |
|--|---|---|--|--|
| Net operating loss.....\$  | 0                                       | \$ 0                                    | \$ 0                                   | \$ 0                                   |
| Net realized gain<br>(loss) on investments...                        | 1,482                                   | (3,500)                                 | 6,426                                  | 13,822                                 |
| Net increase in<br>unrealized<br>appreciation on<br>investments..... | 0                                       | 0                                       | 0                                      | 0                                      |
| Total income tax<br>(benefit)<br>provision.....\$                    | 1,482                                   | \$ (3,500)                              | \$ 6,426                               | \$ 13,822                              |
|  | =====                                   | =====                                   | =====                                  | =====                                  |

The above tax (benefit) provision consists of the following:

|                                      |          |            |          |           |
|--------------------------------------|----------|------------|----------|-----------|
| Current .....                        | \$ 1,482 | \$ (3,500) | \$ 6,426 | \$ 13,822 |
| Deferred -- Federal.....             | 0        | 0          | 0        | 0         |
| Total income tax<br>provision.....\$ | 1,482    | \$ (3,500) | \$ 6,426 | \$ 13,822 |
|                                      | =====    | =====      | =====    | =====     |

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The Company's net deferred tax liability at September 30, 2004, and December 31, 2003, consists of the following:

|  | Sept. 30, 2004 | December 31, 2003 |
|--|----------------|-------------------|
| Tax on unrealized appreciation on investments..... | \$ 1,491,153   | \$ 844,918        |
| Net operating loss and capital carryforward.....   | (175,574)      | (175,574)         |
| Net deferred income tax liability.....             | \$ 1,315,579   | \$ 669,344        |
|  | =====          | =====             |

### NOTE 7. COMMITMENTS

During 1993, we signed a 10-year lease for office space, which lease expired on July 31, 2003. On April 17, 2003, we signed a seven-year sublease for office space at 111 West 57th Street in New York City to replace the expired lease. Total rent expense was \$200,711 for 2003. Future minimum sublease payments in each of the following years are: 2004 -- \$134,816; 2005 -- \$138,187; 2006 -- \$141,641; 2007 -- \$145,182; 2008 -- \$148,811; and thereafter, for the remaining term -- \$203,571.

### NOTE 8. ASSET ACCOUNT LINE OF CREDIT

On November 19, 2001, we established an asset account line of credit. The asset account line of credit is secured by government and government agency securities. Currently, under the asset account line of credit, we may borrow up to \$8,000,000. The asset account line of credit may be increased to up to 95% of the current value of the government and government agency securities with which we secure the line. Our outstanding balance under the asset account line of credit at September 30, 2004, and September 30, 2003, was \$0 and \$7,609,500, respectively. The asset account line of credit bears interest at a rate of the Broker Call Rate plus 50 basis points.

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### NOTE 9. SUBSEQUENT EVENTS

On October 5, 2004, we made a \$400,000 follow-on investment in a Senior Secured Convertible Bridge Note of a privately held portfolio company.

On October 26, 2004, we made a \$171,492 follow-on investment in a privately held portfolio company.

On October 27, 2004, we made a \$348,464 follow-on investment in a Convertible Bridge Note of a privately held portfolio company.

On November 9, 2004, we made a \$74,735 follow-on investment in a Secured Convertible Bridge Note of a privately held portfolio company and a \$783,019 initial equity investment in a privately

held company.

NOTE 10. INTERIM FINANCIAL STATEMENTS

Our interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulations S-X. Accordingly, they do not include all information and disclosures necessary for a presentation of our financial position, results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. In the opinion of management, these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of our financial position, results of operations and cash flows for such periods. The results of operations for any interim period are not necessarily indicative of the results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

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

The information contained in this section should be read in conjunction with our September 30, 2004, Consolidated Financial Statements, and our year-end 2003 Consolidated Financial Statements and the Notes thereto.

Background and Overview

We incorporated under the laws of the state of New York in August 1981. In 1983, we completed an initial public offering and invested \$406,936 in Otisville BioTech, Inc. ("Otisville"), which also completed an initial public offering later that year. In 1984, Charles E. Harris purchased a controlling interest in us, thereby also becoming the control person in Otisville. We then divested our other assets and became a financial services company, with the investment in Otisville as the initial focus of our business activity. We hired new management for Otisville, and Otisville acquired new technology targeting the development of a human blood substitute.

By 1988, we operated two insurance brokerages and a trust company as wholly-owned subsidiaries. In 1989, Otisville changed its name to Alliance Pharmaceutical Corporation ("Alliance"), and by 1990, we had completed selling our \$406,936 investment in Alliance for total proceeds of \$3,923,559.

In 1992, we sold our insurance brokerage and trust company subsidiaries to their respective managements and registered as an investment company under the 1940 Act, commencing operations as a closed-end, non-diversified investment company. In 1995, we elected to become a business development company subject to the provisions of Sections 55 through 65 of the 1940 Act. Throughout our corporate history, we have made early-stage venture capital investments in a variety of industries. In 1994, we made our first nanotechnology investment. Since August 2001, we have made initial investments

exclusively in tiny technology, including our last 17 initial investments.

Since our investment in Otisville in 1983, we have made a total of 59 venture capital investments, including four private investments in public equities. We have sold 38 of these 58 investments, realizing total proceeds of \$108,159,142 on our invested capital of \$40,094,851. Seventeen of these 38 investments were profitable. As measured from first dollar in to last dollar out, the average and median holding periods for these 38 investments were 3.5 years and 3.2 years, respectively. As measured by tranches of cash invested to tranches of cash received, the average and median holding periods for the 122 separate investment tranches were 2.8 years and 2.4 years, respectively. At September 30, 2004, we valued the 21 venture capital investments remaining in our portfolio at \$27,089,249, or 35.4% of our net assets, net of unrealized depreciation of \$149,069. At September 30, 2004, from first dollar in, the average and median holding periods for our 21 current venture capital investments are 3.0 years and 2.3 years, respectively.

We have invested a substantial portion of our assets in private, development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth, have little or no history of operations and are developing unproven technologies. At September 30, 2004, \$17,091,146, or 22.3%, of our net assets, consisted of private venture capital investments at fair value, net of unrealized depreciation of \$5,735,799. At December 31, 2003, \$15,106,576, or 37.1% of our net assets, consisted of private venture capital investments at fair value, of which net unrealized depreciation was \$2,375,303. At December 31, 2002, \$12,036,077, or 44.2%, of our net assets consisted of private venture capital investments at fair value, of which net unrealized appreciation was \$2,718,389.

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At September 30, 2004, \$9,998,103, or 13.1%, of our net assets, consisted of common shares of NeuroMetrix, Inc., a now publicly-traded venture capital investment, at fair value, of which unrealized appreciation was \$5,586,730. We had no publicly-traded venture capital investments at December 31, 2003, and 2002.

We value our investments each quarter at fair value as determined in good faith by our Valuation Committee pursuant to Valuation Procedures established by our Board of Directors in accordance with the 1940 Act. (See "Footnote to Consolidated Schedule of Investments" contained in "Consolidated Financial Statements.")

We have broad discretion in the investment of our capital. However, we invest primarily in illiquid equity securities of private companies. Generally, these investments take the form of preferred stock, are subject to restrictions on resale and have no established trading market. Our principal objective is to achieve long-term capital appreciation. Therefore, a significant portion of our investment portfolio provides little or no income in the form of dividends or interest. We do earn interest income from fixed-income securities, including U.S government and government agency obligations. The amount of interest income we earn varies

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with the average balance of our fixed-income portfolio and the average yield on this portfolio and is usually not material to our results of operations.

General business and capital markets conditions in 2003 were adverse for the venture capital industry. There were few opportunities to take venture capital-backed companies public or sell them to established companies. During this period, it was difficult to finance venture capital-backed companies privately and in general, for venture capital funds themselves to raise capital.

General business and capital markets conditions in the first quarter of 2004 improved for the venture capital industry from those prevailing in 2003, then began deteriorating again in certain respects through the date of this filing.

We present the financial results of our operations utilizing accounting principles generally accepted in the United States for investment companies. On this basis, the principal measure of our financial performance during any period is the net increase/(decrease) in our net assets resulting from our operating activities, which is the sum of the following three elements:

- (1) Net Operating Income / (Loss) -- the difference between our income from interest, dividends, and fees and our operating expenses.
- (2) Net Realized Gain / (Loss) on Investments -- the difference between the net proceeds of dispositions of portfolio securities and their stated cost.
- (3) Net Increase / (Decrease) in Unrealized Appreciation on Investments -- the net change in the fair value of our investment portfolio.

Because of the structure and objectives of our business, we generally expect to experience net operating losses and seek to generate increases in our net assets from operations through the long term appreciation of our venture capital investments. We have in the past relied, and continue to rely, on proceeds from sales of investments, rather than on investment income, to defray a significant portion of our operating expenses. Because such sales are unpredictable, we attempt to maintain adequate working capital to provide for fiscal periods when there are no such sales.

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### Results of Operations

Three months ended September 30, 2004, as compared with the three months ended September 30, 2003

We had a net increase in net assets resulting from operations of \$1,111,121, compared with a net decrease in net assets resulting from operations of \$1,270,298. We had a net increase in net assets resulting from capital stock transactions of \$36,127,675, versus a net increase in net assets resulting from capital transactions of \$0.

### Investment Income and Expenses:

We had net operating losses of \$978,773 and \$572,346,

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respectively. In the three months ended September 30, 2004, our larger net operating loss reflected a net increase to expenses primarily for an increase in provision for profit-sharing expense and for professional fees, offset by an increase in income from fixed-income securities.

Investment income increased by \$222,969, or 728.4%, primarily as a result of additional funds received following the sale of 3,450,000 shares of common stock on July 7, 2004, that were invested in U.S. government and agency obligations.

Operating expenses were \$1,232,354 and \$602,958, respectively.

The profit-sharing provision increased by \$336,820 or 100%. The profit-sharing provision changes as a result of realized gains and losses and increases and decreases in unrealized appreciation. The increase in the profit-sharing provision is primarily a result of the increase in the value of our investment in NeuroMetrix, which completed its IPO on July 27, 2004. Professional fees increased by \$171,867, or 290%, and directors' fees and expenses increased by \$31,938, or 102.2%, primarily as a result of the expenses associated with implementation of the Sarbanes-Oxley Act of 2002 and Rule 38a-1 under the 1940 Act. Salaries and benefits increased by \$59,268, or 16.5%, primarily as a result of four additional employees, offset partially by a decrease in mandatory retirement plan pension expense, that is being amortized through December 31, 2004, pursuant to revised actuarial calculations.

### Realized Gains and Losses on Portfolio Securities:

We realized gains of \$2,704 and losses of \$1,003,919, respectively. During the three months ended September 30, 2003, we realized net losses of \$1,003,919, consisting primarily of a loss of \$1,000,001 on the realized loss resulting from the bankruptcy of Kriton Medical, Inc. from which we did not receive any direct distribution.

### Unrealized Appreciation and Depreciation of Portfolio Securities:

Net unrealized depreciation on investments decreased by \$2,731,943 or 840.8%, from \$3,056,850 at September 30, 2003, to \$324,907 at September 30, 2004.

During the three months ended September 30, 2004, we recorded a net decrease of \$2,678,872 in unrealized depreciation of our venture capital investments. This net decrease in unrealized depreciation was primarily owing to an increase in the valuation of our investment in NeuroMetrix, Inc., of \$3,172,686, partially offset by a decrease in the valuation of our investment in Experion Systems, Inc., of \$468,814.

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Nine Months ended September 30, 2004, as compared with the nine months ended September 30, 2003

We had net decreases in net assets resulting from operations of \$305,401 and \$3,030,134, respectively.

### Investment Income and Expenses:

We had net operating losses of \$2,503,222 and \$1,883,795,



respectively.

Operating expenses were \$2,892,570 and \$2,029,647, respectively. Operating expenses changed primarily for the following reasons:

- o Operating expenses for the nine months ended September 30, 2004, included an expense for employee profit-sharing of \$336,820, as compared with no such expense for the nine months ended September 30, 2003.
- o Salaries and benefits increased by \$300,551, or 27.7%, primarily as a result of the addition of four employees, partially offset by a decrease in mandatory retirement plan pension expense, that is being amortized through December 31, 2004, pursuant to revised actuarial calculations.
- o Administration and operations increased by \$151,486, or 46.7%, primarily as the result of additional expenses to support four new employees.
- o Professional fees increased by \$112,512, or 40.7%, primarily owing to expenses associated with implementation of the Sarbanes-Oxley Act of 2002 and Rule 38a-1 under the 1940 Act.

Realized Gains and Losses on Portfolio Securities:

During the nine months ended September 30, 2004, we realized net gains of \$798,673. During the nine months ended September 30, 2003, we realized net losses of \$975,347.

During the nine months ended September 30, 2004, our realized net gains of \$798,673 consisted primarily of a realized gain of \$1,681,259, resulting from the sale of our investment in NanoGram Devices Corporation, offset by a realized loss of \$915,108 resulting from the sale of our shares of Series D Convertible Preferred Stock in NeoPhotonics Corporation.

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During the nine months ended September 30, 2003, we realized a loss of \$1,000,001 resulting from the bankruptcy of Kriton Medical, Inc., from which bankruptcy we received no direct distribution.

Unrealized Appreciation and Depreciation of Portfolio Securities:

Net unrealized depreciation on investments decreased by \$2,051,809 during the nine months ended September 30, 2004, from \$2,376,716 at December 31, 2003, to \$324,907 at September 30, 2004.

During the nine months ended September 30, 2004, we recorded a net decrease of \$2,226,234 in unrealized depreciation of our venture capital investments. The net decrease in unrealized depreciation during the nine months ended September 30, 2004, was primarily owing to an increase in the valuation of our investment in NeuroMetrix, Inc. of \$3,172,686 and the realization of the loss of \$915,108 on the sale of our shares of Series D Convertible Preferred stock in NeoPhotonics Corporation, as well as decreases in the valuations of our investments in Experion Systems, Inc., of

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\$468,814, Nanotechnologies, Inc., of \$638,840 and Optiva, Inc., of \$625,000.

### Financial Condition

Nine Months ended September 30, 2004

Our total assets and net assets were \$80,757,636 and \$76,505,012, respectively, at September 30, 2004, compared with \$44,115,128 and \$40,682,738, respectively, at December 31, 2003.

Net asset value per share ("NAV") was \$4.44 at September 30, 2004, versus \$2.95 at December 31, 2003. Our shares outstanding increased to 17,248,845 versus 13,798,845 at December 31, 2003.

During the nine months ended September 30, 2004, significant financial developments included the receipt of net proceeds of \$36,501,000, less costs of \$373,325, for a total of \$36,127,675, pursuant to the issuance of 3,450,000 new shares of our common stock. In addition, the value of our venture capital investments increased by \$11,982,673 to \$27,089,249, primarily owing to five new venture capital investments and eight follow-on investments totaling \$11,450,144, the sale of NanoGram Devices and the net increase in the valuation of our venture capital investments.

The net increase in the valuation of our venture capital investments was primarily owing to an increase in the valuation of our investment in NeuroMetrix, Inc. of \$3,172,678, partially offset by decreases in the valuation of our investments in Experion Systems, Inc., Nanotechnologies, Inc., and Optiva, Inc. of \$468,814, \$638,840 and \$625,000, respectively.

On July 27, 2004, NeuroMetrix, Inc., closed its IPO. Our preferred stock was converted into 1,137,570 shares of common stock that are subject to a 180-day lock-up period expiring on January 18, 2005. The valuation of our investment in NeuroMetrix, Inc. at September 30, 2004, reflects a 12.1% discount to the market price.

Upon the completion of the lock-up period, we expect to value NeuroMetrix at its full, undiscounted, market price.

The increase in the value of our investment in U.S. government and agency obligations, from \$27,120,486 at December 31, 2003, to \$51,524,705 at September 30, 2004, resulted primarily from the receipt of net proceeds of \$36,127,675 pursuant to the issuance of 3,450,000 new shares of our common stock, partially offset by five

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new venture capital investments and eight follow-on investments totaling \$11,450,144, as well as operating expenses..

The following table is a summary of additions to our portfolio of venture capital investments during the nine months ended September 30, 2004:

| New Investment<br>-----  | Amount<br>----- |
|--------------------------|-----------------|
| Crystal IS, Inc.         | \$ 199,983      |
| CSwitch, Inc.            | \$ 1,000,000    |
| Molecular Imprints, Inc. | \$ 2,000,000    |

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|                          |              |
|--------------------------|--------------|
| NeoPhotonics Corporation | \$ 1,937,092 |
| Starfire Systems, Inc.   | \$ 250,000   |

Follow-on Investment

|                                      |              |
|--------------------------------------|--------------|
| Agile Materials & Technologies, Inc. | \$ 301,272   |
| Continuum Photonics, Inc.            | \$ 839,000   |
| Experion Systems, Inc.               | \$ 121,262   |
| NanoGram Corporation                 | \$ 1,000,000 |
| NanoOpto Corporation                 | \$ 1,500,000 |
| Nanopharma Corp.                     | \$ 150,000   |
| NeuroMetrix, Inc.                    | \$ 1,749,999 |
| Optiva                               | \$ 401,536   |

|       |              |
|-------|--------------|
| Total | \$11,450,144 |
|-------|--------------|

The following tables summarize the fair values of our portfolios of venture capital investments and U.S. Government and Agency Obligations, as compared with their cost, at September 30, 2004, December 31, 2003, and December 31, 2002:

|  | September 30,<br>2004 | December 31,<br>2003 | December 31,<br>2002 |
|--|-----------------------|----------------------|----------------------|
| Venture capital investments, at cost       | \$27,238,318          | \$17,481,879         | \$14,754,466         |
| Unrealized depreciation (1)                | 149,069               | 2,375,303            | 2,718,389            |
| Venture capital investments, at fair value | \$27,089,249          | \$15,106,576         | \$12,036,077         |

|   | September 30,<br>2004 | December 31,<br>2003 | December 31,<br>2002 |
|---|-----------------------|----------------------|----------------------|
| U.S. Government and Agency Obligations, at cost       | \$51,700,543          | \$27,121,899         | \$15,452,469         |
| Unrealized depreciation (1)                           | 175,838               | 1,413                | 1,724                |
| U.S. Government and Agency Obligations, at fair value | \$51,524,705          | \$27,120,486         | \$15,450,745         |

(1) At September 30, 2004, December 31, 2003, and December 31, 2002, the accumulated unrealized depreciation on investments, including deferred taxes, was \$1,816,061, \$3,221,635 and \$3,565,032, respectively.

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The following table summarizes the fair value composition of our venture capital investment portfolio at September 30, 2004, December 31, 2003, and December 31, 2002:

| Category                             | September 30,<br>2004 | December 31,<br>2003 | December 31,<br>2002 |
|--------------------------------------|-----------------------|----------------------|----------------------|
| Tiny Technology                      | 61.3%                 | 60.7%                | 49.0%                |
| Other Venture Capital<br>Investments | 38.7%                 | 39.3%                | 51.0%                |
| Total Venture Capital<br>Investments | 100.0%                | 100.0%               | 100.0%               |
|                                      | =====                 | =====                | =====                |

### Liquidity and Capital Resources

Our primary sources of liquidity are cash, receivables and freely marketable securities, net of short-term indebtedness. Our secondary sources of liquidity are restricted securities of companies that are publicly traded. At September 30, 2004, we have contractually restricted common shares of NeuroMetrix, Inc. that are publicly traded. We had no restricted securities of companies that were publicly traded during 2003.

#### Nine Months ended September 30, 2004

At September 30, 2004, and December 31, 2003, our total net primary liquidity was \$53,009,203 and \$27,563,886, respectively, and our secondary liquidity was \$9,998,103 and \$0, respectively.

The increase in our primary source of liquidity from December 31, 2003, to September 30, 2004, is primarily owing to the receipt of the net proceeds from the issuance of 3,450,000 new shares of our common stock and the net proceeds from the sale of our investment in NanoGram Devices Corporation, partially offset by our investments in Agile Materials & Technologies, Inc., Continuum Photonics, Inc., Crystal IS, Inc., CSwitch, Inc., Experion Systems, Inc., Molecular Imprints, Inc., NanoGram Corporation, NanoOpto Corporation, Nanopharma Corp., NeoPhotonics Corporation, NeuroMetrix, Inc., Optiva, Inc., and Starfire Systems, Inc., and the use of funds for net operating expenses. The increase in our secondary source of liquidity from December 31, 2003, to September 30, 2004, is owing to the completion of the public offering of NeuroMetrix.

### Critical Accounting Policies

Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments.

### Valuation of Portfolio Investments

As a business development company, we invest primarily in illiquid securities, including debt and equity securities of private companies. The investments are generally subject to

restrictions on resale and generally have no established trading market. We value substantially all of our equity investments at fair value as determined in good faith by our Valuation Committee.

The Valuation Committee, comprised of at least three or more independent Board members, reviews and approves the valuation of our investments pursuant to Valuation Procedures established by the Board of Directors. Fair value is generally defined as the amount that an investment could be sold for in an orderly disposition over a reasonable time. Generally, to increase objectivity in valuing our assets, external measures of value, such as public markets or

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third party transactions, are utilized whenever possible. Valuation is not based on long-term work-out value, nor immediate liquidation value, nor incremental value for potential changes that may take place in the future.

#### Recent Developments

On October 5, 2004, we made a \$400,000 follow-on investment in a Senior Secured Convertible Bridge Note of a privately held portfolio company.

On October 26, 2004, we made a \$171,492 follow-on investment in a privately held portfolio company.

On October 27, 2004, we made a \$348,464 follow-on investment in a Convertible Bridge Note of a privately held portfolio company.

On November 9, 2004, we made a \$74,735 follow-on investment in a Secured Convertible Bridge Note of a privately held portfolio company and a \$783,019 initial equity investment in a privately held company.

#### RISK FACTORS

Investing in our common stock involves a number of significant risks relating to our business and investment objective. You should carefully consider the risks and uncertainties described below before you purchase any of our common stock. These risks and uncertainties are not the only ones we face. Unknown additional risks and uncertainties, or ones that we currently consider immaterial, may also impair our business. If any of these risks or uncertainties materialize, our business, financial condition or results of operations could be materially adversely affected. In this event, the trading price of our common stock could decline, and you could lose all or part of your investment.

Risks related to the companies in our portfolio.  
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Investing in small, private companies involves a high degree of risk and is highly speculative.

We have invested a substantial portion of our assets in privately held development stage or start-up companies. These businesses tend to lack management depth, to have limited or no history of operations and to have not attained profitability. Tiny

technology companies are especially risky, involving scientific, technological and commercialization risks. Because of the speculative nature of these investments, these securities have a significantly greater risk of loss than traditional investment securities. Some of our venture capital investments are likely to be complete losses or unprofitable, and some will never realize their potential. We have been and will continue to be risk seeking rather than risk averse in our approach to venture capital and other investments. Neither our investments nor an investment in our common stock is intended to constitute a balanced investment program.

We may invest in companies working with technologies or intellectual property that currently have few or no proven commercial applications.

Nanotechnology, in particular, is a developing area of technology, of which much of the future commercial value is unknown, difficult to estimate and subject to widely varying interpretations. There are as of yet relatively few nanotechnology products commercially available. The timing of additional future commercially available nanotechnology products is highly uncertain.

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Our portfolio companies working with tiny technology may be particularly susceptible to intellectual property litigation.

Research and commercialization efforts in tiny technology are being undertaken by a wide variety of government, academic and private corporate entities. As additional commercially viable applications of tiny technology begin to emerge, ownership of intellectual property on which these products are based may be contested. Any litigation over the ownership of, or rights to, any of our portfolio companies' technologies or products would have a material adverse affect on those companies' values and may have a material adverse effect on the value of our common stock.

Our portfolio companies may not successfully market their products.

Even if our portfolio companies are able to develop commercially viable products, the market for new products and services is highly competitive, rapidly changing and especially sensitive to adverse general economic conditions. Commercial success is difficult to predict, and the marketing efforts of our portfolio companies may not be successful.

Unfavorable economic conditions could result in the inability of our portfolio companies to access additional capital, leading to financial losses in our portfolio.

Most of the companies in which we have made or will make investments are susceptible to economic slowdowns or recessions. An economic slowdown or adverse capital or credit market conditions may affect the ability of a company in our portfolio to raise additional capital from venture capital or other sources or to engage in a liquidity event such as an initial public offering or merger. These conditions may lead to financial losses in our portfolio, which could have a material adverse effect on the value of our common stock.

The value of our portfolio and the value of our common stock could be adversely affected if the technologies utilized by our portfolio companies are found to cause health or environmental risks.

Our portfolio companies work with new technologies, which could have potential environmental and health impacts. Tiny technology in general and nanotechnology in particular are currently the subject of health and environmental impact research.

If health or environmental concerns about tiny technology or nanotechnology were to arise, our portfolio companies may incur additional research, legal and regulatory expenses, might have difficulty raising capital or could be forced out of business. Such adverse health and environmental effects would have an adverse effect on the value of our portfolio and on the value of our common stock.

Risks related to the illiquidity of our investments.  
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We invest in illiquid securities and may not be able to dispose of them when it is advantageous to do so, or ever.

Most of our investments are or will be equity or equity-linked securities acquired directly from small companies. These equity securities are generally subject to restrictions on resale or otherwise have no established trading market. The illiquidity of most of our portfolio of equity securities may adversely affect our ability to dispose of these securities at times when it may be advantageous for us to liquidate these investments. We may never be able to dispose of these securities.

Unfavorable economic conditions could impair our ability to engage in liquidity events.

Our business of making private equity investments and positioning our portfolio companies for liquidity events may be adversely affected by current and future capital markets and

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economic conditions. The public equity markets currently provide less opportunity for liquidity events than at times in the past when there was more robust demand for initial public offerings, even for more mature technology companies than those in which we typically invest. The potential for public market liquidity could further decrease and could lead to an inability to realize potential gains or could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets. Recent government reforms affecting stock markets, investment banks and securities research practices may make it more difficult for privately held companies to complete successful initial public offerings of their equity securities. Slowdowns in initial public offerings may also have an adverse effect on the frequency and valuations of acquisitions of privately held companies. The lack of opportunities to sell investments in privately held companies also has an adverse effect on the ability of these companies to raise capital from private sources.

Even if our portfolio companies complete initial public offerings,

the returns on our investments may be uncertain.

When companies in which we have invested as private entities complete initial public offerings of their securities, these newly issued securities are by definition unseasoned issues. Unseasoned issues tend to be highly volatile and have uncertain liquidity, which may negatively affect their price. In addition, we are typically subject to lock-up provisions which prohibit us from selling our investment into the public market for specified periods of time after initial public offerings. The market price of securities that we hold may decline substantially before we are able to sell these securities. Most initial public offerings of technology companies are listed on the Nasdaq National Market. Recent government reforms of the Nasdaq National Market have made market making by broker-dealers less profitable, which has caused broker-dealers to reduce their market-making activities, thereby making the market for unseasoned stocks less liquid.

Risks related to our company.  
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Because there is generally no established market in which to value our investments, our Valuation Committee's value determinations may differ materially from the values that a ready market or third party would attribute to these investments.

There is generally no public market for the equity securities in which we invest. Pursuant to the requirements of the 1940 Act, we value substantially all of the equity securities in our portfolio at fair value as determined in good faith by the Valuation Committee of our Board of Directors pursuant to Valuation Procedures established by the Board of Directors. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment pursuant to specified valuation principles and processes. We are required by the 1940 Act to value specifically each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired. Conversely, we must record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value that we assign to our investments may differ from the values that would have been used had a ready market existed for the investments, and the difference could be material. Any changes in fair value are recorded in our consolidated statements of operations as a change in the "Net (decrease) increase in unrealized appreciation on investments."

Because we are a non-diversified company with a relatively concentrated portfolio, the value of our business is subject to greater volatility than the value of companies with more broadly diversified investments.

As a result of being able to invest all of our assets in the securities of a small number of issuers, we are classified as a non-diversified company. We may be more vulnerable to events affecting a single issuer or industry and therefore subject to greater volatility than a company whose investments are more



broadly diversified. Accordingly, an investment in our common stock may present greater risk to you than an investment in a diversified company.

We may be obligated to pay substantial amounts under our profit sharing plan.

Our employee profit-sharing plan requires us to distribute to our officers and employees 20% of any net after-tax realized income as reflected on our consolidated statements of operations for that year, less any non-qualifying gain. These distributions may have a significant effect on the amount of distributions made to our shareholders, if any.

Approximately 37% of the net asset value attributable to our venture capital investment portfolio, or 13% of our net asset value, as of September 30, 2004, is concentrated in one company, NeuroMetrix, Inc., which is not a tiny technology company.

At September 30, 2004, we valued our investment in NeuroMetrix, Inc., which is not a tiny technology company, at \$9,998,103, which represents 36.91% of the net asset value attributable to our venture capital investment portfolio, or 13.07% of our net asset value. Any downturn in the business outlook of NeuroMetrix, Inc., or any failure of the products of NeuroMetrix, Inc., to receive widespread acceptance in the marketplace, would have a significant effect on our specific investment in NeuroMetrix, Inc., and the overall value of our portfolio.

Approximately 39% of the net asset value attributable to our venture capital investment portfolio, or 14% of our net asset value, as of September 30, 2004, is not invested in tiny technology.

Although all 17 of our investments added since August 2001 have been in tiny technology companies and although we consider 16 of the companies in our venture capital investment portfolio to be tiny technology companies, at September 30, 2004, only 61.29% of the net asset value attributable to our venture capital investment portfolio, or 21.70% of our net asset value, was invested in tiny technology companies, which may limit our ability to achieve our investment objective.

We are dependent upon key management personnel for future success.

We are dependent for the selection, structuring, closing and monitoring of our investments on the diligence and skill of our senior management and other key advisers. We utilize lawyers and outside consultants, including two of our directors, Dr. Kelly S. Kirkpatrick and Lori D. Pressman, to assist us in conducting due diligence when evaluating potential investments. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and advisers to obtain information in connection with our investment decisions. Our future success to a significant extent depends on the continued service and coordination of our senior management team, and particularly depends on our Chairman and Chief Executive Officer, Charles E. Harris. The departure of any of our executive officers, key employees or advisers could materially adversely affect our ability to implement our business strategy. We do not maintain for our benefit any key man life insurance on any

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of our officers or employees. Our President, Chief Operating Officer and Chief Financial Officer, Mel P. Melsheimer, is scheduled to retire on December 31, 2004, pursuant to the Mandatory Retirement Plan. We could be adversely affected by his retirement.

We will need to hire additional employees as the size of our portfolio increases.

We anticipate that it will be necessary for us to add investment professionals with expertise in venture capital and/or tiny technology to accommodate the increasing size of our

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portfolio. We may need to provide additional scientific, business, accounting, legal or investment training for our new hires. There is competition for highly qualified personnel, and we may not be successful in our efforts to recruit and retain highly qualified personnel.

The market for venture capital investments, including tiny technology investments, is highly competitive.

We face substantial competition in our investing activities from many competitors, including but not limited to: private venture capital funds; investment affiliates of large industrial, technology, service and financial companies; small business investment companies; wealthy individuals; and foreign investors. Our most significant competitors typically have significantly greater financial resources than we do. Many sources of funding compete for a small number of attractive investment opportunities. Hence, we face substantial competition in sourcing good investment opportunities on terms of investment that are commercially attractive.

In addition to the difficulty of finding attractive investment opportunities, our status as a regulated business development company may hinder our ability to participate in investment opportunities or to protect the value of existing investments.

We are required to disclose on a quarterly basis the names and business descriptions of our portfolio companies and the value of any portfolio securities. Most of our competitors are not subject to these disclosure requirements. Our obligation to disclose this information could hinder our ability to invest in some portfolio companies. Additionally, other current and future regulations may make us less attractive as a potential investor than a competitor not subject to the same regulations.

Our failure to make follow-on investments in our portfolio companies could impair the value of our portfolio.

Following an initial investment in a portfolio company, we may make additional investments in that portfolio company as "follow-on" investments, in order to: (1) increase or maintain in whole or in part our ownership percentage; (2) exercise warrants, options or convertible securities that were acquired in the original or subsequent financing; or (3) attempt to preserve or enhance the value of our investment. Recently, "pay to play" provisions have become common in venture capital transactions. These provisions require proportionate investment in subsequent rounds of financing

in order to preserve preferred rights such as anti-dilution protection or to prevent preferred shares from being converted to common shares.

We may elect not to make follow-on investments or otherwise lack sufficient funds to make those investments. We have the discretion to make any follow-on investments, subject to the availability of capital resources. The failure to make follow-on investments may, in some circumstances, jeopardize the continued viability of a portfolio company and our initial investment, or may result in a missed opportunity for us to increase our participation in a successful operation, or may cause us to lose some or all preferred rights pursuant to "pay to play" provisions. Even if we have sufficient capital to make a desired follow-on investment, we may elect not to make a follow-on investment because we may not want to increase our concentration of risk, because we prefer other opportunities or because we are inhibited by compliance with business development company requirements or the desire to maintain our tax status.

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Bank borrowing or the issuance of debt securities or preferred stock by us to fund investments in portfolio companies or to fund our operating expenses would make our total return to common shareholders more volatile.

Use of debt or preferred stock as a source of capital entails two primary risks. The first risk is that the use of debt leverages our available common equity capital, magnifying the impact on net asset value of changes in the value of our investment portfolio. For example, a business development company that uses 33% leverage (that is, \$50 of leverage per \$100 of common equity) will show a 1.5% increase or decline in net asset value for each 1% increase or decline in the value of its total assets. The second risk is that the cost of debt or preferred stock financing may exceed the return on the assets the proceeds are used to acquire, thereby diminishing rather than enhancing the return to common shareholders. To the extent that we utilize debt or preferred stock financing for any purpose, these two risks would likely make our total return to common shareholders more volatile. In addition, we might be required to sell investments, in order to meet dividend, interest or principal payments, when it may be disadvantageous for us to do so.

As provided in the 1940 Act and subject to some exceptions, we can issue debt or preferred stock so long as our total assets immediately after the issuance, less some ordinary course liabilities, exceed 200% of the sum of the debt and any preferred stock outstanding. The debt or preferred stock may be convertible in accordance with SEC guidelines, which may permit us to obtain leverage at more attractive rates. The requirement under the 1940 Act to pay, in full, dividends on preferred shares or interest on debt before any dividends may be paid on our common stock means that dividends on our common stock from earnings may be reduced or eliminated. An inability to pay dividends on our common stock could conceivably result in our ceasing to qualify as a regulated investment company, or RIC, under the tax Code, which would in most circumstances be materially adverse to the holders of our common shares.

We are authorized to issue preferred stock, which would convey special rights and privileges to its owners.

We are currently authorized to issue up to 2,000,000 shares of preferred stock, under terms and conditions determined by our Board of Directors. These shares would have a preference over our common stock with respect to dividends and liquidation. The statutory class voting rights of any preferred shares we would issue could make it more difficult for us to take some actions that may, in the future, be proposed by the Board and/or holders of common stock, such as a merger, exchange of securities, liquidation or alteration of the rights of a class of our securities if these actions were perceived by the holders of the preferred shares as not in their best interests. The issuance of preferred shares convertible into shares of common stock might also reduce the net income and net asset value per share of our common stock upon conversion. These effects, among others, could have an adverse effect on your investment in our common stock.

Loss of status as a RIC would reduce our net asset value and distributable income.

We currently qualify as a RIC for 2003 under the tax Code. As a RIC, we do not have to pay federal income taxes on our income (including realized gains) that is distributed to our shareholders. Accordingly, we are not permitted under accounting rules to establish reserves for taxes on our unrealized capital gains. If we failed to qualify for RIC status, to the extent that we had unrealized gains, we would have to establish reserves for taxes, which would reduce our net asset value, net of a reduction in the reserve for employee profit sharing, accordingly. To the extent that we, as a RIC, were to decide to make a deemed distribution of net realized capital gains and retain the net realized capital gains, we would have to establish appropriate reserves for taxes upon making that decision.

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We operate in a regulated environment.

We are subject to substantive SEC regulations as a business development company. Securities and tax laws and regulations governing our activities may change in ways adverse to our and our shareholders' interests, and interpretations of these laws and regulations may change with unpredictable consequences. Any change in the laws or regulations that govern our business could have an adverse impact on us or on our operations. Also, as business and financial practices continue to evolve, they may render the regulations under which we operate less appropriate and more burdensome than they were when originally imposed.

Quarterly results fluctuate and are not indicative of future quarterly performance.

Our quarterly operating results fluctuate as a result of a number of factors. These factors include, among others, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we and our portfolio companies

encounter competition in our markets and general economic and capital markets conditions. As a result of these factors, results for any one quarter should not be relied upon as being indicative of performance in future quarters.

To the extent that we do not realize income or retain after-tax realized capital gains, we may have a greater need for additional capital to fund our investments and operating expenses.

As a RIC, we must annually distribute at least 90% of our investment company taxable income as a dividend and may either distribute or retain our realized net capital gains from investments. As a result, these earnings may not be available to fund investments. If we fail to generate net realized capital gains or to obtain funds from outside sources, it would have a material adverse effect on our financial condition and results of operations as well as our ability to make follow-on and new investments. Because of the structure and objectives of our business, we generally expect to experience net operating losses and rely on proceeds from sales of investments, rather than on investment income, to defray a significant portion of our operating expenses. These sales are unpredictable and may not occur. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow to fund such requirements.

Investment in foreign securities could result in additional risks.

The Company may invest in foreign securities, although we currently have no investments in foreign securities. If we invest in securities of foreign issuers, we may be subject to risks not usually associated with owning securities of U.S. issuers. These risks can include fluctuations in foreign currencies, foreign currency exchange controls, social, political and economic instability, differences in securities regulation and trading, expropriation or nationalization of assets, and foreign taxation issues. In addition, changes in government administrations or economic or monetary policies in the United States or abroad could result in appreciation or depreciation of our securities and could favorably or unfavorably affect our operations. It may also be more difficult to obtain and enforce a judgment against a foreign issuer. Any foreign investments made by us must be made in compliance with U.S. and foreign currency restrictions and tax laws restricting the amounts and types of foreign investments.

We will incur increased expenses as a result of recently enacted laws and regulations affecting public companies.

Recently enacted laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted by the Securities and Exchange Commission, including Rule 38a-1, and by the National Association of Securities Dealers, Inc., will result in increased expenses to us. The new rules could make it more difficult or more costly for us to obtain

liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events also could make it more difficult for us to attract and retain qualified persons to serve on our board of directors, on our board committees or as executive officers. We will incur increased expenses in order to comply with these new rules, and we may not be able to accurately predict the timing or amount of these expenses. As of December 31, 2004, the auditors of many public companies, including ours, will be providing opinions on the effectiveness of internal control over financial reporting and on management's assessment of the effectiveness of internal control over financial reporting. There can be no assurance that we will receive an unqualified opinion. In the event that we do not receive an unqualified opinion, it could have a material, adverse effect on the cost and availability of directors' and officers' liability insurance and on our stock price.

#### Forward-Looking Statements

The information contained herein contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives, portfolio growth and availability of funds. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth herein. Other factors that could cause actual results to differ materially include the uncertainties of economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements included herein are reasonable, any of the assumptions could be inaccurate and therefore there can be no assurance that the forward-looking statements included or incorporated by reference herein will prove to be accurate. Therefore, the inclusion of such information should not be regarded as a representation by us or any other person that our plans will be achieved.

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#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our business activities contain elements of risk. We consider the principal types of market risk to be valuation risk and the risk associated with fluctuations in interest rates. We consider the management of risk to be essential to our business.

Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other assets is fair value as determined in good faith by, or under the direction of, the Board of Directors. (See the "Asset Valuation Policy Guidelines" in the "Footnote to Consolidated Schedule of Investments" contained in "Item 1. Consolidated Financial Statements.")

Neither our investments nor an investment in us is intended

to constitute a balanced investment program. We are exposed to public-market price fluctuations as a result of our publicly traded portfolio, which may be composed primarily or entirely of highly risky, volatile securities. Currently, 37% of the value of our portfolio of investments consists of publicly traded securities.

In addition to our publicly traded portfolio, we have invested a substantial portion of our assets in private development stage or start-up companies. These private businesses tend to be based on new technology and to be thinly capitalized, unproven, small companies that lack management depth and have not attained profitability or have no history of operations. Because of the speculative nature and the lack of a public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities. We expect that some of our venture capital investments will be a complete loss or will be unprofitable and that some will appear to be likely to become successful but never realize their potential. Even when our private equity investments complete initial public offerings (IPOs), we are normally subject to lock-up agreements for a period of time.

Because there is typically no public market for the equity interests of many of the small privately held companies in which we invest, the valuation of the equity interests in that portion of our portfolio is determined in good faith by our Board of Directors in accordance with our Asset Valuation Policy Guidelines. In the absence of a readily ascertainable market value, the determined value of our portfolio of equity interests may differ significantly from the values that would be placed on the portfolio if a ready market for the equity interests existed. Any changes in valuation are recorded in our consolidated statements of operations as "Net increase (decrease) in unrealized appreciation on investments."

We also invest in short-term money market instruments, and both short and long-term U.S. Government and Agency Obligations. To the extent that we invest in short and long-term U.S. Government and Agency Obligations, changes in interest rates may result in changes in the value of these Obligations which would result in an increase or decrease of our net asset value. The level of interest rate risk exposure at any given point in time depends on the market environment and expectations of future price and market movements, and will vary from period to period. If the average interest rate on our portfolio of U. S. Government and Agency Obligations at September 30, 2004, were to increase by 25, 75 and 150 basis points, the value of the securities, and our net asset value, would decrease by approximately \$129,530, \$388,590 and \$777,180, respectively.

In addition, we may from time to time borrow amounts on a line of credit that we maintain. We currently have no borrowings outstanding under our line of credit. To the extent we opt to borrow money to make investments in the future, our net investment income will be dependent upon the difference between the rate at which we borrow funds and the rate at which we invest such funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income in the event we choose to borrow funds for investing purposes.

Item 4. Controls and Procedures

As of the end of the period covered by this report, our Chief Executive Officer and our Chief Financial Officer conducted an evaluation of our disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934). Based upon this evaluation, our Chief Executive Officer and our Chief Financial Officer during such period concluded that our disclosure controls and procedures are effective in timely alerting them of any material information relating to us that is required to be disclosed by us in the reports it files or submits under the Securities Exchange Act of 1934.

There have not been any significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings  
Not Applicable

Item 2. Changes in Securities and Use of Proceeds  
Not Applicable

Item 3. Defaults Upon Senior Securities  
Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders  
Not Applicable

Item 5. Other Information  
Not Applicable

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

3.1(a) Restated Certificate of Incorporation, incorporated by reference as Exhibit 2.a to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 dated March 22, 2004.

3.1(b) Restated By-Laws, incorporated by reference as Exhibit 2.b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 dated March 22, 2004.

10.2(a) Amendment No. 2 to Deferred Compensation Agreement, incorporated by reference to Form 8-K filed on October 15, 2004.

10.2(b) Amended and Restated Employment Agreement between



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Harris & Harris Group, Inc. and Charles E. Harris dated October 14, 2004, incorporated by reference to Form 8-K filed on October 15, 2004.

- 31.1\* Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of CEO 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 CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\*filed herewith

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on behalf of the Registrant as Vice President and as its chief accounting officer.

Harris & Harris Group, Inc.

/s/ Helene B. Shavin

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By: Helene B. Shavin, Vice President  
and Controller

Date: November 12, 2004

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EXHIBIT INDEX TO FORM 10-Q

- 31.1 Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of CEO 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 CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.