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## PART I

### Item 1. Business

Harris & Harris Group, Inc. (the "Registrant" or "Company") is a venture capital investment company, operating as a Business Development Company ("BDC") under the Investment Company Act of 1940 (the "1940 Act"). The Company's objective is to achieve long-term capital appreciation, rather than current income, from its investments. The Company has invested a substantial portion of its assets in private development stage or start-up companies and in the development of new technologies in a broad range of industry segments. These private businesses tend to be thinly capitalized, unproven, small companies based on risky technologies that lack management depth and have not attained profitability or have no history of operations. The Company may also invest, to the extent permitted under the 1940 Act, in publicly traded securities, including high risk securities as well as investment grade securities. The Company may participate in expansion financing and leveraged buyout financing of more mature operating companies as well as other investments. As a venture capital company, the Company invests in and provides managerial assistance to its private investees which, in its opinion, have significant potential for growth. There is no assurance that the Company's investment objective will be achieved.

The Company was incorporated under the laws of the State of New York in August 1981. Prior to September 30, 1992, the Company had a class of securities registered, and filed under the reporting requirements, of the Securities Exchange Act of 1934 (the "1934 Act") as an operating company. On that date the Company commenced operations as a closed-end, non-diversified investment company under the 1940 Act. On July 26, 1995, the

Company elected to become a BDC subject to the provisions of Sections 55 through 65 of the 1940 Act. As a BDC, the Company operates as an internally managed investment company whereby its officers and employees, under the general supervision of its Board of Directors, conduct its operations.

#### Venture Capital Investments

The Company has invested a substantial portion of its assets in private development stage or start-up companies. The Company may initially own 100 percent of the securities of a start-up investee company for a period of time and may control such company for a substantial period. In connection with its venture capital investments, the Company may be involved in recruiting management, formulating operating strategies, product development, marketing and advertising, assisting in financial plans, as well as providing management in the initial start-up stages and establishing corporate goals. The Company may assist in raising additional capital for such companies from other potential investors and may subordinate its own investment to that of other investors. The Company may introduce such companies to potential joint-venture partners, suppliers and customers. In addition, the Company may assist in establishing relationships with investment bankers and other professionals. The Company may also assist with mergers and acquisitions. The Company may also find it necessary or appropriate to provide

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additional capital of its own. The Company may derive income from such companies for the performance of any of the above services. Because of the speculative nature of these investments and the lack of any market for such securities, there is significantly greater risk of loss than is the case with traditional investment securities. The Company expects that some of its venture capital investments will be a complete loss or will be unprofitable and that some will appear likely to become successful, but never realize their potential. The Company has in the past sought, and will continue in the future to seek, investments that offer the potential for significantly higher returns but that involve a significantly greater degree of risk than other investments.

The Company may control an investee company for which it has provided venture capital, or it may be represented on the company's board of directors by one or more of its officers or directors, who may also serve as officers of such company. Particularly during the early stages of an investment, the Company may in effect be conducting the operations of the investee company. As a venture company emerges from the developmental stage with greater management depth and experience, the Company expects that its role in the company's operations will diminish. The Company seeks to assist each investee company in establishing its own independent capitalization, management and board of directors. The Company expects to be able to reduce its active involvement in the management of its investment in those start-up companies that become successful by a liquidity event, such as a public offering or sale of a company.

The Company has invested a substantial portion of its assets in securities that do not pay interest or dividends and that are subject to legal or contractual restrictions on resale that may adversely affect the liquidity and marketability of such securities.

In addition to the information discussed above, please see Item 8. "Consolidated Financial Statements and Supplementary Data."

#### Intellectual Property

The Company believes there is a role for organizations like

itself that can assist in technology transfer. Scientists and institutions that develop and patent intellectual property increasingly seek the rewards of entrepreneurial commercialization of their inventions, particularly as governmental, philanthropic and industrial funding for research has become harder to obtain. The Company believes that several factors combine to give it a high value-added role to play in the commercialization of technology: its experience in organizing and developing successful new companies; its willingness to invest its own capital at the highest risk- seed stage; its access to high-grade institutional sources of intellectual property; its experience in mergers, acquisitions and divestitures; its access to and knowledge of the capital markets; and its willingness to do as much of the early work as it is qualified and has time to do.

The Company invests principally but not exclusively in securities issued by companies involved in: 1) research and development of a technology and/or obtaining licensing rights to intellectual property or patents; 2) outright acquisition of

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intellectual property or patents; and 3) formation and funding of companies or joint ventures to commercialize intellectual property. Income from the Company's investments in intellectual property or its development may take the form of participation in licensing or royalty income or some other form of remuneration. At some point during the commercialization of a technology, the Company's investment may be transformed into ownership of securities of a development stage or start-up company as discussed above. Investing in intellectual property is highly risky.

#### Illiquidity of Investments

Many of the Company's investments consist of securities acquired directly from the issuer in private transactions. These investments may be subject to restrictions on resale or otherwise be illiquid. The Company does not anticipate that there will be any established trading market for such securities. Additionally, many of the securities that the Company may invest in will not be eligible for sale to the public without registration under the Securities Act of 1933, as amended, which could prevent or delay any sale by the Company of such investments or reduce the amount of proceeds that might otherwise be realized therefrom. Restricted securities generally sell at a price lower than similar securities not subject to restrictions on resale. Further, even if a portfolio company registers its securities and becomes a reporting company under the 1934 Act, the Company may be considered an insider by virtue of its board representation or otherwise and would be restricted in sales of such company's securities.

#### Managerial Assistance

The Company generally is required by the 1940 Act to make significant managerial assistance available with respect to investee companies that the Company treats as qualifying assets for purposes of the 70 percent test (see "Regulation"). "Making available significant managerial assistance" as defined in the 1940 Act with respect to a BDC such as the Company means (a) any arrangement whereby a BDC, through its directors, officers, employees or general partners, offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company; or (b) the exercise by a BDC of a controlling influence over the management or policies of a portfolio company by a BDC acting individually or as a part of a group acting together which controls such portfolio company. The Company believes that providing managerial assistance to its investees is critical to its business development activities. The nature, timing and amount of

managerial assistance provided by the Company vary depending upon the particular requirements of each investee company.

The Company may be involved with its investees in recruiting management, product planning, marketing and advertising and the development of financial plans, operating strategies and corporate goals. In this connection, the Company may assist clients in developing and utilizing accounting procedures to efficiently and accurately record transactions in books of account, which will facilitate asset and cost control and the ready determination of results of operations. The Company also seeks capital for its investees from other

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potential investors and occasionally subordinates its own investment to those of other investors. The Company may introduce its investees to potential suppliers, customers and joint venture partners and assists its investees in establishing relationships with commercial and investment bankers and other professionals, including management consultants, recruiters, legal counsel and independent accountants. The Company also assists with joint ventures, acquisitions and mergers.

In connection with its managerial assistance, the Company may be represented by one or more of its officers or directors on the board of directors of an investee. As an investment matures and the investee develops management depth and experience, the Company's role ordinarily will become progressively less active. However, when the Company owns or acquires a substantial proportion of a more mature investee company's equity, the Company may remain active in and may initiate planning of major transactions by the investee. The Company typically seeks to assist each investee company in establishing its own independent and effective board of directors and management.

#### Need for Follow-On Investments

Following an initial investment in investees, the Company may make additional investments in such investees as "follow-on" investments, in order to: (1) increase its ownership percentage; (2) exercise warrants, options or convertible securities that were acquired in the original or subsequent financing; (3) preserve the Company's proportionate ownership in a subsequent financing; or (4) attempt to preserve or enhance the value of the Company's investment.

There can be no assurance that the Company will make follow-on investments or have sufficient funds to make such investments; the Company has the discretion to make any follow-on investments as it determines, subject to the availability of capital resources. The failure to make such follow-on investments may, in certain circumstances, jeopardize the continued viability of an investee and the Company's initial investment, or may result in a missed opportunity for the Company to increase its participation in a successful operation. Even if the Company has sufficient capital to make a desired follow-on investment, it may elect not to make a follow-on investment either because it does not want to increase its concentration of risk, because it prefers other opportunities or because it is inhibited by compliance with BDC or RIC requirements, even though the follow-on investment opportunity appears attractive.

#### Competition

Numerous companies and individuals are engaged in the venture capital business and such business is intensely competitive. Many of the competitors have significantly greater resources and managerial capabilities than the Company and are therefore in a better position than the Company to obtain access to attractive venture capital investments. There can be no

assurance that the Company will be able to compete against these competitors for attractive investments.

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## Regulation

The Small Business Investment Incentive Act of 1980 added the provisions of the 1940 Act applicable to BDC's, which are a special type of closed-end investment company. After filing its election to be treated as a BDC, a company may not withdraw its election without first obtaining the approval of holders of a majority of its outstanding voting securities. The following is a brief description of the 1940 Act provisions applicable to BDC's, and is qualified in its entirety by reference to the full text of the 1940 Act and the rules issued thereunder by the SEC.

Generally, to be eligible to elect BDC status, a company must primarily engage in the business of furnishing capital and managerial expertise to companies which do not have ready access to capital through conventional financial channels. Such portfolio companies are termed "eligible portfolio companies." In general, in order to qualify as a BDC, a company must (i) be a domestic company; (ii) have registered a class of its securities pursuant to Section 12 of the 1934 Act; (iii) operate for the purpose of investing in the securities of certain types of portfolio companies, namely, immature or emerging companies and businesses suffering or just recovering from financial distress (see following paragraph); (iv) make available significant managerial assistance to such portfolio companies; (v) have a majority of "disinterested" directors (as defined in the 1940 Act); and (vi) file a proper notice of election with the SEC.

An eligible portfolio company generally is a domestic company that is not an investment company and that (i) does not have a class of equity securities on which "margin" credit can be extended or (ii) is controlled by a BDC (control under the 1940 Act is presumed to exist where a BDC owns at least 25 percent of the outstanding voting securities of the investee).

The 1940 Act prohibits or restricts companies subject to the 1940 Act from investing in certain types of companies, such as brokerage firms, insurance companies, investment banking firms and investment companies. Moreover, the 1940 Act requires that at least 70 percent of the value of the Company's assets consist of qualifying assets. Qualifying assets include: (i) securities of companies that were eligible portfolio companies at the time the Company acquired their securities; (ii) securities of bankrupt or insolvent companies that were eligible at the time of the Company's initial investment in those companies; (iii) securities received in exchange for or distributed in or with respect to any of the foregoing; and (iv) cash items, government securities and high quality short-term debt. The 1940 Act also places restrictions on the nature of the transactions in which, and the persons from whom, securities can be purchased in order for the securities to be considered qualifying assets.

The Company is permitted by the 1940 Act, under specified conditions, to issue multiple classes of senior debt and a single class of preferred stock if its asset coverage, as defined in the 1940 Act, is at least 200 percent after the issuance of the debt or the preferred stock (i.e., such senior securities may not be in excess of its net assets).

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The Company may sell its securities at a price that is below the prevailing net asset value per share only after a majority of its disinterested directors has determined that such sale would be in the best interest of the Company and its stockholders and upon the approval by the holders of a majority

of its outstanding voting securities, including a majority of the voting securities held by non-affiliated persons. If the offering of the securities is underwritten, a majority of the disinterested directors must determine in good faith that the price of the securities being sold is not less than a price which closely approximates market value of the securities, less any distribution discount or commission. As defined by the 1940 Act, the term "majority of the Company's outstanding voting securities" means the vote of (i) 67 percent or more of the Company's Common Stock present at the meeting, if the holders of more than 50 percent of the outstanding Common Stock are present or represented by proxy or (ii) more than 50 percent of the Company's outstanding Common Stock, whichever is less.

Certain transactions involving certain closely related persons of the Company, including its directors, officers and employees, may require the prior approval of the SEC. However, the 1940 Act ordinarily does not restrict transactions between the Company and investee companies.

#### Sub-Chapter M Status

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

Because of the specialized nature of its investment portfolio, the Company could satisfy the diversification requirements under Sub-Chapter M of the Code only if it received a certification from the SEC that it is "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available." On April 8, 1998, the Company announced that it had received a certification from the Securities and Exchange Commission ("SEC") for 1997 relating to the Company's status under section 851(e) of the Code. That certification was necessary for the Company to qualify as a RIC for 1998 and subsequent taxable years.

Pursuant to the Company's receipt of the section 851(e) certification and its intention to qualify as a RIC, in 1998 the Company's Board of Directors declared and paid a one-time cash dividend of \$0.75 per share, for a total of \$8,019,728, to meet one of the Company's requirements for qualification for Sub-Chapter M tax treatment.

As noted above, the qualification of the Company as a RIC under Sub-Chapter M of the Code depends on it satisfying certain technical requirements regarding its income, investment portfolio and distributions. The Company was unable to satisfy these requirements for the 1998 tax year owing to the nature of the Company's ownership interest in one of its investee companies, and therefore it did not elect Sub-Chapter M status

for 1998. In addition, because the Company realized taxable losses in 1998, it was not strategically advantageous for the Company to elect Sub-Chapter M tax status for 1998.

The Company changed the nature of its ownership interest in the non-qualifying investee company effective January 1, 1999 in order to meet the Sub-Chapter M requirements. In 1999, because of changes in its investment portfolio, the Company requested recertification from the SEC relating to the Company's status under section 851(e) of the Code. On February 24, 2000, the Company received the certification, and the Company filed for 1999 to elect treatment as a RIC. On March 8, 2001, the Company received SEC certification and qualified for RIC treatment for 2000. Although the SEC certification for 1999 and 2000 was issued, there can be no assurance that the Company will receive such certification for subsequent years (to the extent it needs additional certification as a result of changes in its portfolio) or that it will actually qualify for Sub-Chapter M treatment in subsequent years. In addition, under certain circumstances, even if the Company qualified for Sub-Chapter M treatment in a given year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than as a RIC.

A C Corporation that elects to qualify as a RIC and that makes an appropriate election continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC from sales of assets that were held by the corporation on the effective date of the election ("C Corporation Assets") to the extent of any gain built into the assets on such date ("Built-In Gain"). The Company incurred ordinary and capital losses during its C Corporation taxable years that remain available for use and may be carried forward to its 2000 and subsequent taxable years. On February 17, 1999, the Company received rulings from the IRS regarding issues relevant to the Company's tax status as a RIC, including a ruling from the IRS concluding that the Company can carry forward its C Corporation losses to offset any Built-In Gains resulting from sales of its C Corporation Assets. That ruling may enable the Company to retain some or all of the proceeds from such sales without disqualifying itself as a RIC or incurring corporate level income tax, depending on whether the Company's sale of C Corporation Assets with Built-In Gains will generate C Corporation E&P. In general, a RIC is not permitted to have, as of the close of any RIC taxable year, E&P accumulated during any C Corporation taxable year. However, because the realization of Built-In Gains will occur while the Company is a RIC, a strong argument exists that, under current law and IRS pronouncements, the sale of C Corporation Assets

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with Built-In Gains during RIC taxable years will not generate C Corporation E&P. In 1999, the Company used the \$6.3 million loss carryforward (which resulted in a tax credit of approximately \$2.2 million) to reduce the taxes resulting from Built-In Gains.

If necessary for liquidity purposes or to fund investment opportunities, in lieu of distributing its taxable net capital gains, the Company as a RIC may retain such net capital gains and elect to be deemed to have made a distribution of the gains, or part thereof, to the shareholders under the "designated undistributed capital gain" rules of section 852(b)(3) of the Code. In that case, the "deemed dividend" is taxable to the shareholders, although the Company would pay tax, at the corporate rate, on the distribution, and the shareholders would receive a tax credit equal to their proportionate share of the tax paid.

To the extent that the Company declares a deemed dividend, each shareholder will receive an IRS Form 2439 which will reflect receipt of the deemed dividend income and a tax credit

equal to the shareholder's proportionate share of the tax paid by the Company. This tax credit, which is paid at the corporate rate, is often credited at a higher rate than the actual tax due by a shareholder on the deemed dividend income. The "residual" credit can be used by the shareholder to offset other taxes due in that year. (See "Note 6 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data" and Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Recent Developments - Sub-Chapter M Status.")

#### Subsidiaries

Harris & Harris Enterprises, Inc. ("Enterprises") is a 100 percent wholly owned subsidiary of the Company. Enterprises holds the lease for the office space, which it subleases to the Company and an unaffiliated party; operates a financial relations and consulting firm; 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 owns a 20 percent limited partnership interest in PHZ Capital Partners, L.P. The partners of Harris Partners I L.P. are Harris & Harris Enterprises, Inc. (sole general partner) and Harris & Harris Group, Inc. (sole limited partner).

Harris Newco, Inc. is currently a 100 percent wholly owned investment of the Company; however, the Company anticipates that in 2001 Harris Newco will issue shares to unrelated third parties and will become a medical device technology company based on proprietary technology.

#### Employees

The Company currently employs directly four full-time employees, and a wholly owned subsidiary of the Company employs two additional full-time employees.

#### Risk Factors

##### Investing in the Company's Stock is Highly Speculative and the Investor Could Lose Some or All of the Amount Invested

The value of the Company's common stock may decline and may be affected by numerous market conditions, which could result in the loss of some or all of the amount invested in the Company's shares. The securities markets frequently experience extreme price and volume fluctuation which affect market prices for securities of companies generally and technology companies in particular. Because of the Company's focus on the technology sector, its stock price is likely to be impacted by these market conditions. General economic conditions, and general conditions in the Internet and information technology and life sciences and other high technology industries, will also affect the Company's stock price.

##### Investing in the Company's Shares May be Inappropriate for the Investor's Risk Tolerance

The Company's investments, in accordance with its investment objective and principal strategies, may result in an above average amount of risk and volatility or loss of principal. The Company's investments in portfolio companies are highly speculative and aggressive and, therefore, an investment in its shares may not be suitable for all investors.

The Market for Venture Capital Investments is Highly Competitive. In Some Cases, the Company's Status as a Regulated Business Development Company May Hinder its Ability to Participate in Investment Opportunities.

The Company faces substantial competition in its investing activities from private venture capital funds, investment affiliates of large industrial, technology, service and financial companies, small business investment companies, wealthy individuals and foreign investors. As a regulated business development company, the Company is required to disclose quarterly the name and business description of portfolio companies and value of any portfolio securities. Most of the Company's competitors are not subject to this disclosure requirement. The Company's obligation to disclose this information could hinder its ability to invest in certain portfolio companies. Additionally, other regulations, current and future, may make the Company less attractive as a potential investor to a given portfolio company than a private venture capital fund not subject to the same regulations.

#### The Company Operates in a Regulated Environment

The Company is subject to substantive SEC regulations as a BDC. Securities and tax laws and regulations governing the Company's activities may change in ways adverse to the Company's and its shareholders' interests and interpretations of such laws

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and regulations may change with unpredictable consequences. Any change in the law or regulations that govern the Company's business could have an adverse impact on the Company or its operations.

#### The Company is Dependent Upon Key Management Personnel for Future Success

The Company is dependent for the selection, structuring, closing and monitoring of its investments on the diligence and skill of its senior management and other management members. The future success of the Company depends to a significant extent on the continued service and coordination of its senior management team, particularly the Chairman and Chief Executive Officer. The departure of any of the executive officers or key employees could materially adversely affect the Company's ability to implement its business strategy. The Company does not maintain key man life insurance on any of its officers or employees.

#### Investment in Small, Private Companies

There are significant risks inherent in the Company's venture capital business. The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies with risky technologies 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. The Company expects that some of its 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. The Company has been risk seeking rather than risk averse in its approach to venture capital and other investments. Neither the Company's investments nor an investment in the Company is intended to constitute a balanced investment program. The Company has in the past relied, and continues to rely to a large extent, upon proceeds from sales of investments rather than investment income to defray a significant portion of its operating expenses.

#### Illiquidity of Portfolio Investments

Most of the investments of the Company are or will be equity securities acquired directly from small companies. The

Company's portfolio of equity securities are and will usually be subject to restrictions on resale or otherwise have no established trading market. The illiquidity of most of the Company's portfolio of equity securities may adversely affect the ability of the Company to dispose of such securities at times when it may be advantageous for the Company to liquidate such investments.

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#### The Inability of the Company's Portfolio Companies to Market Successfully Their Products Would Have a Negative Impact on its Investment Returns

Even if the Company's portfolio companies are able to develop commercially viable products, the market for new products and services is highly competitive and rapidly changing. Commercial success is difficult to predict and the marketing efforts of the Company's portfolio companies may not be successful.

#### Valuation of Portfolio Investments

There is typically no public market for equity securities of the small private companies in which the Company invests. As a result, the valuation of the equity securities in the Company's portfolio is subject to the good faith estimate of the Company's Board of Directors. (See "Asset Valuation Policy Guidelines" in "Footnote to Consolidated Schedule of Investments" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.") In the absence of a readily ascertainable market value, the estimated value of the Company's portfolio of equity securities may differ significantly from the values that would be placed on the portfolio if a ready market for the equity securities existed. Any changes in estimated net asset value are recorded in the Company's consolidated statements of operations as a change in the "Net (decrease) increase in unrealized appreciation on investments." (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

#### Fluctuations of Quarterly Results

The Company's quarterly operating results could fluctuate as a result of a number of factors. These include, among others, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which the Company encounters competition in its markets and general economic 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. (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

#### Risk of Loss of Pass Through Tax Treatment

If the Company meets certain income, diversification and distribution requirements under the Code, it may qualify as a RIC under the Code for pass-through tax treatment. The Company would cease to qualify for pass-through tax treatment if it were unable to comply with these requirements, or if it ceased to qualify as a BDC under the 1940 Act. The Company also could be subject to a four percent excise tax (and, in certain cases, corporate level income tax) if it failed to make certain distributions. (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Recent Developments -- Sub-Chapter M Status.") The lack of Sub-Chapter M tax treatment could have a material adverse effect on the total return, if any, obtainable from an investment in the Company. If the Company fails to qualify as a RIC, the Company

would become subject to federal income tax as if it were an ordinary C Corporation, which would result in a substantial reduction in the Company's net assets and the amount of income available for distribution to the Company's stockholders.

#### Because the Company Must Distribute Income, the Company Will Continue to Need Additional Capital

The Company will continue to need capital to fund investments and to pay for operating expenses. The Company must distribute at least 90 percent of its net operating income other than net realized long-term capital gains to its stockholders to maintain its RIC status. As a result such earnings will not be available to fund investments. If the Company fails to generate net realized long-term capital gains or to obtain funds from outside sources, it could have a material adverse effect on the Company's financial condition and results. The Company does not normally establish reserves for taxes on unrealized capital gains. To the extent that the Company retains capital gains, either as a C corporation or as a Sub-Chapter M corporation, it will have to make provisions for federal taxes and possibly state and local taxes. In addition, as a BDC, the Company is generally required to maintain a ratio of at least 200 percent of total assets to total borrowings, which may restrict its ability to borrow in certain circumstances.

#### Item 2. Properties

The Company maintains its offices at One Rockefeller Plaza, New York, New York 10020, where it leases approximately 4,700 square feet of office space pursuant to a lease agreement expiring in 2003. A portion of this space was sublet in 1997 and 1998 to an early-stage company in which the Company then had an equity interest. In 1999, the same space was sublet to an unaffiliated party. (See "Note 7 of Notes to Consolidated Financial Statements and Schedules" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

#### Item 3. Legal Proceedings

None.

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

The Company did not submit any matters to a vote of its shareholders during the fourth quarter of the 2000 fiscal year.

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## PART II

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

##### Stock Transfer Agent

The Bank of New York, 101 Barclay Street, Suite 12W, New York, New York 10286 (Telephone 800-524-4458, Attention: Ms. Diane Ajjan) serves as transfer agent for the Company's common stock. Certificates to be transferred should be mailed directly to the transfer agent, preferably by registered mail.

##### Market Prices

The Company's common stock is traded on the Nasdaq National Market under the symbol "HHGP." The following table sets forth the range of the high and low selling price of the Company's shares during each quarter of the last two years, as reported by Nasdaq National Market. The quarterly stock prices quoted represent interdealer quotations and do not include markups, markdowns or commissions.

| 2000 Quarter Ending | Low      | High      |
|---------------------|----------|-----------|
| March 31            | \$9.25   | \$32.50   |
| June 30             | \$5.25   | \$17.125  |
| September 30        | \$5.75   | \$10.1875 |
| December 31         | \$2.4375 | \$6.4375  |

| 1999 Quarter Ending | Low       | High     |
|---------------------|-----------|----------|
| March 31            | \$1.3125  | \$2.125  |
| June 30             | \$1.625   | \$2.00   |
| September 30        | \$1.71875 | \$3.125  |
| December 31         | \$2.9375  | \$14.250 |

On February 23, 1999, the Company announced that subsequent to the sale of NBX Corporation to 3Com Corporation, the Board of Directors of the Company declared a cash dividend of \$0.35 per share (approximately \$3.7 million) to shareholders of record on March 19, 1999, payable on March 25, 1999.

On September 20, 2000, the Company declared a cash dividend of \$0.02 per share, payable on November 15, 2000 to shareholders of record on October 15, 2000.

On December 14, 2000, the Company declared a designated undistributed capital gain dividend (also known as a "deemed dividend") of \$1.78 per share with a corresponding tax credit of \$0.62 per share to shareholders of record on December 29, 2000.

Prior to 1998, the Company had not paid dividends since 1991. (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Recent Developments -- Sub-Chapter M Status" and "Note 6 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

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#### Recent Sales of Unregistered Securities

The Company did not sell unregistered shares in the years ended December 31, 2000 and 1999 other than the restricted common stock shares sold to Directors as part of their compensation program. In 1997, the Board of Directors voted that, effective January 1, 1998, 50 percent of all directors' fees be used to purchase Company common stock directly from the Company. On March 1, 1999, the Directors voted to purchase their shares in the open market rather than directly from the Company. In 1999 and 2000, the Directors purchased a total of 29,305 (5,816 shares directly from the Company, prior to March 1, 1999, and 23,489 shares in the open market) and 15,818 shares in 2000. (See "Note 4 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

#### Shareholders

As of March 1, 2001, there were approximately 151 holders of record of the Company's common stock which, the Company has been informed, hold the Company's common stock for approximately 6,750 beneficial owners.

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#### Item 6. Selected Financial Data

The following tables should be read in conjunction with the Consolidated Financial Statements and Supplementary Data included in Item 8 of this Form 10-K.

#### BALANCE SHEET DATA

Financial Position as of December 31:

|  | 2000         | 199          | 1998         | 1997         | 1996         |
|--|--------------|--------------|--------------|--------------|--------------|
| Total  |              |              |              |              |              |
| Assets   | \$43,343,423 | \$65,320,768 | \$25,358,859 | \$39,273,784 | \$38,555,290 |
| Total  |              |              |              |              |              |
| Liabilities                                    | \$11,509,948 | \$11,685,963 | \$ 2,802,150 | \$ 5,618,850 | \$ 2,622,687 |
| Net assets                                     | \$31,833,475 | \$53,634,805 | \$22,556,709 | \$33,654,934 | \$35,932,603 |
| Net asset<br>value per<br>outstanding<br>share | \$ 3.51      | \$ 5.80      | \$ 2.13      | \$ 3.15      | \$ 3.44      |
| Cash dividends<br>Paid                         | \$ 0.02      | \$ 0.35      | \$ 0.75      | \$ 0.00      | \$ 0.00      |
| Shares<br>Outstanding                          | 9,064,231    | 9,240,831    | 10,591,232   | 10,692,971   | 10,442,682   |

Operating Data for year ended December 31:

|   | 2000           | 1999          | 1998          | 1997          | 1996          |
|---|----------------|---------------|---------------|---------------|---------------|
| Total investment<br>Income  | \$ 687,050     | \$ 287,684    | \$ 585,486    | \$ 561,546    | \$ 1,013,417  |
| Total<br>expenses*  | \$(2,623,200)  | \$ 9,924,020  | \$ 3,634,786  | \$ 3,045,290  | \$ 2,985,316  |
| Net operating<br>income<br>(loss)   | \$ 3,310,250   | \$(9,636,336) | \$(2,815,112) | \$(1,550,641) | \$(1,291,065) |
| Net realized<br>gain (loss)<br>on<br>invest-<br>ments   | \$18,963,832   | \$ 8,615,670  | \$(1,718,528) | \$(2,027,177) | \$(2,465,175) |
| Net realized<br>income<br>(loss)  | \$22,274,082   | \$(1,020,666) | \$(4,533,640) | \$(3,577,818) | \$(3,756,240) |
| Net (decrease)<br>increase in<br>unrealized<br>appreciation<br>on<br>invest-<br>ments               | \$(37,781,289) | \$38,102,047  | \$ 1,655,830  | \$ 969,243    | \$ 2,967,248  |
| Net (decrease)<br>increase in<br>net assets<br>resulting<br>from<br>opera-<br>tions                 | \$(15,507,207) | \$37,081,381  | \$(2,877,810) | \$(2,608,575) | \$ (788,992)  |
| (Decrease)<br>increase in<br>net assets<br>resulting<br>from operations<br>per outstanding<br>share | \$ (1.71)      | \$ 4.01       | \$ (0.27)     | \$ (0.24)     | \$ (0.08)     |

Certain reclassifications have been made to the December 31, 1998 and December 31, 1999 financial statements to conform to the December 31, 2000 presentation.

\*Included in Total expenses are the following profit-sharing (reversals) accruals: (\$4,812,675) in 2000; \$8,110,908 in 1999; \$899,751 in 1998; \$423,808 in 1997 and \$0 in 1996.

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

The information contained in this section should be read in conjunction with Company's 2000 Consolidated Financial Statements and notes thereto.

### 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. (See "Risk Factors" contained in Item 1. "Business.") 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 the control of the Company. Although the Company believes 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 the Company or any other person that the objectives and plans of the Company will be achieved.

### Statement of Operations

The Company accounts for its operations under accounting principles generally accepted in the United States for investment companies. On this basis, the principal measure of its financial performance is captioned "Net increase (decrease) in net assets resulting from operations," which is the sum of three elements. The first element is "Net operating income (loss)," which is the difference between the Company's income from interest, dividends, fees and other income and its operating expenses, net of applicable income tax benefit (expense). The second element is "Net realized gain (loss) on investments," which is the difference between the proceeds received from dispositions of portfolio securities and their stated cost, net of applicable income tax benefit (expense). These two elements are combined in the Company's financial statements and reported as "Net realized income (loss)." The third element, "Net (decrease) increase in unrealized appreciation on investments," is the net change in the fair value of the Company's investment portfolio.

"Net realized gain (loss) on investments" and "Net (decrease) increase in unrealized appreciation on investments" are directly related. When a security is sold to realize a gain (loss), net unrealized appreciation decreases (increases) and net realized gain increases (decreases).

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## Financial Condition

The Company's total assets decreased by \$21,977,345 or 33.6 percent to \$43,343,423 and its net assets decreased by \$21,801,330 or 40.6 percent to \$31,833,475 at December 31, 2000, versus \$65,320,768 and \$53,634,805 at December 31, 1999.

Net asset value per share ("NAV") was \$3.51 at December 31, 2000, versus \$5.80 at December 31, 1999. NAV was reduced by \$0.02 in 2000 and \$0.35 in 1999 by the cash dividends paid by the Company.

Among the significant increases in values of the Company's holdings during 2000 including holdings which the Company sold during 2000 were: \$5,854,446 in Alliance Pharmaceutical Corp. (including realized gain), in which the Company sold its position during 2000; \$3,709,449 in Nanophase Technologies; \$1,330,949 in Genomica, as a result of its initial public offering (Genomica Corporation commenced trading on Nasdaq on September 29, 2000); and \$854,467 in Essential.com which acquired Sundial Marketplace.

Among the significant decreases in values of the Company's holdings during 2000 were: \$26,102,456 in SciQuest.com (net of the gain realized on the sale of its original position and including the unrealized loss on the shares purchased during the year); \$3,816,204 in Kana Communications, which acquired Silknet Software, (net of the gain realized on the sale of 61,043 shares); and \$1,165,874 in Questech Corporation.

Net assets were further affected by a decrease in the Company's profit-sharing plan accrual of \$4,812,675, as a result of a net decrease in unrealized appreciation for the year; and an increase in the Company's total tax liability of \$5,598,262, reflecting the shareholder tax payable on long-term gains realized on the sales of shares of SciQuest.com, Alliance Pharmaceutical Corp. and Kana Communications. The Company plans to retain the proceeds of these gains rather than distribute the funds to shareholders as a cash dividend. Accordingly, the Company declared an undistributed capital gain dividend. (See "Recent Developments -- Sub Chapter M Status.")

The Company's shares outstanding as of December 31, 2000 were 9,064,231, versus 9,240,831 at December 31, 1999. On October 12, 2000, the Company announced that the Board of Directors had authorized a repurchase program in the open market of up to \$2 million of the Company's stock. Through December 31, 2000, the Company had purchased a total of 176,600 shares at approximately \$3.00 per share for a total of \$530,051.

The Company's financial condition is dependent on the success of its investments. The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth, are dependent on new, commercially unproven technologies and have no history of operations. At December 31, 2000, \$10,240,018 or 23.6 percent of the Company's total assets consisted of investments at fair value in publicly traded

securities (three of which were private businesses at the time the Company made the investments), of which net unrealized appreciation was \$5,539,997; \$16,782,438 or 38.7 percent of the Company's total assets consisted of non-publicly traded securities at fair value in private businesses and publicly traded companies, of which net unrealized appreciation was \$3,406,915. At December 31, 1999, \$41,556,607 or 63.6 percent of the Company's total assets consisted of investments at fair value in publicly traded securities (that were private businesses at the time the Company made the investments), of which net unrealized appreciation was \$38,864,873; \$18,892,731

or 29.0 percent of the Company's total assets consisted of non-publicly traded securities at fair value in private businesses and publicly traded companies, of which net unrealized appreciation was \$8,553,549.

The decrease in the value of publicly traded securities of \$31,316,589 or 75.4 percent from \$41,556,607 in 1999 to \$10,240,018 in 2000 was primarily owing to: the sales and decrease in value of shares of SciQuest.com of \$26,102,456; and the sales and the decrease in the value of shares of Kana Communications of \$3,816,204. These decreases were partially offset by the increase in value of \$1,330,949 and reclassification of Genomica Corporation to a publicly traded security as a result of its initial public offering (Genomica Corporation commenced trading on Nasdaq on September 29, 2000; the Company's position in Genomica is subject to a lock-up agreement which expires on March 27, 2001), and the increase in the value of Nanophase Technologies of \$3,709,449. The changes in the value of SciQuest.com, Kana Communications and Nanophase Technologies occurred during a period of extreme volatility of publicly traded, small capitalization, high technology stocks. The volatility of the overall market may continue to have a significant impact on the performance of the Company's investments. In addition, the Company may be subject to lock-up agreements which may limit the Company's ability to sell investments. The value of the Company's investments will vary on a quarterly basis. (See "Risk Factors.")

The decrease in the value of the non-publicly traded securities of \$2,110,293 or 11.2 percent from \$18,892,731 at December 31, 1999 to \$16,782,438 at December 31, 2000 was primarily owing to: the reclassification of Genomica Corporation, valued at \$1,209,730 at December 31, 1999, to a publicly traded security as a result of its initial public offering; the sale of the Company's position in Alliance Pharmaceutical valued at \$5,041,000 at December 31, 1999; the liquidation of Adaptive Web Technologies valued at \$1,000,000 at December 31, 1999; and the decrease in the valuation of the Company's investment in Questech Corporation of \$1,165,874 net of the Company's additional \$100,000 investment in that company. These decreases were offset by investments in NeuroMetrix, Inc. of \$750,000; in Sundial Marketplace of \$577,500 as well as an increase in its value of \$854,467 as a result of its June 29, 2000 tax-free acquisition by Essential.com; Experion Systems (formerly named MyPersonalAdvocate.com, Inc.) of \$1,500,000; Informio, Inc. of \$500,000 (formerly named iPacer Corporation); and Harris Newco, Inc. of \$2,000,000.

A summary of the Company's investment portfolio is as follows:

|                            | December 31, 2000 | December 31, 1999 |
|----------------------------|-------------------|-------------------|
| Investments, at cost       | \$33,620,631      | \$16,653,130      |
| Unrealized appreciation    | 8,947,928         | 46,882,521        |
|                            | -----             | -----             |
| Investments, at fair value | \$42,568,559      | \$63,535,651      |
|                            | =====             | =====             |

The accumulated unrealized appreciation on investments net of deferred taxes is \$7,317,422 at December 31, 2000, versus \$45,098,711 at December 31, 1999.

Following an initial investment in a private company, the Company may make additional investments in such investee in order to: (1) increase its ownership percentage; (2) exercise warrants, options or convertible securities that were acquired in the original or subsequent financing; (3) preserve the Company's proportionate ownership in a subsequent financing; or

(4) attempt to preserve or enhance the value of the Company's investment. There can be no assurance that the Company will make follow-on investments or have sufficient funds to make additional investments. The Company has the discretion to make follow-on investments as it determines, subject to the availability of capital resources. The failure to make such follow-on investments may, in certain circumstances, jeopardize the continued viability of the investee company and the Company's initial investment or may result in a missed opportunity for the Company to increase its participation in a successful operation. Even if the Company has sufficient capital to make a desired follow-on investment, it may elect not to make a follow-on investment either because it does not want to increase its concentration of risk, because it prefers other opportunities, or because it is inhibited by compliance with BDC or RIC requirements, even though the follow-on investment opportunity appears attractive.

The following table is a summary of the cash investments and loans made by the Company in its private placement portfolio during the year ended December 31, 2000:

| New Investments:                    | Amount      |
|-------------------------------------|-------------|
| Experion Systems, Inc. (1)          | \$1,500,000 |
| Informio, Inc. (2)                  | \$500,000   |
| Harris Newco, Inc.                  | \$2,000,000 |
|                                     | -----       |
| Additional Investments:             |             |
| Genomica Corporation                | \$500,000   |
| Sundial Marketplace Corporation (3) | \$427,500   |
|                                     | -----       |

(1) Formerly named MyPersonalAdvocate.com, Inc.

(2) Formerly named iPacer Corporation.

(3) Acquired by Essential.com, Inc.

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|                                     |                    |
|-------------------------------------|--------------------|
| Loans:                              |                    |
| NeuroMetrix, Inc. (4)               | \$750,000          |
| Questech Corporation (5)            | \$100,000          |
| Sundial Marketplace Corporation (3) | \$150,000          |
|                                     | -----              |
| Exercise of Warrants Held:          |                    |
| Alliance Pharmaceutical Corp.       | \$490,000          |
|                                     | -----              |
| Total                               | <u>\$6,417,500</u> |

(3) Converted to equity and acquired by Essential.com, Inc.

(4) Converted to equity as part of a recently completed \$13 million equity financing of NeuroMetrix, Inc.

(5) Converted to equity as part of a \$3.4 million equity financing of Questech Corporation.

## Results of Operations

### Investment Income and Expenses:

The Company had a net operating income (loss) of \$3,310,250 in 2000, (\$9,636,336) in 1999 and (\$2,815,112) in 1998. The net operating income for 2000 reflected a decrease in the employee profit-sharing accrual that resulted in a credit to expenses of (\$4,812,675). The net operating losses in 1999 and 1998 reflect accruals for employee profit sharing of \$8,110,908 and \$899,751, respectively. When unrealized appreciation as of a certain period subsequently decreases the profit-sharing accrual will be decreased accordingly, resulting in a credit to expenses, thereby reducing expenses for such subsequent year by that amount.

The Company's primary investment objective is to achieve long-term capital appreciation rather than current income from its investments. Therefore, a significant portion of the

investment portfolio is structured to attempt to enhance the potential for capital appreciation and provides little or no current yield in the form of dividends or interest. The Company does earn interest income from fixed-income securities, including U.S. Government obligations. The amount of interest income earned varies based upon the average balance of the Company's fixed-income portfolio and the average yield on this portfolio. The Company also received or accrued net after-tax distributions from its investment in PHZ Capital Partners, L.P. in 2000 of \$121,510, in 1999 of \$490,950 and in 1998 of \$50,000. The Company does not regard distributions from PHZ as predictable.

The Company had total investment income of \$687,050 in 2000, \$287,684 in 1999 and \$585,486 in 1998. The Company had interest income from fixed-income securities of \$554,233 in 2000, \$234,347 in 1999 and \$355,591 in 1998. The increase from 1999 to 2000 of \$319,886 or 136.5 percent was owing to the Company having additional funds to invest as the result of the sale of the SciQuest.com and Alliance Pharmaceutical securities.

The decrease from 1998 to 1999 of \$121,244 or 34.1 percent was primarily owing to a decline in the balance of the Company's fixed-income portfolio during 1999 and 1998 as a result of the payment of dividends, additional investments and operating expenses.

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The Company had interest income from affiliated companies of \$64,950 in 2000, \$48,526 in 1999 and \$124,877 in 1998. The increase from 1999 to 2000 of \$16,424 or 33.8 percent and the decrease from 1998 to 1999 of \$76,351 or 61.1 percent is owing to the change in amount of outstanding loans during the periods. The amount of outstanding loans to investee companies varies. Typically, loans made to investee companies are bridge loans and are converted into equity at the next financing.

The Company had other income of \$65,867 in 2000, \$3,911 in 1999 and \$102,468 in 1998. The other income in 2000 represents rental income for subleasing office space; in December 1999, the Company began subleasing office space to an unaffiliated party. The other income in 1998 reflected income from an affiliated company, BioSupplyNet, to reimburse the Company for consulting fees previously paid and expensed by the Company on behalf of BioSupplyNet.

Operating expenses were (\$2,623,200) in 2000, \$9,924,020 in 1999 and \$3,634,786 in 1998. The operating expenses for the year ended December 31, 2000 reflect a reversal of a prior expense accrual of \$4,812,675 in the employee profit-sharing plan, as a result of a net decrease in unrealized appreciation for the current year, resulting in a credit to expenses. Salaries and benefits increased \$202,037 or 24.2 percent primarily as a result of the Company's contribution to the Supplemental Executive Retirement Plan or SERP. (See "Note 5 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.") Professional fees decreased by \$21,288 or 6.4 percent. Administration and operations expenses increased \$66,441 or 20.8 percent primarily as a result of increased printing and distribution costs for the Company's shareholder reports as a result of a significant increase in the number of beneficial shareholders from 1999 to 2000. During 2000, the Company incurred a total of \$146,141 in interest costs on outstanding debt during the first quarter of 2000; \$36,500 interest paid on a note and \$109,641 on warrants. Director's fees and expenses decreased by \$19,859 or 16.5 percent as the result of the Company holding fewer director meetings in 2000 than in 1999.

The increase in expenses from 1998 to 1999 of \$6,289,234 or 173.0 percent is primarily owing to an increase in the expense for the Company's employee profit-sharing plan of \$7,211,157 or an 801.5 percent increase over the prior year as a result of the

net increase in unrealized appreciation of the Company's investments of approximately \$40,709,767. A total of \$1,138,551 of the profit-sharing on the 1999 net realized gains was paid in 2000. (See "Note 3 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

Other than the increase in the employee profit-sharing plan accrual and a decrease in professional fees, which decreased by \$79,591 or 19.3 percent as a result of lower legal fees, expenses remained stable. Salaries and benefits increased by \$3,579 or less than one percent; administration and operations decreased by \$11,712 or 3.5 percent; depreciation decreased by \$12,481 or 26.0 percent as a result of assets that were fully depreciated as of the end of 1998; rent increased by \$3,472 or 2.2 percent; directors' fees and expenses decreased by \$8,925 or

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6.9 percent because the Company had one fewer director in 1999 than in 1998. Other expense in 1998 includes the final payment on the Harris & Harris Group Senior Professorship pledge to the Massachusetts Institute of Technology of \$728,862.

During 1999, the Company had no interest expense and no outstanding debt.

The Company has in the past relied, and continues to rely to a large extent, on proceeds from sales of investments, rather than on investment income, to defray a significant portion of its operating expenses. Because such sales are unpredictable, the Company attempts to maintain adequate working capital to provide for fiscal periods when there are no such sales.

#### Realized Gains and Losses on Sales of Portfolio Securities:

During the three years ended December 31, 2000, 1999 and 1998, the Company sold various investments and received distributions, realizing net gains (losses) of \$19,065,267, \$10,976,714 and (\$1,718,528), respectively.

During 2000, the Company realized total net gains of \$19,065,267 including \$9,693,446 on the sale of its entire position in Alliance Pharmaceutical, \$7,407,377 on the sale of its original position in SciQuest.com (the Company purchased an additional 350,000 shares during the year); \$1,054,818 on the sale of 61,043 shares of Kana Communications, \$241,025 on the sale of 85,100 shares of Nanophase Technologies; \$528,021 from PHZ Capital Partners LP; and \$147,528 on the realization of the reserve on the NBX/3Com escrow (the Company received in full the escrowed funds on March 6, 2000). As a result of the gains and losses realized during 2000, unrealized appreciation decreased by \$21,400,036.

During 1999, the Company realized total net gains of \$10,976,714, including \$10,584,630 on the sale of NBX Corporation to 3Com Corporation; \$160,918 on the sale of 87,600 shares of Princeton Video Image, Inc.; and the receipt of a cash distribution from PHZ Capital Partners, L.P. of approximately \$612,170. The Company also incurred losses of approximately \$381,004 on the sale of various publicly traded investments. As a result of gains and losses realized during 1999, unrealized appreciation decreased by \$4,234,794.

During 1998, the Company realized total net losses of \$1,718,528. These net losses included: \$209,999 on its privately held investment in MultiTarget, Inc.; losses on publicly held investments that were once privately held, including (1) CORDEX Petroleum, Inc. in the amount of \$357,736; (2) Princeton Video Image, Inc., \$288,369; and (3) Voice Control Systems, Inc. (which purchased the Company's investee company, PureSpeech, Inc.), \$724,826. The Company also had a realized net loss of \$187,598 in various publicly traded securities.

During 1998, the Company received a cash distribution of \$50,000 from PHZ Capital Partners, L.P. As a result of gains and losses realized during 1998, unrealized appreciation increased by \$1,171,496.

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#### Unrealized Appreciation and Depreciation of Portfolio Securities:

The Board of Directors values the portfolio securities on a quarterly basis pursuant to the Company's Asset Valuation guidelines in accordance with the 1940 Act. (See "Footnote to Consolidated Schedule of Investments" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

In 2000, net unrealized appreciation on investments decreased by \$37,934,593 or 80.9 percent from \$46,882,521 to \$8,947,928, primarily as a result of declines in the values of the Company's holdings in SciQuest.com, Kana Communications, and Questech Corporation of \$26,102,456 (net of gain realized on sale), \$3,816,204 (net of gain realized on sale) and \$1,165,874, respectively, offset by increases in the values of the Company's holdings in Nanophase Technologies Corporation, Genomica Corporation and Essential.com of \$3,709,449, \$1,330,949 and \$854,467, respectively. (See "Consolidated Schedule of Investments" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

In 1999, net unrealized appreciation on investments increased by \$36,474,973 or 350.5 percent, from \$10,407,548 to \$46,882,521. The most significant increases in valuation during 1999 were in: SciQuest.com, Inc., \$31,981,750; Silknet Software, Inc. (which acquired InSite Marketing Technology, Inc.), \$4,899,062; Alliance Pharmaceutical Corp., \$3,839,000; and Nanophase Technologies Corporation, \$1,935,016. The increase in valuations was offset by the reclassification of the Company's gain in NBX Corporation of \$4,716,062 from unrealized to realized.

In 1998, net unrealized appreciation on investments increased by \$2,248,816 or 27.6 percent, from \$8,158,732 to \$10,407,548. The most significant increases in valuations during 1998 were in: NBX Corporation, \$1,865,766; NeuroMetrix, Inc., \$4,400,125; and PHZ Capital Partners, L.P., \$443,432. The most significant decrease during 1998 was in Nanophase Technologies Corporation, \$5,508,466. Other changes included an increased valuation of Genomica Corporation, offset primarily by decreased valuations in MedLogic Global Corporation and Princeton Video Image, Inc.

#### Liquidity and Capital Resources

The Company's primary sources of liquidity are cash, receivables and freely marketable securities (net of discounts for size of positions, if any). The Company's secondary sources of liquidity are restricted securities of companies that are publicly traded. At December 31, 2000, December 31, 1999 and December 31, 1998, respectively, the Company's total primary liquidity was \$23,039,736, \$6,622,216 and \$5,547,984. On the corresponding dates, the Company's total secondary liquidity was \$3,040,679, \$38,230,812 and \$0. The Company's tertiary source of liquidity is its holding in PHZ Capital Partners, L.P., from which the Company received or accrued net after-tax distributions in 2000, 1999 and 1998 of approximately \$121,510, \$490,950 and \$50,000, respectively.

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The increase in the Company's primary source of liquidity from December 31, 1999 to December 31, 2000 is primarily owing

to: (1) Alliance Pharmaceutical shares which became freely tradable and were subsequently sold for proceeds of \$11,385,446; (2) sale of SciQuest.com stock for proceeds of \$8,257,377; (3) increase in the value of Nanophase Technologies shares of \$3,709,449; (4) sale of 61,043 shares of Kana Communications for proceeds of \$1,504,762; (5) receipt of escrowed funds plus interest of \$1,541,136; and (6) receipt of funds from the liquidation of Adaptive Web Technologies of \$993,830.

This increase in the Company's primary liquidity was offset by: (1) the payment of the 1999 employee profit sharing of \$1,138,551; (2) the investments of \$2,000,000 in Harris Newco, Inc., \$1,500,000 in Experion Systems, \$500,000 in Informio, \$500,000 in Genomica, \$490,000 for the exercise of warrants to purchase common stock in Alliance Pharmaceutical, \$577,500 in Sundial Marketplace (which was acquired on June 29, 2000 by Essential.com in a tax-free merger); (3) the loans of \$750,000 to NeuroMetrix, and \$100,000 to Questech; and (4) the use of funds for operating expenses.

The decrease in the Company's secondary source of liquidity from December 31, 1999 to December 31, 2000 is primarily owing to the expirations of the lock-up periods on SciQuest.com and Silknet Software (which subsequently merged with Kana Communications) offset by the completion of the initial public offering of Genomica Corporation, which commenced trading on September 29, 2000. The Company's position in Genomica is subject to a lock-up agreement which expires on March 27, 2001.

In 2000, the changes in the values of SciQuest.com, Kana Communications, Nanophase Technologies and Alliance Pharmaceutical reflected the extreme stock market volatility in the shares of smaller, high technology companies.

From December 31, 1999 to December 31, 2000, restricted funds increased by \$265,183 or 100 percent as a result of the establishment of the Company's contribution to the Supplemental Executive Retirement Plan or SERP account. Funds in escrow decreased by \$1,327,748 or 100 percent, owing to the receipt of the full escrowed funds plus accrued interest for a total of \$1,541,136 on March 6, 2000.

From December 31, 1999 to December 31, 2000, the Company's liability for accrued profit sharing and deferred income tax liability changed significantly. Accrued profit sharing decreased by \$5,951,226 to \$3,483,241 as a result of payment of \$1,138,551 of the 1999 profit sharing and the reversal of a prior expense accrual of \$4,812,675 owing to the decrease in unrealized appreciation for the year ended December 31, 2000. Approximately \$2,325,071 of the profit-sharing accrual will be paid out in 2001 as follows: 90 percent in February 2001 and the remaining 10 percent upon the completion and filing of the Company's 2000 federal tax return.

The Company's total income tax liability increased by \$5,598,262 to \$7,116,036 primarily as a result of the federal income tax payable on the shareholders' behalf on the net realized long-term capital gains which the Company currently plans to retain rather than distribute as a cash dividend. Accordingly, the Company declared a designated undistributed

capital gain dividend for a total of \$16,253,987 and paid a total of \$5,688,896 in federal income taxes in January 2001. (See "Note 6 of Notes to Consolidated Financial Statements" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

On October 12, 2000, the Company announced that the Board of Directors had authorized a repurchase program in the open market of up to \$2 million of the Company's stock. Through December 31, 2000, the Company had purchased a total of 176,600

shares at approximately \$3.00 per share for a total of \$530,051.

The Company's primary sources of liquidity, including cash, receivables and freely marketable securities, are more than adequate to cover the Company's gross cash operating expenses over the next 12 months. Such gross cash operating expenses totaled \$2,051,086, \$1,777,657 and \$2,687,099 in 2000, 1999 and 1998, respectively. The Company's secondary sources of liquidity are the restricted securities of companies, all of which are scheduled to become freely tradable at various times in the year 2001. The Company cannot predict the amount, if any, of net after-tax distributions that it might receive from its holding in PHZ in the year 2001.

#### Recent Developments -- Portfolio Companies

During January 2001, the Company sold in the open market its entire position of 350,000 shares of SciQuest.com, Inc. common stock (NASDAQ: SQST) at an average net price of \$2.08 per share, resulting in a realized loss of \$1,258,679.

On January 26, 2001, the Company announced that it had invested \$750,000 in a Series B Convertible Preferred security for approximately a 10 percent fully diluted equity interest in Schwoo, Inc. Schwoo is a privately held Pittsburgh-based corporation. The company is developing software that automatically manages e-commerce security infrastructure. The Schwoo system is designed to operate on an integrated basis across network, host and application layers to defend systems from security attacks.

On February 28, 2001, the Company noted that it had converted its NeuroMetrix Note to equity as part of NeuroMetrix's \$13 million third round venture financing.

#### Recent Developments -- Sub-Chapter M Status

The qualification of the Company as a RIC under Sub-Chapter M of the Code depends on it satisfying certain technical requirements regarding its income, investment portfolio and distributions. (See "Sub-Chapter M Status" contained in Item. 1 "Business"). The Company was unable to satisfy these requirements for the 1998 tax year owing to the nature of the Company's ownership interest in one of its investee companies. In addition, because it realized taxable losses in 1998, it was not strategically advantageous for the Company to elect Sub-Chapter M tax status for 1998. The Company changed the nature of its ownership interest in the non-qualifying investee company effective January 1, 1999 in order to meet the Sub-Chapter M requirements.

In 1999, because of changes in its investment portfolio, the Company requested recertification from the SEC relating to the Company's status under section 851(e) of the Code. On February 24, 2000, the Company received the certification, and the Company elected Sub-Chapter M tax treatment for 1999. During 1999, the Company declared a cash dividend of \$0.35 per share (for a total of \$3,647,017), thereby distributing part of the long-term capital gain generated in 1999 by the sale of NBX Corporation to 3Com Corporation. Approximately \$143,261 of the long-term capital gain for 1999 was not distributed during 1999. Accordingly, on September 20, 2000, the Company declared a \$0.02 dividend (for a total of \$184,817). For the year ended December 31, 1999, the Company incurred approximately \$20,000 in excise taxes.

On March 8, 2001, the Company received SEC certification and qualified for RIC treatment for 2000. Although the SEC certification for 1999 and 2000 was issued, there can be no assurance that the Company will receive such certification for subsequent years (to the extent it needs additional certification

as a result of changes in its portfolio) or that it will actually qualify as a RIC for subsequent years. In addition, under certain circumstances, even if the Company qualified for Sub-Chapter M treatment in a given year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than as a RIC.

On December 14, 2000, the Company announced that its Board of Directors, in accordance with rules governing a RIC under Sub-Chapter M of the Code, declared a designated undistributed capital gain dividend (also known as a deemed dividend) of \$1.78 per share, for a total of \$16,253,987 and paid corporate taxes on behalf of shareholders of \$0.62 per share, for a total of \$5,688,896. Each shareholder will receive an IRS Form 2439 which will reflect receipt of the deemed dividend income and a tax credit equal to the shareholder's proportionate share of the tax paid by the Company.

#### Tax Consequences of Net Capital Gains

The following simplified examples illustrate the tax treatment under Sub-Chapter M of the Code for the Company and its shareholders with regard to three possible alternatives, assuming a net long-term capital gain of \$1.00 per share, consisting entirely of sales of non-real property assets held for more than 12 months.

Under Alternative A: 100 percent of net capital gain declared as a dividend and distributed to shareholders:

1. No federal taxation at the Company level.
2. Taxable shareholders receive a \$1.00 per share dividend and pay a maximum federal tax of 20 percent\* or \$.20 per share, retaining \$.80 per share.

\*Assumes all capital gains qualify for long-term rates of 20 percent.

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Under Alternative B: 100 percent of net capital gain retained by the Company and designated as "undistributed capital gain" or deemed dividend:

1. The Company pays a corporate-level federal income tax of 35 percent on the undistributed gain or \$.35 per share and retains 65 percent of the gain or \$.65 per share.
2. Taxable shareholders increase their cost basis in their stock by \$.65 per share. They pay a 20 percent\* federal capital gains tax on 100 percent of the undistributed gain of \$1.00 per share or \$.20 per share in tax. Offsetting this tax, shareholders receive a tax credit equal to 35 percent of the undistributed gain or \$.35 per share.

Under Alternative C: 100 percent of net capital gain retained by the Company, with no designated undistributed capital gain or deemed dividend:

1. The Company pays a corporate-level federal income tax of 35 percent on the retained gain or \$.35 per share plus an excise tax of four percent of \$.98 per share, or about \$.04 per share.
2. There is no tax consequence at the shareholder level.

\*Assumes all capital gains qualify for long-term rates of 20 percent.

## Risk

The Company's business activities contain elements of risk. The Company considers a principal type of market risk to be valuation risk. Investments are stated at "fair value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. All assets are valued at fair value 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" contained in Item 8. "Consolidated Financial Statements and Supplementary Data.")

Neither the Company's investments nor an investment in the Company is intended to constitute a balanced investment program. The Company has exposure to public-market price fluctuations to the extent of its publicly traded portfolio.

The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend 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 public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities. The Company expects that some of its 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.

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Because there is typically no public market for the equity interests of the small companies in which the Company invests, the valuation of the equity interests in the Company's portfolio is subject to the estimate of the Company's Board of Directors in accordance with the Company's Asset Valuation Policy Guidelines. In the absence of a readily ascertainable market value, the estimated value of the Company's 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 the Company's consolidated statements of operations as "Net (decrease) increase in unrealized appreciation on investments."

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## Item 8. Consolidated Financial Statements and Supplementary Data

### HARRIS & HARRIS GROUP, INC. INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SCHEDULES

The following reports and consolidated financial schedules of Harris & Harris Group, Inc. are filed herewith and included in response to Item 8.

| Documents  | Page |
|--|------|
| Report of Independent Public Accountants. . . . .  | 30   |
| Consolidated Financial Statements  |      |
| Consolidated Statements of Assets and Liabilities<br>as of December 31, 2000 and 1999. . . . .   | 31   |
| Consolidated Statements of Operations for the<br>years ended December 31, 2000, 1999, and 1998 . | 32   |

|  |       |
|--|-------|
| Consolidated Statements of Cash Flows for the<br>years ended December 31, 2000, 1999, and 1998. . . . .                | 33    |
| Consolidated Statements of Changes in Net Assets<br>for the years ended December 31, 2000, 1999,<br>and 1998 . . . . . | 34    |
| Consolidated Schedule of Investments as of<br>December 31, 2000. . . . .   | 35-39 |
| Footnote to Consolidated Schedule of Investments . . . . .   | 40-42 |
| Notes to Consolidated Financial Statements . . . . .   | 43-50 |
| Selected Per Share Data and Ratios for the<br>years ended December 31, 2000, 1999, 1998,<br>1997 and 1996 . . . . .    | 51    |

Schedules other than those listed above have been omitted because they are not applicable or the required information is presented in the consolidated financial statements and/or related notes.

## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To Harris & Harris Group, Inc.:

We have audited the accompanying consolidated statements of assets and liabilities of Harris & Harris Group, Inc. (a New York corporation) as of December 31, 2000 and 1999, including the consolidated schedule of investments as of December 31, 2000, and the related consolidated statements of operations, cash flows and changes in net assets for the three years ended December 31, 2000, and the selected per share data and ratios for each of the five years ended December 31, 2000. These consolidated financial statements and selected per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and selected per share data and ratios based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements and selected per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 2000 and 1999, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 2, the consolidated financial statements include securities valued at \$16,782,438 (52.72 percent of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

In our opinion, the consolidated financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of Harris & Harris Group, Inc. as of December 31, 2000 and 1999, the results of their operations, their cash flows and the changes in

their net assets for the three years ended December 31, 2000, and the selected per share data and ratios for each of the five years ended December 31, 2000 in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP  
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New York, New York  
 February 28, 2001

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## CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

### ASSETS

December 31, 2000    December 31, 1999

|   |              |              |
|---|--------------|--------------|
| Investments, at value (See accompanying consolidated schedule of investments and notes) . . . . . | \$42,568,559 | \$63,535,651 |
| Cash and cash equivalents . . . . .   | 253,324      | 133,256      |
| Restricted funds (Note 5) . . . . .   | 265,183      | 0            |
| Funds in escrow (Note 7) . . . . .  | 0            | 1,327,748    |
| Interest receivable . . . . .   | 30,082       | 44,189       |
| Prepaid expenses . . . . .  | 82,615       | 74,328       |
| Note receivable . . . . .   | 10,888       | 32,663       |
| Other assets . . . . .  | 132,772      | 172,933      |
|   | -----        | -----        |
| Total assets . . . . .  | \$43,343,423 | \$65,320,768 |

### LIABILITIES & NET ASSETS

|  |              |              |
|--|--------------|--------------|
| Accounts payable and accrued liabilities . . . . . | \$771,763    | \$ 700,566   |
| Payable to broker for unsettled trade . . . . .    | 115,005      | 0            |
| Accrued profit sharing (Note 3) . . . . .          | 3,483,241    | 9,434,467    |
| Deferred rent . . . . .                            | 23,903       | 33,156       |
| Current income tax liability (Note 6) . . . . .    | 5,751,566    | 0            |
| Deferred income tax liability (Note 6) . . . . .   | 1,364,470    | 1,517,774    |
|  | -----        | -----        |
| Total liabilities . . . . .                        | 11,509,948   | 11,685,963   |
| Commitments and contingencies (Notes 7) . . . . .  | -----        | -----        |
|  | -----        | -----        |
| Net assets . . . . .                               | \$31,833,475 | \$53,634,805 |

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, 25,000,000<br>shares authorized; 10,692,971 issued<br>at 12/31/00 and at 12/31/99 . . . . .                                 | 106,930      | 106,930      |
| Additional paid in capital (Note 4) . . . . .   | 26,724,595   | 16,159,504   |
| Additional paid in capital - common<br>stock warrants . . . . .   | 109,641      | 0            |
| Accumulated net realized gain (loss) . . . . .  | 642,418      | (5,192,860)  |
| Accumulated unrealized appreciation of<br>investments, net of deferred tax<br>liability of \$1,630,506 at 12/31/00<br>and \$1,783,810 at 12/31/99 . . . . . | 7,317,422    | 45,098,711   |
| Treasury stock, at cost (1,628,740<br>shares at 12/31/00 and<br>1,452,140 at 12/31/99) . . . . .  | (3,067,531)  | (2,537,480)  |
|   | -----        | -----        |
| Net assets . . . . .  | \$31,833,475 | \$53,634,805 |
|   | -----        | -----        |
| Shares outstanding . . . . .  | 9,064,231    | 9,240,831    |
|   | -----        | -----        |
| Net asset value per outstanding share . . . . .   | \$ 3.51      | \$ 5.80      |

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

## CONSOLIDATED STATEMENTS OF OPERATIONS

|  | Year Ended<br>December<br>31, 2000 | Year Ended<br>December<br>31, 1999 | Year Ended<br>December<br>31, 1998 |
|--|------------------------------------|------------------------------------|------------------------------------|
| Investment income:   |                                    |                                    |                                    |
| Interest from:   |                                    |                                    |                                    |
| Fixed-income   |                                    |                                    |                                    |
| Securities . . . . \$  | 554,233                            | \$ 34,347                          | \$ 355,591                         |
| Affiliated   |                                    |                                    |                                    |
| Companies . . . . .  | 64,950                             | 48,526                             | 124,877                            |
| Dividend income --   |                                    |                                    |                                    |
| unaffiliated   |                                    |                                    |                                    |
| companies . . . . .  | 2,000                              | 900                                | 2,550                              |
| Other income . . . . .   | 65,867                             | 3,911                              | 102,468                            |
|  | -----                              | -----                              | -----                              |
| Total investment   |                                    |                                    |                                    |
| Income . . . . .   | 687,050                            | 287,684                            | 585,486                            |
| Expenses:  |                                    |                                    |                                    |
| Profit-sharing   |                                    |                                    |                                    |
| (reversal) accrual   |                                    |                                    |                                    |
| (Note 3) . . . . .   | (4,812,675)                        | 8,110,908                          | 899,751                            |
| Salaries and benefits . . . . .                                    | 1,036,737                          | 834,700                            | 831,121                            |
| Professional fees . . . . .  | 310,601                            | 331,889                            | 411,480                            |
| Administration and   |                                    |                                    |                                    |
| Operations . . . . .   | 385,608                            | 319,167                            | 330,879                            |
| Rent . . . . .   | 166,816                            | 162,987                            | 159,515                            |
| Directors' fees  |                                    |                                    |                                    |
| and expenses . . . . .   | 100,469                            | 120,328                            | 129,253                            |
| Depreciation . . . . .   | 28,748                             | 35,455                             | 47,936                             |
| Custodian fees . . . . .   | 14,355                             | 8,586                              | 10,513                             |
| Other expense . . . . .  | 0                                  | 0                                  | 728,862                            |
| Interest expense   |                                    |                                    |                                    |
| (Note 4) . . . . .   | 146,141                            | 0                                  | 85,476                             |
|  | -----                              | -----                              | -----                              |
| Total expenses . . . . .   | (2,623,200)                        | 9,924,020                          | 3,634,786                          |
| Operating income   |                                    |                                    |                                    |
| (loss) before  |                                    |                                    |                                    |
| income taxes . . . . .   | 3,310,250                          | (9,636,336)                        | (3,049,300)                        |
| Income tax benefit   |                                    |                                    |                                    |
| (Note 6) . . . . .   | 0                                  | 0                                  | 234,188                            |
|  | -----                              | -----                              | -----                              |
| Net operating  |                                    |                                    |                                    |
| income (loss) . . . . .  | 3,310,250                          | (9,636,336)                        | (2,815,112)                        |
| Net realized gain (loss) on investments:                           |                                    |                                    |                                    |
| Realized gain (loss)   |                                    |                                    |                                    |
| on sale of   |                                    |                                    |                                    |
| investments . . . . .  | 19,065,267                         | 10,976,714                         | (1,718,528)                        |
|  | -----                              | -----                              | -----                              |
| Total realized   |                                    |                                    |                                    |
| gain (loss) . . . . .  | 19,065,267                         | 10,976,714                         | (1,718,528)                        |
| Income tax expense   |                                    |                                    |                                    |
| (Note 6) . . . . .   | (101,435)                          | (2,361,044)                        | 0                                  |
|  | -----                              | -----                              | -----                              |
| Net realized gain  |                                    |                                    |                                    |
| (loss) on  |                                    |                                    |                                    |
| investments . . . . .  | 18,963,832                         | 8,615,670                          | (1,718,528)                        |
|  | -----                              | -----                              | -----                              |
| Net realized   |                                    |                                    |                                    |
| income (loss) . . . . .  | 22,274,082                         | (1,020,666)                        | (4,533,640)                        |
| Net (decrease) increase in unrealized appreciation on investments: |                                    |                                    |                                    |
| Increase as a  |                                    |                                    |                                    |
| result of  |                                    |                                    |                                    |
| investment sales . . . . .   | 0                                  | 704,801                            | 2,135,176                          |
| Decrease as a  |                                    |                                    |                                    |

|  |                 |               |                |
|--|-----------------|---------------|----------------|
| result of  |                 |               |                |
| investment sales. . .  | (21,400,036)    | (4,939,595)   | (963,680)      |
| Increase on  |                 |               |                |
| investments held. . .  | 26,741,283      | 43,186,960    | 9,766,320      |
| Decrease on  |                 |               |                |
| investments held. . .  | (43,275,840)    | (2,477,193)   | (8,689,000)    |
|  | -----           | -----         | -----          |
| Change in unrealized   |                 |               |                |
| appreciation on  |                 |               |                |
| investments. . . .   | (37,934,593)    | 36,474,973    | 2,248,816      |
| Income tax benefit   |                 |               |                |
| (expense) (Note 6).  | 153,304         | 1,627,074     | (592,986)      |
|  | -----           | -----         | -----          |
| Net (decrease)   |                 |               |                |
| increase in  |                 |               |                |
| unrealized   |                 |               |                |
| appreciation   |                 |               |                |
| on investments. . .  | (37,781,289)    | 38,102,047    | 1,655,830      |
|  | -----           | -----         | -----          |
| Net (decrease) increase in net assets resulting from operations: |                 |               |                |
| Total. . . . .   | \$ (15,507,207) | \$ 37,081,381 | \$ (2,877,810) |
|  | =====           | =====         | =====          |
| Per outstanding  |                 |               |                |
| Share . . . . .  | \$ (1.71)       | \$ 4.01       | \$ (0.27)      |
|  | =====           | =====         | =====          |

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

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#### CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Year Ended | Year Ended | Year Ended |
|--|------------|------------|------------|
|  | December   | December   | December   |
|  | 31, 2000   | 31, 1999   | 31, 1998   |

|  |                 |               |                |
|--|-----------------|---------------|----------------|
| Cash flows used in operating activities: |                 |               |                |
| Net (decrease)                           |                 |               |                |
| increase in net                          |                 |               |                |
| assets resulting                         |                 |               |                |
| from operations . . .                    | \$ (15,507,207) | \$ 37,081,381 | \$ (2,877,810) |
| Adjustments to reconcile net             |                 |               |                |
| (decrease) increase in net assets        |                 |               |                |
| resulting from operations to net         |                 |               |                |
| cash used in operating activities:       |                 |               |                |
| Net realized and                         |                 |               |                |
| unrealized loss                          |                 |               |                |
| (gain) on                                |                 |               |                |
| investments. . . . .                     | 18,869,326      | (47,451,687)  | (480,288)      |
| Deferred income                          |                 |               |                |
| Taxes. . . . .                           | (153,304)       | 586,710       | 263,367        |
| Depreciation. . . . .                    | 28,748          | 35,455        | 47,936         |
| Other . . . . .                          | 109,641         | 0             | (2,927)        |
| Interest received                        |                 |               |                |
| in stock. . . . .                        | (27,009)        | 0             | 0              |
| Changes in assets and liabilities:       |                 |               |                |
| Restricted funds . .                     | (265,183)       | 0             | 0              |
| Receivable from                          |                 |               |                |
| broker for                               |                 |               |                |
| unsettled trades. .                      | 0               | 380,707       | (380,707)      |
| Funds in escrow. . .                     | 1,327,748       | (1,327,748)   | 0              |
| Interest receivable.                     | 14,107          | (43,523)      | 110,440        |
| Prepaid expenses . .                     | (8,287)         | 16,321        | (5,523)        |
| Notes receivable . .                     | 0               | 0             | (32,663)       |
| Other assets . . . .                     | 18,384          | (41,281)      | 86,312         |
| Accounts payable                         |                 |               |                |
| and accrued                              |                 |               |                |
| liabilities . . . . .                    | 71,197          | 195,448       | 81,235         |
| Payable to broker                        |                 |               |                |
| for unsettled                            |                 |               |                |

|  |              |             |              |
|--|--------------|-------------|--------------|
| trade . . . . .  | 115,005      | 0           | 0            |
| Accrued profit   |              |             |              |
| Sharing . . . . .  | (5,951,226)  | 8,110,908   | 899,751      |
| Deferred rent. . . .   | (9,253)      | (9,253)     | (9,253)      |
| Current income tax   |              |             |              |
| Liability . . . . .  | 62,670       | 0           | 0            |
|  | -----        | -----       | -----        |
| Net cash used in operating activities. . . . .                                   | (1,304,643)  | (2,466,562) | (2,300,130)  |
| Cash provided by investing activities:   |              |             |              |
| Net (purchase) sale of short-term investments and marketable securities. . . . . | (14,480,590) | 240,590     | 14,683,171   |
| Investment in private placements and loans . . . . .                             | (6,417,500)  | (4,077,001) | (960,308)    |
| Proceeds from sale of investments . . . . .                                      | 23,022,868   | 12,274,632  | 32,663       |
| Purchase of fixed assets. . . . .  | (6,974)      | (9,261)     | (16,426)     |
|  | -----        | -----       | -----        |
| Net cash provided by investing activities. . . . .                               | 2,117,804    | 8,428,960   | 13,739,100   |
| Cash flows used in financing activities:   |              |             |              |
| Payment of dividend. . . . .   | (184,817)    | (3,647,017) | (8,019,728)  |
| Purchase of treasury stock (Note 4). . . . .                                     | (530,051)    | (2,373,551) | (254,786)    |
| Proceeds from note payable. . . . .  | 3,000,000    | 0           | 0            |
| Payment of note payable (Note 4). . . . .  | (3,000,000)  | 0           | (4,000,000)  |
| Proceeds from sale of stock (Note 4). . . . .                                    | 0            | 17,283      | 54,099       |
| Collection on notes Receivable. . . . .  | 21,775       | 10,000      | 800,000      |
|  | -----        | -----       | -----        |
| Net cash used in financing activities. . . . .                                   | (693,093)    | (5,993,285) | (11,420,415) |
| Net increase (decrease) in cash and cash equivalents:                            |              |             |              |
| Cash and cash equivalents at beginning of the year. . . . .                      | 133,256      | 164,143     | 145,588      |
| Cash and cash equivalents at end of the year. . . . .                            | 253,324      | 133,256     | 164,143      |
|  | -----        | -----       | -----        |
| Net increase (decrease) in cash and cash equivalents. . . . .                    | \$ 120,068   | \$ (30,887) | \$ 18,555    |
| Supplemental disclosures of cash flow information:                               |              |             |              |
| Income taxes paid . . . . .  | \$ 117,134   | \$ 122,560  | \$ 372       |
| Interest paid . . . . .  | \$ 36,500    | \$ 0        | \$ 85,476    |

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

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

| Year Ended | Year Ended | Year Ended |
|------------|------------|------------|
| December   | December   | December   |
| 31, 2000   | 31, 1999   | 31, 1998   |

Changes in net assets from operations:

|                         |              |                |               |
|-------------------------|--------------|----------------|---------------|
| Net operating income    |              |                |               |
| (loss) . . . . .        | \$ 3,310,250 | \$ (9,636,336) | \$(2,815,112) |
| Net realized gain       |              |                |               |
| (loss) on               |              |                |               |
| investments . . . . .   | 18,963,832   | 8,615,670      | (1,718,528)   |
| Net (decrease) increase |              |                |               |
| in unrealized           |              |                |               |
| appreciation on         |              |                |               |
| investments as a        |              |                |               |
| result of sales . . .   | (21,246,732) | (2,607,720)    | 578,510       |
| Net (decrease)          |              |                |               |
| increase in             |              |                |               |
| unrealized              |              |                |               |
| appreciation on         |              |                |               |
| investments held . .    | (16,534,557) | 40,709,767     | 1,077,320     |
|                         | -----        | -----          | -----         |

|                                  |              |            |             |
|----------------------------------|--------------|------------|-------------|
| Net (decrease)                   |              |            |             |
| increase in net assets resulting |              |            |             |
| from operations . . .            | (15,507,207) | 37,081,381 | (2,877,810) |

Changes in net assets from capital stock transactions:

|                         |             |             |             |
|-------------------------|-------------|-------------|-------------|
| Payment of dividend . . | (184,817)   | (3,647,017) | (8,019,728) |
| Purchase of             |             |             |             |
| treasury stock . . . .  | (530,051)   | (2,373,551) | (254,786)   |
| Proceeds from sale      |             |             |             |
| of stock . . . . .      | 0           | 17,283      | 54,099      |
| Deemed dividend         |             |             |             |
| shareholder tax         |             |             |             |
| credit . . . . .        | (5,688,896) | 0           | 0           |
| Additional paid in      |             |             |             |
| capital warrants . . .  | 109,641     | 0           | 0           |
|                         | -----       | -----       | -----       |

|                        |             |             |             |
|------------------------|-------------|-------------|-------------|
| Net decrease in net    |             |             |             |
| assets resulting       |             |             |             |
| from capital stock     |             |             |             |
| transactions . . . . . | (6,294,123) | (6,003,285) | (8,220,415) |
|                        | -----       | -----       | -----       |

|                  |              |            |              |
|------------------|--------------|------------|--------------|
| Net (decrease)   |              |            |              |
| increase in net  |              |            |              |
| assets . . . . . | (21,801,330) | 31,078,096 | (11,098,225) |
|                  | -----        | -----      | -----        |

Net Assets:

|                        |              |              |              |
|------------------------|--------------|--------------|--------------|
| Beginning of the year. | 53,634,805   | 22,556,709   | 33,654,934   |
|                        | -----        | -----        | -----        |
| End of the year. . . . | \$31,833,475 | \$53,634,805 | \$22,556,709 |
|                        | =====        | =====        | =====        |

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

CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF DECEMBER 31, 2000

| Method of     | Shares/   |       |
|---------------|-----------|-------|
| Valuation (3) | Principal | Value |

Investments in Unaffiliated Companies (16)(18)(19) -- 17.2% of total investments

Publicly Traded Portfolio -- 8.4% of total investments

Genomica Corporation (1)  
(2)(6)(7) -- Develops software that enables the study of complex genetic diseases -- 2.94% of fully diluted equity  
Common Stock . . . . . (C) 731,111 \$3,040,679

Kana Communications, Inc.  
(1)(8) -- Provides customer-centric e-business applications and systems  
Common Stock . . . . . (C) 6,791 78,096

SciQuest.com, Inc. (1)(9)  
-- Internet e-commerce source for scientific products  
Common Stock . . . . . (C) 350,000 459,375

Total Publicly Traded Portfolio (cost: \$3,537,817) . . \$3,578,150

Private Placement Portfolio (Illiquid) -- 8.8% of total investments

Essential.com, Inc. (1)(2)  
(10) -- Online energy and communications marketplace - 0.59% of fully diluted equity  
Common Stock . . . . . (B) 169,185 \$2,204,000

Exponential Business Development Company (2)(5)  
-- Venture capital partnership focused on early stage companies  
Limited partnership  
Interest . . . . . (A) - 25,000

Informio, Inc. (1)(2)(4)  
(6)(11) -- Developing audio web portal technology  
Series A Convertible  
Preferred Stock . . . . . (A) - 504,601

Kriton Medical, Inc. (1)  
(2)(5)(6) -- Research and development of medical devices -- 1.86% of fully diluted equity  
Series B Convertible  
Preferred Stock . . . . . (A) 476,191 1,000,001

MedLogic Global Corporation  
(1)(2)(6) -- Medical cyanoacrylate adhesive -- 0.23% of fully diluted equity  
Series B Convertible  
Preferred Stock . . . . . (D) 54,287  
Common Stock . . . . . (D) 25,798 --

Total Private Placement Portfolio (cost: \$3,912,910) . \$3,733,602

Total Investments in Unaffiliated Companies (cost: \$7,450,727) . . . . . \$7,311,752

The accompanying notes are an integral part of this consolidated schedule.

## CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF DECEMBER 31, 2000

| Method of<br>Valuation (3)  | Shares/<br>Principal | Value       |
|---|----------------------|-------------|
| Investments in Non-Controlled Affiliated Companies (16)(19) -- 41.6%<br>of total investments  |                      |             |
| Publicly Traded Portfolio -- 15.6% of total investments   |                      |             |
| Nanophase Technologies<br>Corporation (1)(12) -<br>Manufactures and markets<br>inorganic crystals of<br>nanometric dimensions --<br>4.44% of fully diluted<br>equity        |                      |             |
| Common Stock. . . . .   | (C) 672,916          | \$6,661,868 |
| -----   |                      |             |
| Total Publicly Traded Portfolio (cost: \$1,162,204). . . \$6,661,868  |                      |             |
| -----   |                      |             |
| Private Placement Portfolio (Illiquid) -- 26.0% of total investments  |                      |             |
| Experion Systems, Inc. (1)<br>(2)(4)(6)(13) -- Provides<br>e-business software selling<br>platforms based on trust-<br>based marketing -- 15.35%<br>of fully diluted equity |                      |             |
| Convertible Preferred Stock. (A)  | 187,500              | \$1,500,000 |
| NeuroMetrix, Inc. (1)<br>(2)(6)(15) -- Medical<br>devices for monitoring<br>neuromuscular disorders<br>-- 15.63% of fully diluted<br>equity                                 |                      |             |
| Series A Convertible<br>Preferred Stock. . . . .  | (B) 175,000          |             |
| Series B Convertible<br>Preferred Stock. . . . .  | (B) 125,000          |             |
| Series C-2 Convertible<br>Preferred Stock. . . . .  | (B) 229,620          |             |
| 8% Convertible Note . . . .   | (A) \$750,000        | 6,708,225   |
| PHZ Capital Partners<br>Limited Partnership (2)(14)<br>-- Organizes and manages<br>investment partnerships<br>-- 20.0% of fully diluted<br>equity                           |                      |             |
| Limited partnership<br>Interest . . . . .   | (D) -                | 1,870,013   |
| Questech Corporation (1)<br>(2)(6) -- Manufactures and<br>markets proprietary metal<br>decorative tiles and signs<br>-- 9.87% of fully diluted equity                       |                      |             |
| Common Stock. . . . .   | (B) 646,954          |             |
| Warrants at \$5.00<br>expiring 11/15/04. . . . .  | (A) 1,965            |             |
| Warrants at \$4.00<br>expiring 11/28/01. . . . .  | (A) 152,422          |             |
| Warrants at \$1.50<br>expiring 11/16/05. . . . .  | (A) 1,250            | 970,598     |
| -----   |                      |             |
| Total Private Placement Portfolio (cost: \$7,462,613). \$11,048,836   |                      |             |
| -----   |                      |             |
| Total Investments in Non-Controlled Affiliated  |                      |             |

Companies (cost: \$8,624,817). . . . . \$17,710,704

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 The accompanying notes are an integral part of  
 this consolidated schedule.

CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF DECEMBER 31, 2000

| Method of<br>Valuation (3) | Shares/<br>Principal | Value |
|----------------------------|----------------------|-------|
|----------------------------|----------------------|-------|

Private Placement Portfolio in Controlled Affiliated (16)(19) -- 4.7%  
 of total investments

|  |     |             |
|--|-----|-------------|
| Harris Newco, Inc. (1)<br>(2)(4)(6)(17) -- 100%<br>of fully diluted equity<br>Series A Convertible<br>Preferred Stock. . . . . (A) | 100 | \$2,000,000 |
|--|-----|-------------|

-----  
 Total Private Placement Portfolio in  
 Controlled Affiliates (cost: \$2,000,000). . . . . \$2,000,000

-----  
 U.S. Government and Agency Obligations -- 36.5% of total investments

|  |             |             |
|--|-------------|-------------|
| Federal Home Loan Bank<br>Discount Notes -<br>due date 1/3/01. . . . . (K)               | \$1,800,000 | \$1,799,046 |
| Federal Home Loan Bank<br>Discount Notes -<br>due date 1/5/01. . . . . (K)               | \$2,000,000 | 1,998,240   |
| U.S. Treasury Bill dated<br>7/27/00 due date -<br>1/25/01 - 5.5% yield . . (K)           | \$1,600,000 | 1,593,872   |
| Federal Home Loan Bank<br>Discount Notes -<br>due date 1/24/01 . . . . (K)               | \$ 950,000  | 946,029     |
| Federal Home Loan Bank<br>Discount Notes -<br>due date 02/07/01. . . . (K)               | \$ 400,000  | 397,352     |
| U.S. Treasury Bill dated<br>8/10/00 due date -<br>2/8/01 -- 5.4% yield . . (K)           | \$2,800,000 | 2,783,648   |
| Federal Farm Credit Bank<br>Discount Notes -<br>due date 3/1/01. . . . . (K)             | \$1,000,000 | 989,560     |
| Federal National Mortgage Assn.<br>Bank Discount Notes -<br>due date - 3/8/01. . . . (K) | \$3,300,000 | 3,261,522   |
| Federal Home Loan Bank<br>Discount Notes -<br>due date 3/15/01. . . . (K)                | \$1,800,000 | 1,776,834   |

-----  
 Total Investments in U.S. Government and  
 Agency Obligations (cost: \$15,545,087). . . . . \$15,546,103

-----  
 Total Investments -- 100% (cost: \$33,620,631) . . . . \$42,568,559

-----  
 The accompanying notes are an integral part of  
 this consolidated schedule.

CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF DECEMBER 31, 2000

Notes to Consolidated Schedule of Investments

(1) Represents a non-income producing security. Equity  
 investments that have not paid dividends within the last  
 twelve months are considered to be non-income producing.

- (2) Legal restrictions on sale of investment.
- (3) See Footnote to Schedule of Investments for a description of the Methods of Valuation A to L.
- (4) These investments were made during 2000. Accordingly, the amounts shown on the schedule represent the gross additions in 2000.
- (5) No changes in valuation occurred in these investments during the 12 months ended December 31, 2000.
- (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) In 1996, Genomica Corporation was cofounded by the Company, Cold Spring Harbor Laboratory ("CSHL"), a not-for-profit institution, and Falcon Technology Partners, LP. Mr. G. Morgan Browne serves on the Board of Directors of the Company and is Chief Financial Officer of CSHL. In late 1998, Charles E. Harris, Chairman and CEO of Harris & Harris Group, became a trustee of CSHL. On September 29, 2000, Genomica Corporation (National Market Symbol: GNOM) commenced trading on Nasdaq. The Company's 731,111 shareholding in Genomica Corporation before a discount for the six month lock-up which expires on March 27, 2001 and illiquidity was valued at \$3,861,180. On February 28, 2001 the market price per share of Genomica Corporation was \$5.625.
- (8) On October 5, 1999, Silknet Software, Inc. acquired InSite Marketing Technology, Inc. On April 19, 2000, Kana Communications, Inc. (National Market Symbol: KANA) and Silknet Software completed a merger, in which each share of Silknet Software was exchanged tax free for 1.66 Kana Communications shares. Upon the completion of the merger, 90 percent of the Kana Communications shares became freely tradable, and the Company was subject to a lock-up agreement on the remaining 10 percent of the stock that expired on December 31, 2000. During 2000, the Company sold 90 percent of the Kana Communications shares for proceeds of \$1,504,762. On February 28, 2001, the market price per share of Kana Communications was \$3.06.
- (9) During January 2001, the Company sold all of the shares of SciQuest.com, Inc. that it had acquired in the open market and realized a loss of \$1,258,679.

The accompanying notes are an integral part of this consolidated schedule.

- (10) On June 29, 2000, Sundial Marketplace Corporation was acquired in a tax-free merger by Essential.com, Inc.
- (11) Previously named iPacer Corporation.
- (12) The Company's 672,916 share holding in Nanophase Technologies Corporation (National Market Symbol: NANX) before a discount for illiquidity was valued at \$7,402,076. On February 28, 2001, the market price per share of Nanophase Technologies was \$7.06.
- (13) Previously named MyPersonalAdvocate.com, Inc.
- (14) Harris Partners I L.P. owns a 20 percent limited partnership interest in PHZ Capital Partners L.P. The partners of Harris

Partners I L.P. are Harris & Harris Enterprises, Inc. (sole general partner) and Harris & Harris Group, Inc. (sole limited partner). Harris & Harris Enterprises, Inc. is a 100 percent owned subsidiary of Harris & Harris Group, Inc.

- (15) On February 27, 2001, the Note converted to equity as part of NeuroMetrix's third round venture financing.
- (16) Investments in unaffiliated companies consist of investments in which the Company owns less than five percent of the investee company. Investments in non-controlled affiliated companies consist of investments in which the Company owns more than five percent but less than 25 percent of the investee company. Investments in controlled affiliated companies consist of investments in which the Company owns more than 25 percent of the investee company.
- (17) Currently the Company owns 100 percent of Harris Newco, Inc.
- (18) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is \$7,450,727. The gross unrealized appreciation based on the tax cost for these securities is \$2,422,882. The gross unrealized depreciation based on the tax cost for these securities is \$2,561,857.
- (19) The percentage ownership of each investee company disclosed in the Consolidated Schedule of Investments expresses the potential common equity interest in each such investee. The calculated percentage represents the amount of the issuer's common stock the Company owns or can acquire as a percentage of the issuer's total outstanding common stock plus common shares reserved for issued and outstanding warrants, convertible securities and stock options.

The accompanying notes are an integral part of this consolidated schedule.

## FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS

### ASSET VALUATION POLICY GUIDELINES

The Company's 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 the Company's portfolio to determine 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.

The Company's Board of Directors is responsible for 1) determining overall valuation guidelines and 2) ensuring the valuation of investments within the prescribed guidelines.

The Company's Investment and Valuation Committee is responsible for reviewing and approving the valuation of the

Company's assets within the guidelines 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 the assets of the Company, 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.

Valuation assumes that, in the ordinary course of its business, the Company will eventually sell its investment.

The Company's 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 the original cost to the Company. 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 such events are: (1) a major recapitalization; (2) a major refinancing; (3) a significant third-party transaction; (4) the development of a meaningful public market for the company's common stock; (5) significant positive or negative changes in the company's business.

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B. Private Market: The private market method uses actual third-party transactions in the company's securities as a basis for valuation, using actual, executed, historical transactions in the company's securities 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.

C. Public Market: The public market method is used when there is an established public market for the class of the company's securities held by the Company. The Company discounts market value for securities that are subject to significant legal, contractual or practical restrictions, including large blocks in relation to trading volume. Other securities, for which market quotations are readily available, 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.

D. 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 the Company 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 the Company's Investment and 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 owned by the Company and the nature of any rights to require the company to register restricted securities under applicable securities laws.

#### INVESTMENTS IN INTELLECTUAL PROPERTY OR PATENTS OR 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 the original cost to the Company. Such 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. Private Market: The private market method uses actual third-party investments in 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.

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G. 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 the Company 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 the Company's Investment and 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 and projected markets.

#### 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.

Securities for which market quotations are not readily available are carried at fair value using one or more of the following basic methods of valuation:

I. Fixed-Income Securities are valued by independent pricing services that provide market quotations based primarily on quotations from dealers and brokers, market transactions, and other sources.

J. Other Fixed-Income Securities that are not readily marketable are valued at fair value by the Investment and Valuation Committee.

#### SHORT-TERM FIXED-INCOME INVESTMENTS

K. Short-Term Fixed-Income Investments are valued at market value at the time of valuation. Short-term debt with remaining

maturity of 60 days or less is valued at amortized cost.

## ALL OTHER INVESTMENTS

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

The reported values of securities for which market quotations are not readily available and for other assets reflect the Investment and Valuation Committee's judgment of fair values as of the valuation date using the outlined basic methods of valuation. They do not necessarily represent an amount of money that would be realized if the securities had to be sold in an immediate liquidation. The Company makes many of its portfolio investments with the view of holding them for a number of years, and the reported value of such investments may be considered in terms of disposition over a period of time. Thus valuations as of any particular date are not necessarily indicative of amounts that may ultimately be realized as a result of future sales or other dispositions of investments held.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. THE COMPANY

Harris & Harris Group, Inc. (the "Company") is a venture capital investment company operating as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). A BDC is a specialized type of investment company under the 1940 Act. The Company operates as an internally managed investment company whereby its officers and employees, under the general supervision of its Board of Directors, conduct its operations.

The Company elected to become a BDC on July 26, 1995, after receiving the necessary approvals. From September 30, 1992 until the election of BDC status, the Company operated as a closed-end, non-diversified, investment company under the 1940 Act. Upon commencement of operations as an investment company, the Company revalued all of its assets and liabilities at fair value as defined in the 1940 Act. Prior to such time, the Company was 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 percent wholly owned subsidiary of the Company. Enterprises holds the lease for the office space, which it subleases to the Company and an unaffiliated party; operates a financial relations and consulting firm; 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 owns a 20 percent limited partnership interest in PHZ Capital Partners, L.P. The partners of Harris Partners I L.P. are Enterprises (sole general partner) and Harris & Harris Group, Inc. (sole limited partner).

The Company filed for 1999 to elect treatment as a Regulated Investment Company ("RIC") under Sub-Chapter M of the Internal Revenue Code of 1986 (the "Code") and qualified for the same treatment for 2000. There can be no assurance that the Company will qualify as a RIC in subsequent years or that if it does qualify, it will continue to qualify for subsequent years. In addition, even if the Company were to qualify as a RIC for a given year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than a RIC. As a RIC, the Company must, among other things, distribute at least 90 percent of its taxable

net income and may either distribute or retain its taxable net realized capital gains on investments. (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Sub Chapter M Status.")

## 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 "fair value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. All assets are valued at fair value 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 on specific identification for financial reporting and tax reporting.

**Income Taxes.** Prior to January 1, 1999, the Company 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 difference of which relates to the Company's unrealized appreciation on investments.

The December 31, 2000 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 the Company through December 31, 1998.

These statements also reflect a tax liability on net realized long-term capital gains which the Company intends to retain for liquidity and to fund investment opportunities, rather than distribute to shareholders as a cash distribution. Accordingly, the Company declared a designated undistributed capital gain dividend for the year. (See "Note 6 Income Taxes" and Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operation -- Recent Developments -- Sub-Chapter M Status.")

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

**Reclassifications.** Certain reclassifications have been made to the December 31, 1998 and December 31, 1999 financial statements to conform to the December 31, 2000 presentation.

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 December 31, 2000 and 1999, and the reported amounts of revenues and expenses for the three years ended December 31, 2000. Actual results could differ from these estimates.

#### NOTE 3. EMPLOYEE PROFIT SHARING PLAN

On August 3, 1989, the shareholders of the Company approved the 1988 Long Term Incentive Compensation Plan. The Company's 1988 Plan was cancelled as of December 31, 1997, canceling all outstanding stock options and eliminating all potential stock option grants. As a substitution for the 1988 Stock Option Plan, the Company adopted an employee profit-sharing plan.

As of January 1, 1998, the Company began implementing the Harris & Harris Group, Inc. Employee Profit Sharing Plan (the "1998 Plan") that provides for profit sharing equal to 20 percent of the net realized income of the Company as reflected on the Consolidated Statements of Operations for such year, less the nonqualifying gain, if any. The 1998 Plan was terminated by the Company as of December 31, 1999, subject to the payment of any amounts owed on the 1999 realized gains under the 1998 Plan.

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In March 2000, the Company paid out, under the 1998 Plan, 90 percent of the profit sharing in the amount of \$1,024,696 on the 1999 realized gains; the remaining 10 percent or \$113,855 was paid out in September 2000, upon the completion and filing of the Company's 1999 federal tax return.

As of January 1, 2000, the Company implemented the Harris & Harris Group, Inc. Employee Profit-Sharing Plan (the "Plan") that provides for profit sharing equal to 20 percent of the net realized income of the Company as reflected on the Consolidated Statements of Operations of the Company for such year, less the nonqualifying gain, if any.

Under the Plan, net realized income of the Company includes investment income, realized gains and losses, and operating expenses (including taxes paid or payable by the Company), but is calculated without regard to dividends paid or distributions made to shareholders, payments under the Plan, unrealized gains and losses, and loss carry-overs from other years ("Qualifying Income"). The portion of net after-tax realized gains attributable to asset values as of September 30, 1997 is considered non-qualifying gain, which reduces Qualifying Income.

As soon as practicable following the year-end audit, the Board of Directors will determine whether, and if so how much, Qualifying Income exists for a plan year, and 90 percent of the Qualifying Income will be paid out to Plan participants pursuant to the distribution percentages set forth in the Plan. The remaining 10 percent will be paid out after the Company has filed its federal tax return for that year in which Qualifying Income exists. Currently, the distribution amounts for each officer and employee are as follows: Charles E. Harris, 13.790 percent; Mel P. Melsheimer, 4.233 percent; Rachel M. Pernia, 1.524 percent; and Jacqueline M. Matthews, 0.453 percent. If a participant leaves the Company for other than cause, the amount earned will be accrued and may subsequently be paid to such participant.

Notwithstanding any provisions of the Plan, in no event may the aggregate amount of all awards payable for any Plan year during which the Company remains a "business development company" within the meaning of 1940 Act be greater than 20 percent of the Company's "net income after taxes" within the

meaning of Section 57(n)(1)(B) of the 1940 Act. In the event the awards exceed such amount, the awards will be reduced pro rata.

The Plan may be modified, amended or terminated by the Company's Board of Directors at any time with the stipulation that no such modification, amendment or termination may adversely affect any participant that has not consented to such modification, amendment or termination. Nothing in this Plan shall preclude the Committee from, for any Plan Year subsequent to the current Plan Year, naming additional Participants in the Plan or changing the Award Percentage of any Full Participant or New Participant (subject to the overall percentage limitations contained herein).

The Company calculates the Plan accrual at each quarter end based on the realized and unrealized gains at that date, net of operating expenses and income taxes for the year. Any adjustments to the Plan accrual are then reflected in the Consolidated Statements of Operations for that quarter. The Plan accrual is not paid out until the gains are realized. During 2000, the Company, as a result of a net decrease in the unrealized appreciation, decreased the profit-sharing accrual by \$4,812,675; paid out the 1999 profit sharing in the amount of \$1,138,551, both of which decreased the cumulative accrual under the Plan to \$3,483,241 at December 31, 2000.

The amounts payable under the Plan of approximately \$2,325,071 for the gains realized during the year ended December 31, 2000 will be paid out as follows: 90 percent in February 2001; the remaining 10 percent upon the completion and filing of the Company's 2000 federal tax return.

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On April 26, 2000 the shareholders of the Company approved the performance goals under the Plan in accordance with Section 162(m) of the Code. The Code generally provides that a public company such as the Company 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 any such officer/employee exceeds \$1 million in any tax year, unless the payment is made upon the attainment of objective performance goals that are approved by the Company's shareholders.

#### NOTE 4. CAPITAL TRANSACTIONS

In 1998, the Board of Directors approved that, effective January 1, 1998, 50 percent of all Directors' fees be used to purchase Company common stock from the Company. However, effective on March 1, 1999, the directors may purchase the Company's common stock in the market, rather than from the Company. During 1998 and 1999, the Directors bought directly from the Company 24,491 and 5,816 shares, respectively.

On April 15, 1998, the Company announced that the Board of Directors had approved the purchase of up to 700,000 shares of Company stock in the open market. The Company purchased a total of 401,878 shares in the open market for a total of \$795,529. On July 14, 1999, the Board of Directors announced a tender offer to purchase up to 1,100,000 shares of its common stock for cash at a price equal to \$1.63 per share. A total of 1,080,569 shares were tendered for a total cost, including related expenses of approximately \$71,500, of \$1,832,831. Of these shares, 1,075,269 were tendered by one shareholder, which tendered all of its holdings.

On January 27, 2000, the Company placed privately, with an unaffiliated investor, for \$3 million in cash, a one-year 12 percent note with one-year warrants to purchase 25,263 shares of the Company's common stock at \$11.8750 per share. Unless the note was prepaid, six months after its issuance, the investor would have received additional one-year warrants to purchase an

additional \$300,000 worth of the Company's common stock at the then-current market price. During March 2000, with part of the proceeds from the sale of SciQuest.com stock, the Company prepaid the Note. The Company incurred total interest costs of \$146,141: \$36,500 in interest paid on the note and \$109,641 on warrants.

On October 12, 2000, the Company announced that the Board of Directors had authorized a repurchase program in the open market of up to \$2 million of the Company's stock, at the discretion of management. As of December 31, 2000, the Company had repurchased a total of 176,600 shares in the open market at approximately \$3.00 per share for a total of \$530,051.

Since 1998, as a result of the shares purchased through the tender offer in 1999, including the shares purchased in 2000 in the open market, the Company has purchased a total of 1,659,047 shares for a total of \$3,158,388, including commissions and expenses, at an average price of \$1.90 per share. These treasury shares were reduced by the purchases made by the Directors.

On December 14, 2000, the Company declared a deemed dividend of \$1.78 per share for a total of \$16,253,987 and in 2001 paid federal income taxes on behalf of shareholders of \$0.62 per share for a total of \$5,688,896. The Company paid the tax at the corporate rate on the distribution, and the shareholders received a tax credit equal to their proportionate share of the tax paid.

The net of the total deemed dividend declared (\$16,253,987) and the taxes paid on behalf of shareholders (\$5,688,896) is considered to be reinvested by the shareholders; therefore, during 2000 additional paid in capital has increased by such amount (\$10,565,091).

#### NOTE 5. EMPLOYEE BENEFITS

On October 19, 1999, Charles E. Harris signed an Employment Agreement with the Company (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 the Company or Mr. Harris, by written notice, decides not to extend the Term, in which case the Term will expire five years from the date of the written notice.

During the period of employment, Mr. Harris shall serve as the Chairman and Chief Executive Officer of the Company; be responsible for the general management of the affairs of the Company and all its subsidiaries, reporting directly to the Board of Directors of the Company; 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 President of the Company and as an officer and director of any subsidiary or affiliate of the Company.

Mr. Harris is to receive compensation under his Employment Agreement in the form of base salary of \$208,315 for 2000, 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 the Company's 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, the Company is to 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 disability insurance in the amount of 100 percent of his base salary. These benefits are for the term of the Employment Agreement.

The Employment Agreement provides for the Company to adopt a supplemental executive retirement plan (the "SERP") for the benefit of Mr. Harris. Under the SERP, the Company will cause an amount equal to one-twelfth of the Mr. Harris's current base salary to be credited each month (a "Monthly Credit") to a special account maintained for this purpose on the books of the Company for the benefit of Mr. Harris (the "SERP 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' benefit under the SERP will equal the balance in the SERP Account and such benefit will always be 100 percent 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, 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. The Company will establish a rabbi trust for the purpose of accumulating funds to satisfy the obligations incurred by the Company under the SERP. The restricted funds for the SERP Plan total \$265,183 as of December 31, 2000. Mr. Harris' rights to benefits pursuant to this SERP will be no greater than those of a general creditor of the Company.

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The Employment Agreement provides severance pay in the event of termination without cause or by constructive discharge and also 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 the Company, effective August 15, 1990. The severance compensation agreement provides that if, following a change in control of the Company, as defined in the agreement, such individual's employment is terminated by the Company 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' 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, the Company adopted an employee benefits program covering substantially all employees of the Company under a 401(k) Plan and Trust Agreement. As of January 1, 1999, the Company adopted the Harris & Harris Pension Plan and Trust, a money purchase plan which would allow the Company to stay compliant with the 401(k) top-heavy regulations and deduction limitation regulations. Contributions to the plan are at the discretion of the Company. During 2000, contributions to both plans that have been charged to salaries and benefits totaled approximately \$50,000.

On June 30, 1994, the Company adopted a plan to provide

medical and health insurance for retirees, their spouses and dependents who, at the time of their retirement, have ten years of service with the Company and have attained 50 years of age or have attained 45 years of age and have 15 years of service with the Company. On February 10, 1997, the Company 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. Based upon actuarial estimates, the Company provided an original reserve of \$176,520 that was charged to operations for the period ending June 30, 1994. As of December 31, 2000 the Company had a reserve of \$354,840 for the plan.

#### NOTE 6. INCOME TAXES

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification as a RIC under Sub-Chapter M of the Code. As a RIC, the Company annually must distribute at least 90 percent of its investment company taxable income as a dividend and may either distribute or retain its taxable net capital gains from investments. To initially qualify as a RIC, among other requirements, the Company had to pay a dividend to shareholders equal to the Company's cumulative realized earnings and profits ("E&P"). On April 9, 1998, the Company declared a one-time cash dividend of \$0.75 per share to meet this requirement (for a total of \$8,019,728). The cash dividend was paid on May 12, 1998.

The Company elected Sub-Chapter M status for the year ended December 31, 1999. On February 23, 1999, the Company declared a cash dividend of \$0.35 per share (for a total of \$3,647,017), thereby distributing part of the long-term capital gain generated in 1999 by the sale of NBX Corporation to 3Com Corporation. Approximately \$143,261 of the long-term capital gain for 1999 was not distributed during 1999. Accordingly, on September 20, 2000, the Company declared a \$0.02 dividend (for a total of \$184,817). For the year ended December 31, 1999, the Company incurred approximately \$20,000 in excise taxes.

A 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 from sales of assets that were held by the corporation on the effective date of the election ("C Corporation Assets") to the extent of any gain built into the assets on such date ("Built-In Gain"). On February 17, 1999, the Company received a ruling from the IRS concluding that the Company can carry forward its C Corporation losses to offset any Built-In Gains resulting from sales of its C Corporation Assets. That ruling may enable the Company to retain some or all of the proceeds from such sales without disqualifying itself as a RIC or incurring corporate level income tax, depending on whether the Company's sale of C Corporation Assets with Built-In Gains will generate C Corporation E&P. In general, a RIC is not permitted to have, as of the close of any RIC taxable year, E&P accumulated during any C Corporation taxable year. However, because the realization of Built-In Gains will occur while the Company is a RIC, the Company believes that, under current law and IRS pronouncements, the sale of C Corporation Assets with Built-In Gains during RIC taxable years will not generate C Corporation E&P. In 1999, the Company utilized net operating loss and capital loss carryforwards of approximately \$6.3 million in order to retain most of its long-term capital gain for 1999. The Company had accumulated net ordinary and capital losses of approximately \$7.0 million (resulting in a potential tax credit of approximately \$2.5 million) during its C Corporation taxable years, of which \$0.8 million still remains available for use. The Company intends to use the remaining \$0.8 million loss carryforward (resulting in a potential tax credit of approximately \$0.3 million) to reduce its taxes which are the result of Built-In Gains.

Continued qualification as a RIC requires the Company to satisfy certain portfolio diversification requirements in future years. The Company's ability to satisfy those requirements may not be controllable by the Company. (See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation -- Sub-Chapter M Status.") There can be no assurance that the Company will qualify as a RIC in subsequent years.

To the extent that the Company retains capital gains, and declares a deemed dividend to shareholders, the dividend is taxable to the shareholders. The Company would pay tax, at the corporate rate, on the distribution, and the shareholders would receive a tax credit equal to their proportionate share of the tax paid. The Company took advantage of this rule for 2000. Accordingly, the Company's financial statements for 2000 include a tax liability of \$5,709,884. The taxes paid by the Company's shareholders as a result of its deemed dividend declaration (\$5,688,896) are reflected as a deduction to the additional paid in capital in the Company's Consolidated Statement of Assets and Liabilities rather than an expense in the Consolidated Statement of Operations.

The Company also realized short-term capital gains of approximately \$2,111,865 in 2000 primarily on sales of shares of Alliance Pharmaceutical Corp. The Company believes that by offsetting the realized short-term gain with current year expenses, it will neither owe federal income taxes on this gain, nor be required to distribute any portion of this gain to shareholders.

For the years ended December 31, 2000, 1999 and 1998, the Company's income tax (benefit) expense was allocated as follows:

|   | 2000        | 1999        | 1998        |
|---|-------------|-------------|-------------|
| Investment operations. . . . .                              | \$ 0        | \$ 0        | \$(234,188) |
| Realized gain (loss)  |             |             |             |
| on investments . . . . .                                    | 101,435     | 2,361,044   | 0           |
| Increase in unrealized appreciation on investments. . . . . | (153,304)   | (1,627,074) | 592,986     |
|   | -----       | -----       | -----       |
| Total income tax (benefit) expense. . . . .                 | \$ (51,869) | \$ 733,970  | \$ 358,798  |
|   | =====       | =====       | =====       |

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

|   | 2000       | 1999        | 1998      |
|---|------------|-------------|-----------|
| Current. . . . .                            | \$101,435  | \$2,361,044 | \$ 95,430 |
| Deferred -- Federal. . . . .                | (153,304)  | (1,627,074) | 263,368   |
|   | -----      | -----       | -----     |
| Total income tax (benefit) expense. . . . . | \$(51,869) | \$ 733,970  | \$358,798 |
|   | =====      | =====       | =====     |

The Company's net deferred tax liability at December 31, 2000 and 1999 consists of the following:

|  | 2000        | 1999        |
|--|-------------|-------------|
| Unrealized appreciation on investments. . . . .      | \$1,630,506 | \$1,783,810 |
| Net operating and capital loss carryforward. . . . . | (266,036)   | (266,036)   |
|  | -----       | -----       |
| Net deferred income tax Liability. . . . .           | \$1,364,470 | \$1,517,774 |

=====

NOTE 7. COMMITMENTS AND CONTINGENCIES

During 1993, the Company signed a ten-year lease with sublet provisions for office space. In 1995, this lease was amended to include additional office space. During 1999, the Company sublet this additional space to an unaffiliated party. Rent expense under this lease for the year ended December 31, 2000 was \$178,561. Future minimum lease payments in each of the following years are: 2001 -- \$178,561; 2002 -- \$178,561; 2003 -- \$101,946.

The Company had a total of \$1,475,276 of funds in escrow as of December 31, 1999 as a result of the sale of NBX Corporation to 3Com Corporation. These funds were in a one-year interest-bearing escrow account for the benefit of the Company, subject to any 3Com Corporation warranty claims associated with its acquisition of NBX Corporation. The Company set up a reserve of 10 percent for any potential claims, therefore the funds in escrow reflected \$1,327,748 net of the reserve of \$147,528. The Company received the full escrow monies including interest of \$65,860 for a total of \$1,541,136 on March 6, 2000, and accordingly realized the \$147,528 in 2000.

NOTE 8. SUBSEQUENT EVENTS

During January 2001, the Company sold all of the shares of SciQuest.com, Inc. that it had acquired in the open market and realized a loss of \$1,258,679.

On January 26, 2001, the Company announced that it had invested \$750,000 in a Series B Convertible Preferred security for approximately a 10 percent fully diluted equity interest in Schwoo, Inc. Schwoo is a privately held Pittsburgh-based corporation. The company is developing software that automatically manages e-commerce security infrastructure. The Schwoo system is designed to operate on an integrated basis across network, host and application layers to defend systems from security attacks.

On February 28, 2001, the Company noted that it had converted its NeuroMetrix Note in the amount of \$750,000 to equity as part of NeuroMetrix's \$13 million third round venture financing.

SELECTED PER SHARE DATA AND RATIOS

Per share operating performance:

| Year Ended Dec. 31, 2000 | Year Ended Dec. 31, 1999 | Year Ended Dec. 31, 1998 | Year Ended Dec. 31, 1997 | Year Ended Dec. 31, 1996 |
|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
|                          |                          |                          |                          |                          |

|  |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|
| Net asset value, beginning of period . . . | \$ 5.80 | \$ 2.13 | \$ 3.15 | \$ 3.44 | \$ 3.54 |
|--|---------|---------|---------|---------|---------|

|   |      |        |        |        |        |
|---|------|--------|--------|--------|--------|
| Net operating income (loss) . . .       | 0.37 | (1.04) | (0.26) | (0.14) | (0.12) |
| Net realized gain (loss) on investments | 2.09 | 0.93   | (0.16) | (0.19) | (0.24) |
| Net (decrease) increase in              |      |        |        |        |        |

|   |        |        |        |        |        |
|---|--------|--------|--------|--------|--------|
| unrealized appreciation as a result of sales. . .                             | (2.35) | (0.46) | 0.11   | (0.17) | 0.16   |
| Net decrease (increase) in unrealized appreciation on investments held. . . . | (1.82) | 4.58   | 0.05   | 0.26   | 0.13   |
| Net decrease as a result of cash dividend. . .                                | (0.02) | (0.35) | (0.75) | 0.0    | 0.0    |
| Net decrease as a result of deemed dividend. . .                              | (0.62) | 0.00   | 0.00   | 0.00   | 0.00   |
| Net increase (decrease) from capital stock transactions.                      | 0.06   | 0.01   | (0.01) | (0.05) | (0.03) |

|   |      |         |         |         |         |
|---|------|---------|---------|---------|---------|
| Net asset value, end of period*. . . \$ | 3.51 | \$ 5.80 | \$ 2.13 | \$ 3.15 | \$ 3.44 |
|---|------|---------|---------|---------|---------|

|                                       |      |         |         |         |         |
|---------------------------------------|------|---------|---------|---------|---------|
| Cash dividends paid per share. . . \$ | 0.02 | \$ 0.35 | \$ 0.75 | \$ 0.00 | \$ 0.00 |
|---------------------------------------|------|---------|---------|---------|---------|

|                               |      |         |         |         |         |
|-------------------------------|------|---------|---------|---------|---------|
| Deemed dividend per share. \$ | 1.78 | \$ 0.00 | \$ 0.00 | \$ 0.00 | \$ 0.00 |
|-------------------------------|------|---------|---------|---------|---------|

|   |        |          |         |         |         |
|---|--------|----------|---------|---------|---------|
| Market value per share, end of period. \$ | 2.4375 | \$ 11.50 | \$ 1.50 | \$ 3.50 | \$ 3.75 |
|---|--------|----------|---------|---------|---------|

|  |      |         |         |         |         |
|--|------|---------|---------|---------|---------|
| Total income tax liability per share. \$ | 0.78 | \$ 0.16 | \$ 0.09 | \$ 0.06 | \$ 0.21 |
|--|------|---------|---------|---------|---------|

|  |       |        |       |      |      |
|--|-------|--------|-------|------|------|
| Ratio of expenses to average net assets. . . | 6.21% | 34.08% | 10.9% | 9.1% | 8.1% |
|--|-------|--------|-------|------|------|

|   |       |         |         |        |        |
|---|-------|---------|---------|--------|--------|
| Ratio of net operating gain (loss) to average net assets. . . | 52.7% | (3.50)% | (10.4)% | (4.5)% | (3.5)% |
|---|-------|---------|---------|--------|--------|

|                             |         |         |        |         |        |
|-----------------------------|---------|---------|--------|---------|--------|
| Investment return based on: |         |         |        |         |        |
| Stock price. (78.8)%        | 666.7%  | (45.5)% | (6.7)% | (52.4)% |        |
| Net asset Value. . . .      | (39.5)% | 188.7%  | (8.3)% | (8.4)%  | (2.8)% |

|                         |        |        |        |       |       |
|-------------------------|--------|--------|--------|-------|-------|
| Portfolio Turnover. . . | 20.56% | 53.54% | 19.71% | 77.2% | 51.3% |
|-------------------------|--------|--------|--------|-------|-------|

|                               |            |              |              |              |              |
|-------------------------------|------------|--------------|--------------|--------------|--------------|
| Net assets, end of period. \$ | 31,833,475 | \$53,634,805 | \$22,556,709 | \$33,654,934 | \$35,932,603 |
|-------------------------------|------------|--------------|--------------|--------------|--------------|

Number of  
shares  
outstanding 9,064,231 9,240,831 10,591,232 10,692,971 10,442,682

\*Reflects the decline in net asset value as a result of the \$0.02 dividend paid in 2000, the \$0.35 dividend paid in 1999 and the \$0.75 dividend paid in 1998.

The accompanying notes are an integral part of this schedule.

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#### Item 9. Disagreements on Accounting and Financial Disclosure

None.

### PART III

#### Item 10. Directors and Executive Officers of the Company

The information set forth under the captions "Election of Directors" on page 2, "Executive Officers" on page 9 and "Section 16(a) Beneficial Ownership Reporting Compliance" on page 15 in the Company's Proxy Statement for Annual Meeting of Shareholders to be held April 24, 2001, filed pursuant to Regulation 14A under the Securities Exchange Act of 1934 on or about March 26, 2001 (the "2001 Proxy Statement") is herein incorporated by reference.

#### Item 11. Executive Compensation

The information set forth under the captions "Summary Compensation Table" on pages 9 and 10 and "Compensation of Directors" on page 14 in the 2001 Proxy Statement is herein incorporated by reference.

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

The information set forth under the caption "Security Ownership of Directors and Executive Officers and other principal holders of the Company's voting securities" on page 7 in the 2001 Proxy Statement is herein incorporated by reference.

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

There were no relationships or transactions within the meaning of this item during the year ended December 31, 2000.

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### PART IV

#### Item 14. Exhibits, Consolidated Financial Statements, Schedules and Reports on Form 8-K

(a) The following documents are filed as a part of this report:

(1) The following Consolidated Financial Statements of the Company are set forth under Item 8:

Consolidated Statements of Assets and Liabilities as of  
December 31, 2000 and 1999  
Consolidated Statements of Operations for the years ended  
December 31, 2000, 1999 and 1998  
Consolidated Statements of Cash Flows for the years ended

December 31, 2000, 1999 and 1998  
Consolidated Statements of Changes in Net Assets for the  
years ended December 31, 2000, 1999 and 1998  
Consolidated Schedule of Investments as of December 31, 2000  
Footnote to Consolidated Schedule of Investments  
Notes to Consolidated Financial Statements  
Selected Per Share Data and Ratios for the years ended  
December 31, 2000, 1999, 1998, 1997 and 1996

- (2) Report of Independent Public Accountant.
- (3) The following exhibits are filed with this report or are incorporated herein by reference to a prior filing, in accordance with Rule 12b-32 under the Securities Exchange Act of 1934. (Asterisk denotes exhibits filed with this report.)
- 3.1(a) Restated Certificate of Incorporation of the Company, as amended, incorporated by reference to Exhibit 3.1 (a) to the Company's Form 10-K for the year ended December 31, 1995.
- 3.1(b) Restated By-laws of the Company, incorporated by reference to Exhibit 3.1(b) to the Company's Form 10-K for the year ended December 31, 1995 and the Company's Form 10-Q for the quarter ended September 30, 1998.
- 4.1 Specimen certificate of common stock certificate, incorporated by reference to Exhibit 4 to Company's Registration Statement on Form N-2 filed October 29, 1992.
- 9.1 Harris & Harris Group, Inc. Custodian Agreement with JP Morgan, incorporated by reference to Exhibit 9.1 to the Company's Form 10-K for the year ended December 31, 1995.
- 10.5 Severance Compensation Agreement by and between the Company and Charles E. Harris dated August 15, 1990, incorporated by reference as exhibit 10 (s) to the Company's Annual Report on Form 10-K for the year ended December 31, 1990.
- 10.13 Stock Purchase Agreement, Standstill Agreement and Termination and Release by and among Harris & Harris Group, Inc. and American Bankers Life Assurance Company of Florida dated May 18, 1995, incorporated by reference as Exhibit 10.13 to the Company's Form 10-K for the year ended December 31, 1995.
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- 10.14 Form of Indemnification Agreement which has been established with all directors and executive officers of the Company, incorporated by reference as Exhibit 10.14 to the Company's Form 10-K for the year ended December 31, 1995.
- 10.16 Demand Promissory Note, Corporate Certificate-Borrowing, Statement of Purpose for an Extension of Credit Secured by Margin Stock by and among Harris & Harris Group, Inc. and J.P. Morgan incorporated by reference as Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 1997.
- 10.17 Harris & Harris Group, Inc. Employee Profit Sharing Plan, incorporated by reference as Exhibit (c) to the Company's Form 8-K filed June 15, 1998.
- 10.18 Employment Agreement Between Harris & Harris Group, Inc. and Charles E. Harris, dated October 19, 1999, incorporated by reference as Exhibit (C) to the Company's Form 8-K filed on October 27, 1999.

- 10.19 Deferred Compensation Agreement Between Harris & Harris Group, Inc. and Charles E. Harris, incorporated by reference as Exhibit 10.19 to the Company's Form 10-K for the year ended December 31, 1999.
- 10.20 Trust Under Harris & Harris Group, Inc. Deferred Compensation Agreement, incorporated by reference as Exhibit 10.20 to the Company's Form 10-K for the year ended December 31, 1999.
- 10.21 Note due January 26, 2001; Form of Warrant to Purchase 25,263 Shares of Harris & Harris Group, Inc. common stock, incorporated by reference as Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 1999.
- 10.22 Harris & Harris Group, Inc. Employee Profit-Sharing Plan, incorporated by reference as Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 1999.
- 10.23\* Harris & Harris Group, Inc. Directors Stock Purchase Plan 2001.
- 11.0\* Computation of Per Share Earnings is set forth under Item 8.
- 23\* Consent of Arthur Andersen LLP.

(b) Reports on Form 8-K. None

\*Exhibits attached.

SIGNATURES

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

HARRIS & HARRIS GROUP, INC.

By: /s/ Charles E. Harris

-----

Date: March 20, 2001                      Charles E. Harris  
 Chairman of the Board

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

| Signatures                     | Title                               | Date           |
|--------------------------------|-------------------------------------|----------------|
| /s/ Charles E. Harris<br>----- | Chairman of the Board and Chief     | March 20, 2001 |
| Charles E. Harris              | Executive Officer                   |                |
| /s/ Mel P. Melsheimer<br>----- | President, Chief Operating Officer, | March 20, 2001 |

Mel P. Melsheimer Chief Financial Officer  
and Chief Compliance Officer

/s/ Rachel M. Pernia Vice President, March 20, 2001  
-----  
Controller, Treasurer  
Rachel M. Pernia and Principal  
Accounting Officer

/s/ C. Wayne Bardin Director March 19, 2001  
-----  
C. Wayne Bardin

/s/ Phillip A. Bauman Director March 17, 2001  
-----  
Phillip A. Bauman

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/s/ G. Morgan Browne Director March 16, 2001  
-----  
G. Morgan Browne

/s/ Harry E. Ekblom Director March 17, 2001  
-----  
Harry E. Ekblom

/s/ Dugald A. Fletcher Director March 17, 2001  
-----  
Dugald A. Fletcher

/s/ Glenn E. Mayer Director March 15, 2001  
-----  
Glenn E. Mayer

/s/ James E. Roberts Director March 21, 2001  
-----  
James E. Roberts

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## EXHIBIT INDEX

The following exhibits are filed with this report in accordance with Rule 12b-32 under the Securities Exchange Act of 1934.

### Exhibit No. Description

10.23 Harris & Harris Group, Inc. Directors Stock Purchase Plan  
2001

11.0 Computation of Per Share Earnings is set forth under Item  
8.

23 Consent of Arthur Andersen LLP.

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HARRIS & HARRIS GROUP, INC.

DIRECTORS STOCK PURCHASE PLAN 2001

The Board of Directors of Harris & Harris Group, Inc (the "Company") has adopted this Director Stock Purchase Plan 2001 (the "Plan") to enable individuals who serve as directors of the Company (the "Directors"), through the retention by the Company of fees paid to such Directors for services as directors, to purchase shares of the Company's common stock, \$0.01 par value per share (the "Common Stock"). The purpose of the Plan is to benefit the Company's growth and success and enabling the Company to continue to attract highly qualified persons to serve as Directors. The provisions of the Plan are set forth below.

1. Shares Subject to the Plan.

All shares purchased pursuant to the Plan will be purchased in the open market on behalf of each Director. A brokerage account will be established for each Director at Investec Ernst & Co. (the "Broker") or another brokerage firm to be approved by the Board at a later date.

2. Administration.

The Plan shall be administered by the Board. The Board's actions under the Plan shall be limited to taking all actions authorized by this Plan or as otherwise reasonably necessary to effect the purposes hereof.

3. Interpretation.

Subject to the express provisions of the Plan, the Board shall have authority to interpret the Plan, to prescribe, amend and rescind rules relating to it, and to make all other determinations necessary or advisable in administering the Plan, all of which determinations will be final and binding upon all persons.

4. Eligibility to Participate.

The only persons eligible in the Plan shall be Directors of the Company. All Directors are required to participate in the Plan during their respective terms as members of the Board.

5. Fee Retention.

From and after the effective date of the Plan, each Director shall have an amount equal to fifty percent (50%) of eligible fees payable to such Director retained by the Company at the time such eligible fee is due to be paid. For purposes of this Plan, "eligible fees" includes each Director's monthly retainer and Board meeting fees, which the Director is entitled to receive from the Company for his or her service as a Director. Such retained amounts will be credited to the Director's account under the Plan. Once a Director's account accumulates a minimum amount of two thousand five hundred dollars (\$2,500) in value, the Broker will purchase the Common Stock of the Company in an open market transaction on behalf of the Director. A Director may not contribute amounts to purchase Common Stock under the Plan other than through fee retentions.

For the Directors who currently have a credit balance, the brokerage account will be funded once the credit balance has been completely offset by fifty percent (50%) of a Director's eligible fees. For purposes of this Plan, "credit balance" is defined as any Common Stock purchases made by a Director or on a Director's behalf (i) in excess of his or her year 2000 Common Stock purchase obligation, and (ii) prior to the date of Board approval of this Plan.

Effective upon the date of approval of this Plan by the Board, any Company stock purchases made directly by any Directors cannot be applied to the 50 percent stock purchase commitment unless it is to satisfy their year 2000 Common Stock purchase obligation.

Subject to compliance with Section 16 of the Securities Exchange Act of 1934 which may affect a Director's ability to sell or purchase shares of the Common Stock (See Section 11 of the Plan below), Directors may sell, transfer or assign their shares of Common Stock under the Plan at any time and for any reason after the shares of Common Stock have been purchased for their account pursuant to the Plan.

6. Purchase Price.

The purchase price of each share of Common Stock will be the fair market value. For purpose of this Plan, "fair market value" means, if the Common Stock is listed on an established national or regional exchange, is admitted to quotation on the New York Stock Exchange or the National Association of Securities Dealers Automated Quotation System, or is publicly traded in an established securities market, the current quoted price on such exchange at the time the Brokers purchase order is executed on behalf of the Director, less any applicable brokerage commissions.

7. No Right to Continued Membership on the Board.

Neither the Plan nor any right to purchase Common Stock under the Plan confers upon any Director any right to continued membership on the Board, nor will a Director's participation in the Plan create any obligation on the part of the Board to nominate any Director for re-election by the Company's stockholders.

8. Amendment of Plan.

Unless otherwise required by law, the Board may, at any time, amend the Plan in any respect.

9. Assignment.

No participating Director may assign his or her rights to purchase shares of Common Stock under the Plan, whether voluntarily, by operation of law or otherwise. Any payment of cash or issuance of shares of Common Stock under the Plan may be made only to the participating Director (or in the event of the Director's death, to the Director's estate).

10. Rule 10b5-1.

Transactions under this Plan are intended to comply with all applicable conditions of Rule 10b5-1 or any successor provision under the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 10b5-1's provisions define when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. If any provision of the Plan or action by the Board fails to so comply, it shall be deemed null and void to the extent permitted by law and advisable by the Board.

11. Section 16 of the Exchange Act.

Purchases and sales made by Directors of Common Stock acquired through the Plan will not be considered to be exempt transactions under Rule 16b-3 under the Exchange Act and will be subject to the reporting, matching and short-swing profit provisions of Section 16 of the Exchange Act and the Rules promulgated thereunder.

12. Effective Date; Term and Termination of the Plan.

The Plan shall be effective as of the date of adoption by the Board, which date is set forth below. The Board may terminate the Plan at any time for any reason or for no reason, provided that such termination shall not impair any rights of participating Directors.

13. Payment of Plan Expenses.

The Company will bear all costs of administering and carrying out the Plan, excluding any brokerage commissions payable.

This Plan was duly adopted and approved by the Board of Directors of the Company by resolution at a meeting held on the 1st of March, 2001.

/s/ Rachel M. Pernia

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Rachel M. Pernia  
Secretary of  
Harris & Harris Group, Inc.

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to use of our report dated February 28, 2001 included in this Form 10-K. It should be noted that we have not audited any financial statements of the company subsequent to December 31, 2000 or performed any audit procedures subsequent to the date of our report.

/s/ Arthur Andersen LLP

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Arthur Andersen LLP

New York, New York  
March 21, 2001