

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

Form 10-Q

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

For quarterly period ended March 31, 2002

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-11576

HARRIS & HARRIS GROUP, INC.

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

New York 13-3119827

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

One Rockefeller Plaza, Rockefeller Center, New York, New York 10020

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

(212) 332-3600

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

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

Yes  No

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

Class	Outstanding at May 4, 2002
-----	-----
Common Stock, \$0.01 par value per share	8,864,231 shares

Harris & Harris Group, Inc.  
Form 10-Q, March 31, 2002

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Harris & Harris Group, Inc.  
Form 10-Q, March 31, 2002

## PART I. FINANCIAL INFORMATION

### Item 1. Consolidated Financial Statements

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

On June 30, 1994, shareholders of Harris & Harris Group, Inc. (the "Company") approved a proposal to allow the Company to make an election to become a Business Development Company ("BDC") under the amended Investment Company Act of 1940. The Company made such election on July 26, 1995. Certain information and disclosures normally included in the consolidated financial statements in accordance with Generally Accepted Accounting Principles have been condensed or omitted as permitted by Regulation S-X and Regulation S-K. It is suggested that the accompanying consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2001 contained in the Company's 2001 Annual Report.

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 Securities and Exchange Commission ("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 March 7, 2002, the Company received SEC certification and qualified for RIC treatment for 2001 (as it had for 2000 and 1999). Although the SEC certification for 2001 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.

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## CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

### ASSETS

March 31, 2002    December 31, 2001  
(Unaudited) (Audited)

Investments, at value (Cost: \$33,316,719 at 3/31/02, \$37,714,285 at 12/31/01).....	\$ 33,975,983	\$ 38,930,705
Cash and cash equivalents.....	312,025	135,135
Restricted funds (Note 5).....	554,967	482,020
Interest receivable.....	0	82
Note receivable (\$10,487, net of reserve of \$10,487).....	0	10,487
Prepaid expenses.....	71,117	14,833
Other assets.....	91,478	109,105
Total assets.....	<u>\$ 35,005,570</u>	<u>\$ 39,682,367</u>

### LIABILITIES & NET ASSETS

Accounts payable and accrued liabilities.....	\$ 1,029,753	\$ 1,039,350
Bank loan payable (Note 8).....	8,996,740	12,495,777
Accrued profit sharing (Note 3).....	306,241	178,282
Deferred rent.....	12,337	14,650
Current income tax receivable (Note 6).....	(1,807)	255,068
Deferred income tax liability (Note 6).....	1,364,470	1,364,470
Total liabilities.....	<u>11,707,734</u>	<u>11,509,948</u>
Commitments and contingencies (Note 7)		
Net assets.....	<u>\$ 23,297,836</u>	<u>\$ 24,334,770</u>

Net assets are comprised of:  
Preferred stock, \$0.10 par value,  
2,000,000 shares authorized;

none issued.....	\$ 0	\$ 0
Common stock, \$0.01 par value, 25,000,000 shares authorized; 10,692,971 issued at 3/31/02 and 12/31/01.....	106,930	106,930
Additional paid in capital (Note 4).	27,228,748	27,228,748
Additional paid in capital - common stock warrants.....	109,641	109,641
Accumulated net realized gain (loss).....	138,829	618,606
Accumulated unrealized appreciation of investments, net of deferred tax liability of \$1,540,044 at 3/31/02 and 12/31/01.....	(880,781)	(323,624)
Treasury stock at cost (1,828,740 shares at 3/31/02 and 12/31/01)...	(3,405,531)	(3,405,531)
Net assets.....	<u>\$ 23,297,836</u>	<u>\$ 24,334,770</u>
Shares outstanding.....	<u>8,864,231</u>	<u>8,864,231</u>
Net asset value per outstanding share.....	<u>\$ 2.63</u>	<u>\$ 2.75</u>

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

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#### CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

Three Months Ended Three Months Ended  
March 31, 2002 March 31, 2001

Investment income:		
Interest from:		
Unaffiliated issuers.....	\$ 54,136	\$ 152,530
Affiliated companies.....	0	9,617
Other income.....	5,326	29,812
Total investment income.....	<u>59,462</u>	<u>191,959</u>
Expenses:		
Profit-sharing accrual (reversal) (Note 3).....	127,959	(846,290)
Salaries and benefits.....	255,376	299,704
Administration and operations.....	87,902	93,256
Professional fees.....	43,095	59,203
Rent.....	42,724	42,073
Directors' fees and expenses.....	41,076	22,990
Depreciation.....	5,948	7,500
Custodian fees.....	3,839	3,646
Interest expense (Note 4).....	7,776	0
Total expenses.....	<u>615,695</u>	<u>(317,918)</u>
Operating (loss) income before income taxes.....	(556,233)	509,877
Income tax provision (Note 6).....	0	0
Net operating (loss) income.....	<u>(556,233)</u>	<u>509,877</u>
Net realized gain (loss) on investments:		
Realized gain (loss) on investments.....	110,679	(1,194,652)
Total realized gain (loss).....	<u>110,679</u>	<u>(1,194,652)</u>
Income tax provision (Note 6).....	(34,223)	(29,634)

Net realized gain (loss) on investments.....	76,456	(1,224,286)
Net realized loss.....	(479,777)	(714,409)
Net decrease in unrealized appreciation on investments:		
Decrease as a result of		
investment sales.....	0	0
Increase as a result of		
investment sales.....	0	1,528,082
Increase on investments held.....	45,006	0
Decrease on investments held.....	(602,163)	(4,611,013)
Change in unrealized appreciation on investments.....		
on investments.....	(557,157)	(3,082,931)
Income tax provision (Note 6).....	0	0
Net decrease in unrealized appreciation on investments.....		
on investments.....	(557,157)	(3,082,931)
Net decrease in net assets resulting from operations:		
Total.....	\$ (1,036,934)	\$ (3,797,340)
Per outstanding share.....	\$ (0.12)	\$ (0.42)

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

Three Months Ended Three Months Ended  
March 31, 2002 March 31, 2001

Cash flows from operating activities:

Net decrease in net assets resulting from operations.....\$ (1,036,934) \$(3,797,340)

Adjustments to reconcile net decrease in net assets resulting from operations to net cash used in operating activities:

Net realized and unrealized loss on investments..... 442,349 4,277,583  
Depreciation..... 5,948 7,500

Changes in assets and liabilities:

Restricted funds..... (72,947) (65,919)  
Interest receivable..... 82 30,000  
Note receivable..... 10,487 0  
Prepaid expenses..... (56,284) 20,371  
Other assets..... 17,627 (18,417)  
Accounts payable and accrued liabilities..... (9,597) 6,670  
Payable to broker for unsettled trade..... 0 (115,005)  
Accrued profit sharing..... 127,959 (2,938,855)  
Current income tax liability..... (256,875) (5,682,250)  
Deferred rent..... (2,313) (2,313)

Net cash used in operating activities..... (830,498) (8,277,975)

Cash flows from investing activities:

Net (purchase) sale of short-term investments and marketable securities.....	6,753,035	8,895,704
Proceeds from investments.....	180,211	0
Investment in private placements and loans.....	(2,425,000)	(750,000)
Purchase of fixed assets.....	(1,821)	(2,609)
	-----	-----
Net cash provided by investing activities.....	4,506,425	8,143,095
Cash flows from financing activities:		
Payment of bank loan payable.....	(3,499,037)	0
	-----	-----
Net cash used in financing activities.....	(3,499,037)	0
Net increase (decrease) in cash and cash equivalents:		
Cash and cash equivalents at beginning of the period.....	135,135	253,324
Cash and cash equivalents at end of the period.....	312,025	118,444
	-----	-----
Net increase (decrease) in cash and cash equivalents.....	\$ 176,890	\$ (134,880)
	=====	=====
Supplemental disclosures of cash flow information:		
Income taxes paid.....	\$ 290,748	\$ 5,711,884
Interest paid.....	\$ 11,108	\$ 0

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

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CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS  
(Unaudited)

Three Months Ended Three Months Ended  
March 31, 2002 March 31, 2001

Changes in net assets from operations:		
Net operating (loss) income.....	\$ (556,233)	\$ 509,877
Net realized gain (loss) on investments.....	76,456	(1,224,286)
Net increase in unrealized appreciation on investments as a result of sales.....	0	1,528,082
Net decrease in unrealized appreciation on investments held..	(557,157)	(4,611,013)
	-----	-----
Net decrease in net assets resulting from operations.....	(1,036,934)	(3,797,340)
Net decrease in net assets.....	(1,036,934)	(3,797,340)
	-----	-----
Net assets:		
Beginning of the period.....	24,334,770	31,833,475
	-----	-----
End of the period.....	\$23,297,836	\$ 28,036,135
	=====	=====

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

CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF MARCH 31, 2002  
(Unaudited)

Method of Valuation (3)	Shares/ Principal	Value
Investments in Unaffiliated Companies (10)(11)(12) -- 9.7% of total investments		
Private Placement Portfolio (Illiquid) - 9.7% of total investments		
AlphaSimplex Group, LLC (2) -- Investment advisory firm headed by Dr. Andrew W. Lo, holder of the Harris & Harris Group Chair at MIT.....(D)		
	--	\$ 4,763
Exponential Business Development Company (1)(2)(5) -- Venture capital partnership focused on early stage companies Limited partnership interest.....(A)		
	--	25,000
Informio, Inc. (1)(2)(5)(6)(7) -- Develops audio web portal technology -- 0.86% of fully diluted equity Series A Convertible Preferred Stock.....(D)		
	229,364	151,380
Kriton Medical, Inc. (1)(2)(5)(6) -- Develops ventricular assist devices -- 1.83% of fully diluted equity Series B Convertible Preferred Stock.....(A)		
	476,191	1,000,001
NanoOpto Corporation (1)(2)(4)(6) -- Develops and manufactures high performance, integrated optical communication sub-components on a chip -- 1.45% of fully diluted equity Series A-1 Convertible Preferred Stock.....(A)		
	267,857	625,000
Nantero, Inc. (1)(2)(5)(6) -- Develops a high density nonvolatile random access memory chip using nanotechnology -- 4.18% of fully diluted equity Series A Convertible Preferred Stock.....(A)		
	345,070	489,999
NeoPhotonics Corporation (1)(2)(4)(6) -- Develops and manufactures planar optical devices and components using nanomaterials deposition technology -- 2.27% of fully diluted equity Series D Convertible Preferred Stock.....(A)		
	1,478,197	1,000,000
Total Private Placement Portfolio (cost: \$3,648,509).....\$3,296,143		
	-----	

Total Investments in Unaffiliated Companies  
(cost: \$3,648,509).....\$3,296,143

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

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CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF MARCH 31, 2002  
(Unaudited)

Method of Valuation (3)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies (10)(11)(13)		
- -- 34.2% of total investments		
Private Placement Portfolio (Illiquid) - 34.2% of total investments		
Experion Systems, Inc. (1)(2)(6)(8)		
-- Develops and sells software to credit unions -- 10.86% of fully diluted equity		
Series A Convertible Preferred Stock.....(D)	187,500	
Series B Convertible Preferred Stock.....(D)	22,500	\$ 600,000
Nanopharma Corp. (1)(2)(4)(6) --		
Develops advanced drug delivery systems - 14.69% of fully diluted equity		
Series A Convertible Preferred Stock.....(A)	684,516	700,000
NeuroMetrix, Inc. (1)(2)(5)(6) --		
Develops and sells medical devices for monitoring neuromuscular disorders -- 13.40% of fully diluted equity		
Series A Convertible Preferred Stock.....(D)	875,000	
Series B Convertible Preferred Stock.....(D)	625,000	
Series C-2 Convertible Preferred Stock.....(D)	1,148,100	
Series E Convertible Preferred.....(D)	266,665	6,708,225
PHZ Capital Partners Limited		
Partnership (2)(9) -- Organizes and manages investment partnerships utilizing its proprietary algorithms -- 20.0% of fully diluted equity		
Limited partnership interest.....(D)	--	2,892,498
Questech Corporation (1)(2)(5)(6) --		
Manufactures and markets proprietary metal decorative tiles - 6.89% of fully diluted equity		
Common Stock.....(B)	646,954	
Warrants at \$5.00 expiring 11/15/04..(B)	1,965	
Warrants at \$1.50 expiring 11/16/05..(B)	1,250	724,588
Schwoo, Inc. (1)(2)(5)(6) -- Develops software that automatically manages e-commerce security infrastructure -- 14.88% of fully diluted equity		
Series B Convertible Stock.....(D)	2,306,194	
Convertible Bridge Loans.....(D)	\$360,250	
Series B Convertible Preferred Warrants.....(D)	934,985	0



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Total Private Placement Portfolio (cost: \$10,612,494).....\$11,625,311

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Total Investments in Non-Controlled Affiliated  
Companies (cost: \$10,612,494).....\$11,625,311  
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The accompanying notes are an integral part  
of this consolidated schedule.

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CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF MARCH 31, 2002  
(Unaudited)

Method of Valuation (3)	Shares/ Principal	Value
U.S. Government and Agency Obligations - 56.1% of total investments		
U.S. Treasury Bills -- due date 04/04/02.....(K)	\$9,000,000	\$ 8,998,740
U.S. Treasury Bills -- due date 04/11/02.....(K)	\$2,000,000	\$ 1,999,060
U.S. Treasury Bills -- due date 04/18/02.....(K)	\$1,400,000	\$ 1,398,866
U.S. Treasury Bills -- due date 05/09/02.....(K)	\$2,875,000	\$ 2,869,825
U.S. Treasury Bills -- due date 05/23/02.....(K)	\$2,000,000	\$ 1,995,040
U.S. Treasury Bills -- due date 06/20/02.....(K)	\$1,800,000	\$ 1,792,998
-----		
Total Investments in U.S. Government (cost: \$19,055,716).....		\$19,054,529
-----		
Total Investments -- 100% (cost: \$33,316,719).....		<u><u>\$33,975,983</u></u>

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

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CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF MARCH 31, 2002  
(Unaudited)

Notes to Consolidated Schedule of Investments

- (1) Represents a non-income producing security. Equity investments that have not paid dividends within the last 12 months are considered to be non-income producing.
- (2) Legal restrictions on sale of investment.
- (3) See Footnote to Schedule of Investments for a description of the Methods of Valuation A to L.
- (4) Initial investment was made during 2002. The amounts shown on the schedule as cost represent the gross additions in 2002.
- (5) No changes in valuation occurred in these investments during the three months ended March 31, 2002.
- (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) Previously named iPacer Corporation.
- (8) Previously named MyPersonalAdvocate.com, Inc.
- (9) 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.
- (10) Investments in unaffiliated companies consist of investments in which the Company owns less than five percent of the portfolio 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 portfolio company. Investments in controlled affiliated companies consist of investments in which the Company owns more than 25 percent of the portfolio company.
- (11) The percentage ownership of each portfolio company disclosed in the Consolidated Schedule of Investments expresses the potential common equity interest in each such portfolio company. 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.
- (12) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is \$3,648,509. The gross unrealized depreciation based on the tax cost for these securities is \$353,221. The gross unrealized appreciation based on the tax cost for these securities is \$855.
- (13) The aggregate cost for federal income tax purposes of investments in non-controlled affiliated companies is \$10,612,494. The gross unrealized depreciation based on the tax cost for these securities is \$4,767,268. The gross unrealized appreciation based on the tax cost for these securities is \$3,754,451.

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, comprised of at least three or more outside Board members, 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

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

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 and contractual restrictions. 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.

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The private market method may also use, where applicable, unconditional firm offers by responsible third parties as a basis for valuation.

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 (Unaudited)

#### 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 the Company (sole limited partner).

The Company qualified for 2001 as a Regulated Investment Company ("RIC") under Sub-Chapter M of the Internal Revenue Code of 1986 (the "Code"). There can be no assurance that the Company will qualify as a RIC in 2002 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.

## 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 funds.

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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 the "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 the specific identification basis 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 related to the Company's unrealized appreciation on investments.

The March 31, 2002 consolidated financial statements include a liability 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.

The March 31, 2001 and December 31, 2001 consolidated financial statements also reflect a tax provision on net realized long-term capital gains which the Company retained 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.)

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 March 31, 2002 and December 31, 2001, and the reported amounts of revenues and expenses for the three months ended March 31, 2002 and March 31, 2001. 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 "1988 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 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 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 Statement 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 carryovers from other years ("Qualifying Income"). The portion of net after-tax realized gains attributable to asset values as of September 30, 1997 is considered nonqualifying 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; Helene B. Shavin, 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 Board of Directors 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 net realized and gross unrealized gains at that date, net of operating expenses for the year. Any adjustments to the Plan accrual are then reflected in the Consolidated Statements of Operations for the quarter. The Plan accrual is not paid out until the gains are realized. During the first quarter of 2002, primarily as a result of an increase in the net realized gains from investments which are included in the bonus accrual calculation, the cumulative accrual was increased by \$127,959 to \$306,241.

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

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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 March 1, 1999, the directors may purchase the Company's common stock in the open market, rather than from the Company. During 1999, the Directors bought directly from the Company 5,816 shares.

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. The warrants expired unexercised.

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 March 31, 2002, the Company had repurchased a



total of 376,600 shares in the open market, at approximately \$2.30 per share, for a total of \$868,051.

Since 1998, the Company has repurchased a total of 1,859,047 of its shares for a total of \$3,496,388, including commissions and expenses, at an average price of \$1.88 per share. These treasury shares were reduced by the purchases made by the Directors.

On December 14, 2000, the Company declared a deemed dividend of \$1.78 per share for a total of \$16,253,987, and in 2001, the Company 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.

On January 22, 2002, the Company announced a deemed dividend of \$0.0875 per share for 2001 for a total of \$775,620, and in 2002 the Company paid federal income taxes on behalf of shareholders of \$0.030625 per share for a total of \$271,467. 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 dividends declared in 2000 (\$16,253,987) and 2001 (\$775,620) and the taxes paid on behalf of shareholders in 2000 (\$5,688,896) and 2001 (\$271,467) is considered to be reinvested by the shareholders; therefore, during 2000 and 2001, additional paid in capital has increased by \$10,565,091 and \$504,153, respectively.

The tax character of the 2001 deemed dividend is long-term capital gain.

As of December 31, 2001, there are no distributable earnings. The difference between the book basis and tax basis components of distributable earnings is attributed to Built-In Gains generated at the time of the Company's qualification as a RIC (see Note 6. "Income Taxes") and after tax earnings that are not required to be distributed.

#### 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 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 \$554,967 as of March 31, 2002. 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. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 which has increased the deduction limits for plans such as the 401(k) Plan. This Act eliminates the need for the Company to maintain two separate plans. Effective December 31, 2001, the Pension Plan merged into the 401(k) Plan, with the 401(k) Plan being the surviving plan. Contributions to the plan are at the discretion of the Company.

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 March 31, 2002 the Company had a reserve of \$385,935 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 realized 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. 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"). The Company had Built-In Gains at the time of its qualification as a RIC. Prior to 1999, the Company incurred ordinary and capital losses from its operations. After the Company's election of RIC

status, those losses remained available to be carried forward to subsequent taxable years. Recently issued Internal Revenue Service regulations (issued in temporary and proposed form) confirm that such losses may be used to offset realized Built-In Gains and, to the extent so used, to eliminate C Corporation taxation of such gains. Notwithstanding any such offset, however, the new regulations also provide that all realized Built-In Gains (calculated without regard to the offset, but net of any C Corporation tax imposed on the Built-In Gains after application of the offset) must be included in calculating a RIC's investment company taxable income or net capital gains, as the case may be, and therefore appear to require that such Built-In Gains must be distributed to avoid Sub-Chapter M taxation of such investment company taxable income or net capital gains (and, in the case of any Built-In Gains that are includible in investment company taxable income, possible loss of RIC status).

The Company has previously used loss carryforwards to offset Built-In Gains. As of January 1, 2002, the Company had \$501,640 of loss carryforwards remaining and \$4,663,457 of unrealized Built-In Gains. During the current period, the Company did not realize any 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 2. "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.

During the three months ended March 31, 2002, the Company accrued a net tax provision of \$34,223. The Company pays federal, state and local taxes on behalf of its wholly owned subsidiary, Harris & Harris Enterprises, Inc., which is taxed as a C Corporation.

For the three months ended March 31, 2002 and 2001, the Company's income tax provision was allocated as follows:

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Investment operations	\$ 0	\$ 0
Net realized gain on investments	34,223	29,634
Net decrease in unrealized appreciation on investments	0	0
Total income tax provision	<u>\$ 34,223</u>	<u>\$ 29,634</u>

The above tax provision consists of the following:

Current	\$ 34,223	\$ 29,634
Deferred -- Federal	0	0
Total income tax provision	<u>\$ 34,223</u>	<u>\$ 29,634</u>

The Company's net deferred tax liability at March 31, 2002 and December 31, 2001 consists of the following:

	March 31, 2002	December 31, 2001
Tax on unrealized appreciation on investments	\$1,540,044	\$1,540,044
Net operating loss and capital carryforward	(175,574)	(175,574)
Net deferred income tax liability	<u>\$1,364,470</u>	<u>\$1,364,470</u>

#### 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 space to an unaffiliated party. Rent expense under this lease for the three months ended March 31, 2002 and March 31, 2001, was \$42,724 and \$41,475, respectively. Future minimum lease payments in 2003 are \$101,946.

On November 19, 2001, the Company established an asset account line of credit of up to \$12,700,000. The asset account line of credit is secured by the Company's government agency securities. Under the asset account line of credit, the Company may borrow up to 95 percent of the current value of its government agency securities. The Company's outstanding balance

under the asset line of credit at March 31, 2002 was \$8,996,740.

The asset line of credit bears interest at a rate of the Broker Call Rate plus 50 basis points. On April 4, 2002, the Company repaid the entire outstanding balance under the asset line of credit.

#### NOTE 8. SUBSEQUENT EVENTS

On April 26, 2002, the Company filed a registration statement on Form N-2 with the SEC for the issuance of transferable rights to its shareholders. The rights will allow the Company's shareholders to subscribe for a maximum of 2,954,743 new shares of the Company's common stock. Upon consummation of the offer, the Company intends to raise gross proceeds of approximately \$6,648,172, without exclusion of expenses relating to the offer. The Company expects to invest, directly or indirectly, the proceeds of the offer, excluding expenses, in accordance with its investment objectives and policies within 12 months after receipt of such proceeds, depending on the available investment opportunities for the types of investments in which the Company principally invests.

On May 6, 2002, the Company invested \$750,000 in Series B convertible preferred stock of privately held Nanotechnologies, Inc. Nanotechnologies, Inc., which is based in Austin, Texas, was founded to develop and commercialize a process for synthesizing nanoscale materials by utilizing a proprietary plasma-based technology to produce a wide variety of materials.

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

The Company accounts for its operations utilizing 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, and fees and its operating expenses. The second element is "Net realized (loss) gain on investments," which is the difference between the proceeds received from dispositions of portfolio securities and their stated cost, net of applicable income tax provisions (benefits). These two elements are combined in the Company's financial statements and reported as "Net realized (loss) income." The third element, "Net increase (decrease) in unrealized appreciation on investments," is the net change in the fair value of the Company's investment portfolio.

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

#### Financial Condition

The Company's total assets and net assets were, respectively, \$35,005,570 and \$23,297,836 at March 31, 2002, compared with \$39,682,367 and \$24,334,770 at December 31, 2001.

Among the significant changes in the first quarter of 2002 were: (1) the payment of \$271,467 in federal income taxes as a result of the Company's deemed dividend distribution; (2) decline in the value of the Company's investment in Experion Systems, Inc. of \$600,000; (3) decrease in bank loan payable of \$3,499,037; and (4) establishment of a reserve against the note receivable of \$10,487.

Net asset value per share ("NAV") was \$2.63 at March 31, 2002, versus \$2.75 at December 31, 2001.

The Company's shares outstanding remained unchanged during the three months ended March 31, 2002.

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 and have little or no history of operations. At March 31, 2002, \$14,921,454 or 42.6 percent of the Company's total assets (64.0 percent of the Company's net assets) consisted of non-publicly traded securities at fair value, of which net unrealized appreciation was \$660,451.

The increase in the value of the non-publicly traded securities from \$13,120,978 at December 31, 2001 to \$14,921,454 at March 31, 2002 resulted primarily from the Company's new investments in Nanopharma Corp., NanoOpto Corporation and NeoPhotonics Corporation. The increase was partially offset by the net effect of an additional investment and decrease in valuation of the Company's holdings in Experion Systems, Inc.

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

	March 31, 2002	December 31, 2001
Investments, at cost	\$33,316,719	\$37,714,285
Unrealized appreciation	659,264	1,216,420
Investments, at fair value	<u>\$33,975,983</u>	<u>\$38,930,705</u>

The accumulated unrealized appreciation on investments net of deferred taxes is (\$705,206) at March 31, 2002, versus (\$148,049) at December 31, 2001.

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 or would preserve rights pursuant to "pay to play" provisions.

The following table is a summary of the cash investments made by the Company in its private placement portfolio during the three months ended March 31, 2002:

New Investments:	Amount
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Nanopharma Corp.	\$ 700,000
NanoOpto Corporation	625,000
NeoPhotonics Corporation	1,000,000

Additional Investments  
 Experion Systems, Inc. \$ 100,000

Total \$2,425,000

## Results of Operations

### Investment Income and Expenses:

The Company had net operating (loss) income of (\$556,233) and \$509,877 for the three months ended March 31, 2002 and March 31, 2001, respectively. The Company's net operating (loss) income reflected an increase to expenses of \$127,959 in the three months ended March 31, 2002 and a reduction to expenses of \$846,290 in the three months ended March 31, 2001 relating to changes in the employee profit-sharing accrual.

The Company's principal objective is to achieve capital appreciation. Therefore, a significant portion of the investment portfolio is structured to maximize 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 and Agency Obligations. The amount of interest income earned varies with the average balance of the Company's fixed-income portfolio and the average yield on this portfolio.

The Company had interest income from fixed-income securities of \$54,136 and \$152,530 for the three months ended March 31, 2002 and March 31, 2001, respectively. The decrease of \$98,394 or 64.5 percent reflects the steep decline in interest rates during the three months ended March 31, 2002 versus the three months ended March 31, 2001.

The Company had interest income from affiliated companies of \$0 and \$9,617 for the three months ended March 31, 2002 and March 31, 2001, respectively. The decrease of \$9,617 is owing to the decrease in the outstanding loans to investee companies since the first quarter of 2001. The amount of outstanding loans to investee companies varies.

The Company had other income of \$5,326 and \$29,812 for the three months ended March 31, 2002 and March 31, 2001, respectively. Other income primarily represents rental income from subletting office space to an unaffiliated party. The rental income was offset in the three months ended March 31, 2002 by a reserve against a note receivable and in the three months ended March 31, 2001 by a gain on the sale of Company property.

Operating expenses were \$615,695 and (\$317,918) for the three months ended March 31, 2002 and March 31, 2001, respectively. The operating expenses of the first quarter of 2002 and 2001 reflect increases (decreases) in the employee profit-sharing accrual of \$127,959 and (\$846,290), respectively, owing primarily to decreases in the unrealized appreciation for the respective three month periods offset by gain income. Salaries and benefits decreased \$44,328 or 14.8 percent primarily as the result of no bonus payroll taxes in 2002. Professional fees decreased \$16,108 or 27.2 percent. Director's fees and expenses increased \$18,086 or 78.7 percent as a result of audit committee meetings regarding the appointment of PricewaterhouseCoopers LLP as independent public accountants for the Company for the year ending December 31, 2002 and nominating committee meetings resulting in the appointment of two additional members of the Board of Directors.

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. Because such sales cannot be predicted, the Company attempts to maintain adequate working capital to provide for fiscal periods when there are no such sales.

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

During the three months ended March 31, 2002 and 2001, the Company realized gains (losses) of \$55,498 and (\$1,194,652), respectively. During the three months ended March 31, 2002, the Company's realized gains of \$55,498 consisted primarily of cash received from the Nanophase Technologies Litigation Settlement Fund.

During the three months ended March 31, 2001, the Company realized losses of \$1,194,652, primarily from the sale of 350,000 shares of SciQuest.com stock.

#### 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 1. Consolidated Financial Statements.")

Net unrealized appreciation on investments decreased by \$557,157 or 45.8 percent during the three months ended March 31, 2002, from \$1,216,421 to \$659,264, primarily as a result of the decline in the value of the Company's holdings of Experion Systems, Inc. of \$600,000.

Net unrealized appreciation on investments decreased by \$3,082,931 or 34.4 percent during the three months ended March 31, 2001, from \$8,947,928 to \$5,864,997, primarily as a result of the decline in the value of the Company's holdings of Nanophase Technologies Corporation and Essential.com, Inc. of \$2,287,914 and \$2,187,413, respectively.

The changes in the values of Experion Systems, Inc. reflect the extreme volatility of private and small capitalization, high technology stocks, as well as the inherent risks at all times of such investments (see "Risk Factors").

#### Liquidity and Capital Resources

The Company's primary sources of liquidity are cash, receivables and freely tradable marketable securities. The Company's secondary sources of liquidity are restricted securities of companies that are publicly traded. At March 31, 2002 and December 31, 2001, respectively, the Company's total primary liquidity was \$10,369,814 and \$13,459,654. On both of the corresponding dates, the Company's total secondary liquidity was \$0 as the Company had no publicly traded securities. The

Company's tertiary source of liquidity is its holding of PHZ Capital Partners, L.P., from which the Company received cash distributions in the first quarter of 2002 of \$140,352.

The decrease in the Company's primary source of liquidity from December 31, 2001 to March 31, 2002 is primarily owing to the: (1) payment of federal income taxes of \$271,467; (2) investment in Nanopharma Corp. of \$700,000; (3) investment in NanoOpto Corporation of \$625,000; (4) investment in NeoPhotonics Corporation of \$1,000,000; (5) investment in Experion Systems, Inc. of \$100,000; and (6) use of funds for operating expenses.

From December 31, 2001 to March 31, 2002, the Company's



liabilities for accrued employee profit sharing increased by \$127,959 or 71.8 percent to \$306,241 primarily as a result of an increase in the realized gains from investments included in the bonus accrual calculation.

The Company's total income tax liability decreased by \$256,875 or 15.9 percent to \$1,362,663 primarily as a result of the payment of taxes in connection with the deemed dividend distribution.

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

On March 7, 2002, the Company received SEC certification and qualified for RIC treatment for 2001. Although the SEC certification for 1999, 2000 and 2001 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 January 22, 2002, the Company announced that its Board of Directors had declared a deemed dividend for 2001 of \$0.0875 per share for a total of \$775,620 and paid corporate taxes on behalf of shareholders of \$0.030625 per share, for a total of \$271,467.

#### 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 of common stock. The securities markets frequently experience extreme price and volume fluctuations which affect market prices for securities of companies generally, and technology and very small capitalization companies in particular.

Because of the Company's focus on the technology and very small capitalization sectors and because it is a small capitalization company, its stock price is especially likely to be affected by these market conditions. General economic conditions, and general conditions in the Internet and information technology, life sciences, nanotechnology, small technology, material sciences and other high technology industries, will also affect the Company's stock price. During the first quarter of 2002, the Company decided to make all of its new private equity investments in small technology, including nanotechnology, microsystems and microelectromechanical systems (MEMS). Small technology investments are new and especially risky, involving science and technology risks as well as commercialization risks.

Investing in the Company's common stock may be inappropriate for the investor's risk tolerance.

The Company's investments, in accordance with its investment objective and principal strategies, result in a far above average amount of risk and volatility and may well result in 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 investors for whom such risk is inappropriate.

The market for venture capital investments, including small technology investments, is highly competitive. In addition to finding attractive investment opportunities, in some cases, the Company's status as a regulated business development company may hinder its ability to participate in investment opportunities or

to protect the value of existing investments because of "pay to play" provisions in which preferred protections such as dilution protection may be forfeited or preferred stock may be converted to common stock by failure to invest in subsequent rounds of financing.

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 result, the sources of funding are many, but attractive investment opportunities are too few. Hence, we face substantial competition in sourcing good investment opportunities on terms of investment that are commercially attractive. Further, 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 such disclosure requirements. The Company's obligation to disclose such 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. Also, compliance with certain regulations applicable to the Company's business may prevent the Company from making follow-on investments that would be in the Company's and its investors' best interest.

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 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. Also, as business and financial practices continue to evolve, they may render the regulations under which the Company operates less appropriate and more burdensome than they were when originally imposed.

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 Company utilizes outside consultants and lawyers, including its two newest Directors, Dr. Kelly S. Kirkpatrick and Lori D. Pressman, to assist the Company in conducting due diligence when evaluating potential investments. The future success of the Company depends to a significant extent on the continued service and coordination of its senior management team, particularly Charles E. Harris, the Company's Chairman and Chief Executive

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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 for its benefit any key man life insurance on any of its officers or employees.

Investing in small, private companies involves a high degree of risk and is highly speculative.

There are significant risks inherent in the Company's venture capital business. The Company has invested a substantial portion of its assets in privately held development stage or start-up companies. These privately held 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. Small technology companies in particular are unproven, with significant science and technology risks as well as commercialization risks. 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. Such sales are unpredictable and may not occur.

The Company invests in securities that are illiquid and may not be able to dispose of such securities when it is advantageous to do so.

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.

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, rapidly changing and especially sensitive to adverse general economic conditions. Commercial success is difficult to predict and the marketing efforts of the Company's portfolio companies may not be successful.

Because there is generally no established market in which to value the Company's investments, the Company's Investment and Valuation Committee's determination of their values may differ materially from the values that a ready market or third party would attribute to these investments.

There is typically no public market for equity securities of the small privately held companies in which the Company invests. As a result, the valuation of most 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 1. "Consolidated Financial Statements.") 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. The Company adjusts quarterly the valuation of its

portfolio to reflect the Investment and Valuation Committee's estimate of the current fair value of each investment in its portfolio. Any changes in estimated fair 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 2. "Management's Discussion and

Analysis of Financial Condition and Results of Operations.")

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

The Company's quarterly operating results could fluctuate as a result of a number of factors. These factors include, among others, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which the Company and its portfolio companies encounter competition in their markets and general economic and market 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 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

Loss of pass-through tax treatment would substantially reduce net assets and income available for dividends.

The Company currently qualifies as a RIC under the Code for pass-through treatment because it meets certain diversification and distribution requirements under the Code. The Company would cease to qualify for pass-through tax treatment if it were unable to comply with these requirements. 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 gain or income distributions. (See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Recent Developments -- Sub-Chapter M Status.") The lack of pass-through 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 tax would result in a corresponding reduction in the Company's net assets and the amount of income available for distribution to the Company's stockholders.

During some periods, there are few opportunities to take early stage companies public or sell them to established companies.

During some periods, there may be few opportunities to gain liquidity or realize a gain on an otherwise successful investment, as the market for initial public offerings may be moribund, particularly for early stage, high technology companies. During such periods or other periods, it may also be difficult to sell such companies to established companies. The lack of exit strategies during such periods also tends to have an adverse effect on the ability of private equity companies to raise capital privately.

Because the Company must distribute income, the Company will continue to need additional capital to fund its investments and operating expenses.

The Company will continue to need capital to fund investments and to pay for operating expenses. Unless the Company elects to pay a Federal income tax and retain the after-tax income, the Company must distribute at least 90 percent of its investment company taxable income 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 as well as its ability to make follow-on and new investments. The Company does not

normally establish reserves for taxes on unrealized capital gains. 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.

Loss of status as a RIC would reduce the Company's net asset value by forcing it to establish currently unestablished reserves for taxes.

As a RIC, the Company does not have to pay Federal income taxes on its income that is distributed to its shareholders. Accordingly, it does not establish reserves for taxes on its unrealized capital gains. If the Company failed to qualify for RIC status, it would have to establish such reserves for taxes, which would reduce its net asset value, net of a reduction in the reserve for employee profit sharing, accordingly. To the extent that the Company, as a RIC, were to decide to make a deemed distribution of net realized capital gains and were to retain such net realized capital gains, it would have to establish appropriate reserves for taxes upon making such a decision.

Leveraging by the Company could result in making the Company's total return to common shareholders more volatile.

Leverage entails two primary risks. The first risk is that the use of leverage magnifies the impact on the common shareholders of changes in net asset value. For example, a fund that uses 33% leverage (that is, \$50 of leverage per \$100 of common equity) will show a 1.5% increase or decline in net asset value for each 1% increase or decline in the value of its total assets. The second risk is that the cost of leverage will exceed the return on the securities acquired with the proceeds of leverage, thereby diminishing rather than enhancing the return to common shareholders. If the Company were to utilize leverage, these two risks would generally make its total return to common shareholders more volatile. In addition, the Company might be required to sell investments in order to meet dividend or interest payments on the debt or preferred stock when it may be disadvantageous to do so.

As provided in the 1940 Act and subject to certain exceptions, the Company can issue debt or preferred stock so long as its total assets immediately after such issuance, less certain ordinary course liabilities, exceed 200% of the amount of the debt outstanding and exceed 200% of the sum of the amount of the preferred stock and debt outstanding. Such debt or preferred stock may be convertible in accordance with SEC guidelines which may permit the Company to obtain leverage at attractive rates. A leveraged capital structure creates certain special risks and potential benefits not associated with unleveraged funds having similar investment objectives and policies. Any investment income or gains from the capital represented by preferred shares or debt which is in excess of the dividends payable thereon will cause the total return of the common shares to be higher than would otherwise be the case. Conversely, if the investment performance of the capital represented by preferred shares or debt fails to cover the dividends payable thereon, the total return of the common shares would be less or, in the case of negative returns, would result in higher negative returns to a greater extent than would otherwise be the case. The requirement under the 1940 Act to pay in full dividends on preferred shares or interest on debt before any dividends may be paid on the common shares means that dividends on the common shares from earnings may be reduced or eliminated. Although an inability to pay dividends on the common shares could conceivably result in the Company ceasing to qualify as a regulated investment company under the Code, which would be materially adverse to the holders of the common shares, such inability can be avoided through the use of mandatory redemption requirements designed to ensure that the Company maintains the necessary asset coverage.

The class voting rights of preferred shares could make it more difficult for the Company to take certain actions that may, in the future, be proposed by the Board and/or the holders of

common stock, such as a merger, exchange of securities, liquidation or alteration of the rights of a class of the Company's securities if such action would be adverse to the preferred shares.

Preferred shares will be issued only if the Company's Board of Directors determines in light of all relevant circumstances known to the Board that to do so would be in the Company's best interest and in the best interest of the Company's common shareholders. The circumstances that the Board will consider before issuing preferred shares include not only the dividend rate on the preferred shares in comparison to the Company's historical performance but also such matters as the terms on which the Company can call the preferred shares and the Company's ability to meet the asset coverage tests and other requirements imposed by the rating agencies for such preferred shares.

The issuance of preferred shares convertible into shares of common stock might also reduce the net income and net asset value per share of the common shares upon conversion. Such income dilution would occur if the Company could, from the investments made with the proceeds of the preferred shares, earn an amount per common share issuable upon conversion greater than the dividend required to be paid on the amount of preferred stock convertible into one share of common stock. Such net asset value dilution would occur if preferred shares were converted at a time when the net asset value per common share was greater than the conversion price.

Unfavorable economic conditions could result in financial losses for the Company as well as impair its ability to engage in liquidity events.

Most of the companies in which the Company has made or will make investments are susceptible to economic slowdowns or recessions. An economic slowdown, capital markets conditions or credit squeeze may affect the ability of a company to raise additional capital from venture capital or other private equity sources or to engage in a liquidity event such as an initial public offering or merger. These conditions could lead to financial losses in the Company's portfolio. Unfavorable economic conditions also could increase the Company's cost of capital.

On September 11, 2001, the World Trade Center in New York City and the Pentagon near Washington, DC were targets of terrorists attacks. As a result of these events and other general economic conditions, it was especially difficult for small companies to sell new products and services or to raise new capital, and the United States equity markets experienced declines. For the quarter ended September 30, 2001, the Nasdaq Composite Index declined 31%.

The Company's business of making private equity investments and positioning them for liquidity events also may be adversely affected by current and future market and economic conditions. Significant changes in the public equity markets could have an effect on the valuations of privately held companies and on the potential for liquidity events involving such companies, and this could adversely affect the amount and timing of gains that may be realized on the Company's investments.

The Company invests in privately held companies that may complete initial public offerings. These types of companies can be highly volatile and have uncertain liquidity.

When companies in which the Company has invested as private entities complete initial public offerings, they are by definition unseasoned issues. Typically, they have relatively small capitalizations. Thus, they can be expected to be highly volatile and of uncertain liquidity. If they are perceived as suffering from adverse news or developments and/or the capital

markets are in a negative phase, not only their market prices, but also their liquidity can be expected to be affected negatively. Historically, the Company has also invested in unseasoned publicly traded companies with similar characteristics and thus with similar exposure to potential negative volatility

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and illiquidity. The decimalization of the stock markets, particularly Nasdaq, may decrease liquidity of stocks in general and small capitalization issues in particular. In addition, the imposition of decimalization on the stock exchanges, particularly Nasdaq, may reduce liquidity and increase volatility and riskiness of small, thinly traded public companies because it may create a disincentive for dealers to market and make markets in smaller issues.

#### Forward-Looking Statements

The information contained herein contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives, portfolio growth and availability of funds. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth herein. Other factors that could cause actual results to differ materially include the uncertainties of economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond 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.

#### Item 3. Quantitative and Qualitative Disclosures About Market 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 SEC. All assets are valued at fair value as determined in good faith by, or under the direction of, the Board of Directors. (See the "Asset Valuation Policy Guidelines" in the "Footnote to Consolidated Schedule of Investments contained in "Item 1. Consolidated Financial Statements.")

Neither 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, which portfolio may be composed primarily or entirely of highly risky, volatile securities.

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 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. Even when the Company's private equity investments complete initial public offerings (IPOs), the Company is normally subject to lock-up agreements for a period of time.

Because there is typically no public market for the equity interests of the small privately held 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

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for the equity interests existed. Any changes in valuation are recorded in the Company's consolidated statements of operations as "Net increase (decrease) in unrealized appreciation on investments."

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Not Applicable

### Item 2. Changes in Securities and Use of Proceeds

Not Applicable

### Item 3. Defaults Upon Senior Securities

Not Applicable

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

Not Applicable

### Item 5. Other Information

#### Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

On February 26, 2002, the Company appointed the accounting firm of PricewaterhouseCoopers LLP as independent public accountants for the Company for the fiscal year ending December 31, 2002. Arthur Andersen LLP was dismissed upon completion of the December 31, 2001 audit. The decision to change accountants was approved by the Company's Audit Committee and is subject to ratification by its stockholders.

In connection with its audits for the two most recent fiscal years, (1) there were no disagreements with Arthur Andersen on any matter of accounting principle or practice, financial statement disclosure, auditing scope or procedure, whereby such disagreements, if not resolved to the satisfaction of Arthur Andersen, would have caused them to make reference thereto in their report on the financial statements for such years; and (2) there have been no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K).

The reports of Arthur Andersen on the financial statements of the Company for the past two years contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principle.

The Company has not consulted with PricewaterhouseCoopers LLP during the last two years or subsequent interim periods on either the application of accounting principles to a specified transaction either completed or proposed or the type of audit opinion PricewaterhouseCoopers LLP might



issue on the Company's financial statements.

The Company requested that Arthur Andersen furnish a letter addressed to the SEC stating whether or not Arthur Andersen agrees with the above statements. A copy of such letter to the SEC, dated March 1, 2002, was filed as Exhibit 16.1 to the Form 8-K filed with the SEC on March 1, 2002.

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 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 10K for the year ended December 31, 1995.
- 4.1 Specimen Certificate of Common Stock, incorporated by reference to Exhibit 4 to Company's Registration Statement on Form N-2 filed October 29, 1992.
- 10.22 Harris & Harris Group, Inc. Employee Profit-Sharing Plan, incorporated by reference as Exhibit 10.22 to the Company's Form 10K for the year ended December 31, 1999.
- 11.0\* Computation of per share earnings. See Consolidated Statements of Operations.

(b) Reports on Form 8-K

On March 1, 2002, the Company filed a Form 8-K stating that on February 26, 2002, the Company appointed the accounting firm of PricewaterhouseCoopers LLP as independent accountants for the fiscal year ending December 31, 2002. Arthur Andersen was dismissed upon completion of the December 31, 2001 audit.

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EXHIBIT INDEX

Item Number (of Item 601 of Regulation S-K)

SIGNATURE

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

Harris & Harris Group, Inc.

/s/ Helene B. Shavin

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By: Helene B. Shavin,  
Vice President and  
Controller

Date: May 15, 2002

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