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

Form 10-Q

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

For quarterly period ended March 31, 1998

[ ] 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 incorporation or organization) | (I.R.S. Employer 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 __X__ No ____

Harris & Harris Group, Inc.
Form 10-Q, March 31, 1998

TABLE OF CONTENTS

Harris & Harris Group, Inc.
Form 10-Q, March 31, 1998

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The information furnished in the accompanying financial statements reflects 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, the Company's shareholders approved a proposal to allow the Company to make an election to become a Business Development Company ("BDC") under the Investment Company Act of 1940, as amended. The Company made such election on July 26, 1995. Certain information and disclosures normally included in the 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 financial statements be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 1997 contained in the Company's 1997 Annual Report.

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification of the Company in 1998 as a Regulated Investment Company ("RIC") under Sub-Chapter M of the Internal Revenue (the "Code"). (At that time, the Company was taxable under Sub-Chapter C of the Code (a "C Corporation").) On April 8, 1998, the Company announced that it had received a certification from the Securities and Exchange Commission for 1997 relating to the Company's status under section 851(e) of the Code. That certification was necessary for the Company to qualify as a RIC for 1998 and subsequent taxable years.

Pursuant to the Company's receipt of the section 851(e) certification, the Company's Board of Directors declared a one-time cash dividend of $0.75 per share to meet one of the Company's requirements for qualification for Sub-Chapter M tax treatment in 1998. The Company has requested rulings from the Internal Revenue Service (the "IRS") regarding other issues relevant to the Company's tax status as a RIC. (See Note 5 of Notes to Financial Statements.) Although there is no assurance such rulings will be issued, the management of the Company believes favorable rulings are likely.

The qualification of the Company as a RIC under Sub-Chapter M of the Code depends on it satisfying certain technical requirements regarding its income, investment portfolio, and distributions. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Recent Developments".) There can be no assurance that the Company will qualify for Sub-Chapter M treatment for 1998 or subsequent years. Nevertheless, the Company's financial statements for 1998 assume that the Company will qualify for such treatment and that the rulings requested from the IRS will be issued.



<TABLE>
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STATEMENTS OF ASSETS AND LIABILITIES

ASSETS

| <S> | <C> March 31, 1998 (Unaudited) | <C> December 31, 1997 (Audited) |
|---|---|---|
| Investments, at value (See accompanying schedule of investments and notes). . . . | $ 35,676,498 | $ 38,659,230 |
| Cash and cash equivalents . . . . . . . . . | 163,534 | 145,588 |
| Prepaid expenses. . . . . . . . . . . . . . | 112,353 | 85,126 |
| Other assets. . . . . . . . . . . . . . . . | 215,273 | 383,840 |
| | ------------- | ------------- |

| | | |
|---|---|---|
| Total assets. . . . . . . . . . . . . . . | $ 36,167,658 | $ 39,273,784 |

LIABILITIES & NET ASSETS

| | | |
|---|---|---|
| Accounts payable and accrued liabilities. | $ 814,923 | $ 899,491 |
| Deferred rent . . . . . . . . . . . . . . | 49,349 | 51,662 |
| Deferred income tax liability (Note 5). . | 151,983 | 667,697 |
| Note Payable (Note 6) . . . . . . . . . . | 1,500,000 | 4,000,000 |
| Total liabilities . . . . . . . . . . . . | 2,516,255 | 5,618,850 |
| Commitments and contingencies (Note 6) | | |
| Net assets. . . . . . . . . . . . . . . . | $ 33,651,403 | $ 33,654,934 |
| 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 and outstanding at 3/31/98 and 12/31/97 . . . . . . . . . . . . . . . | 106,930 | 106,930 |
| Additional paid in capital. . . . . . . . | 16,178,979 | 16,178,979 |
| Accumulated net realized income . . . . . | 11,552,730 | 12,028,191 |
| Accumulated unrealized appreciation of investments, net of deferred tax liability of $2,008,941 at 3/31/98 and $2,817,898 at 12/31/97 . . . . . . | 5,812,764 | 5,340,834 |
| Net assets. . . . . . . . . . . . . . . . | $ 33,651,403 | $ 33,654,934 |
| Total net assets and liabilities. . . . . | $ 36,167,658 | $ 39,273,784 |
| Shares outstanding. . . . . . . . . . . . | 10,692,971 | 10,692,971 |
| Net asset value per outstanding share . . | $ 3.15 | $ 3.15 |

The accompanying notes are an integral part of these financial statements.
</TABLE>



<TABLE>
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STATEMENTS OF OPERATIONS
(Unaudited)

| <S> | <C> Three Months Ended March 31, 1998 | <C> Three Months Ended March 31, 1997 |
|---|---|---|
| Investment income: | | |
| Interest from: | | |
| Fixed-income securities. . . . . | $ 192,291 | $ 136,287 |
| Affiliated companies . . . . . . | 10,932 | 10,000 |
| Other income . . . . . . . . . . | 7,348 | 869 |
| Total investment income. . . . . | 210,571 | 147,156 |
| Expenses: | | |
| Salaries and benefits. . . . . . . | 37,848 | 440,324 |
| Administration and operations. . . | 88,204 | 98,327 |
| Professional fees. . . . . . . . . | 89,026 | 88,097 |
| Depreciation . . . . . . . . . . . | 12,500 | 15,000 |
| Rent . . . . . . . . . . . . . . . | 38,808 | 39,497 |
| Directors' fees and expenses . . . | 28,742 | 35,848 |
| Custodian fees . . . . . . . . . . | 2,907 | 3,506 |
| Interest expense (Note 6). . . . . | 73,415 | 0 |
| Total expenses . . . . . . . . . . | 371,450 | 720,599 |
| Operating loss before income taxes. . . . . . . . . . . . . | (160,879) | (573,443) |
| Income tax (provision) benefit (Note 5) . . . . . . . . . . . . | (365,712) | 198,881 |
| Net operating loss . . . . . . . . . | (526,591) | (374,562) |
| Net realized gain on investments: | | |
| Realized gain on sale of investments. . . . . . . . . . . | 78,661 | 623,108 |
| Total realized gain. . . . . . . | 78,661 | 623,108 |
| Income tax provision (Note 5). . . | (27,531) | (218,088) |

| | | |
|---|---|---|
| Net realized gain on investments . | 51,130 | 405,020 |
| Net realized (loss) income . . . . . | (475,461) | 30,458 |
| Net increase (decrease) in unrealized appreciation on investments: | | |
| Decrease as a result of investment sales. . . . . . . . . . . . . . | (87,898) | (1,764,909) |
| Increase on investments held . . . | 3,825,792 | 1,414,354 |
| Decrease on investments held . . . | (4,074,921) | (2,253,670) |
| Change in unrealized appreciation on investments . . . . . . . . . | (337,027) | (2,604,225) |
| Income tax benefit (Note 5). . . . | 808,957 | 911,479 |
| Net increase (decrease) in unrealized appreciation on investments. . . | 471,930 | (1,692,746) |
| Net decrease in net assets from operations: | | |
| Total. . . . . . . . . . . . . . . | $ (3,531) | $ (1,662,288) |
| Per outstanding share. . . . . . . | $ (0.00) | $ (0.16) |

The accompanying notes are an integral part of these financial statements.
</TABLE>



<TABLE>
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STATEMENTS OF CASH FLOWS
(Unaudited)

| <S> | <C> Three Months Ended March 31, 1998 | <C> Three Months Ended March 31, 1997 |
|---|---|---|
| Cash flows (used in) provided by operating activities: | | |
| Net decrease in net assets resulting from operations . . . . . . | $ (3,531) | $ (1,662,288) |
| Adjustments to reconcile net decrease in net assets from operations to net cash (used in) provided by operating activities: | | |
| Net realized and unrealized loss (gain) on investments. . . . . . . . . . . | 258,366 | 1,981,117 |
| Deferred income taxes . . . . . . . . | (415,714) | (908,469) |
| Depreciation. . . . . . . . . . . . . | 12,500 | 15,000 |
| Changes in assets and liabilities: | | |
| Receivable from brokers . . . . . . . | 0 | (25,374) |
| Prepaid expenses. . . . . . . . . . . | (27,227) | 20,976 |
| Taxes receivable. . . . . . . . . . . | 0 | 16,197 |
| Other assets. . . . . . . . . . . . . | 156,067 | 224,586 |
| Accounts payable and accrued liabilities . . . . . . . . . . . | (215,719) | (28,297) |
| Payable to brokers. . . . . . . . . . | 0 | 411,354 |
| Deferred rent . . . . . . . . . . . . | (2,313) | (2,313) |
| Purchase of fixed assets. . . . . . . | 0 | (2,847) |
| Net cash (used in) provided by operating activities. . . . . . . . | (237,571) | 39,642 |
| Cash provided by (used in) investing activities: | | |
| Net sale of short-term investments and marketable securities . . . . . | 2,877,319 | 1,709,625 |
| Investment in private placements and loans . . . . . . . . . . . . . | (121,802) | (1,745,585) |
| Net cash provided by (used in) investing activities. . . . . . . . | 2,755,517 | (35,960) |
| Cash flows used in financing activities: | | |
| Payment of note payable (Note 6). . . | (2,500,000) | 0 |
| Net cash used in financing activities | (2,500,000) | 0 |
| Net increase in cash and cash equivalents: | | |
| Cash and cash equivalents at beginning of the period . . . . . . . . . . . | 145,588 | 155,440 |
| Cash and cash equivalents at end of the period. . . . . . . . . . . . . | 163,534 | 159,122 |
| Net increase in cash and cash equivalents | $ 17,946 | $ 3,682 |
| Supplemental disclosures of cash flow information: | | |
| Income taxes paid . . . . . . . . . . | $ 300 | $ 5,909 |

| | | |
|---|---|---|
| Interest paid . . . . . . . . . . . . | $ 44,180 | $ 0 |

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



STATEMENTS OF CHANGES IN NET ASSETS
(Unaudited)

| | Three Months Ended March 31, 1998 | Three Months Ended March 31, 1997 |
|---|---|---|
| Changes in net assets from operations: | | |
| Net operating loss. . . . . . . . | $ (526,591) | $ (374,562) |
| Net realized gain on investments. | 51,130 | 405,020 |
| Net decrease in unrealized appreciation on investments as a result of sales . . . . . . . | (87,898) | (1,147,190) |
| Net increase (decrease) in unrealized appreciation on investments held. . . . . . . . | 559,828 | (545,556) |
| Net decrease in net assets resulting from operations . . . . . . . . | (3,531) | (1,662,288) |
| Net decrease in net assets . . . . . | (3,531) | (1,662,288) |
| Net assets: | | |
| Beginning of the period . . . . . | 33,654,934 | 35,932,603 |
| End of the period . . . . . . . . | $ 33,651,403 | $ 34,270,315 |

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



SCHEDULE OF INVESTMENTS MARCH 31, 1998
(Unaudited)

| | Method of Valuation (3) | Shares/ Principal | Value |
|---|---|---|---|
| Investments in Unaffiliated Companies (12)(13)(14) - -- 16.0% of total investments | | | |
| Publicly Traded Portfolio (Common stock unless noted otherwise) -- 13.4% of total investments | | | |
| Oil and Gas Related | | | |
| CORDEX Petroleums Inc. (1) Argentine and Chilean oil and gas exploration Class A Common Stock . . . . . . . . . | (C) | 4,052,080 | $ 145,342 |
| Biotechnology and Healthcare Related | | | |
| Alliance Pharmaceutical Corp. (1)(4) . . | (C) | 57,500 | 434,843 |
| Fuisz Technologies, Ltd. (1) . . . . . . | (C) | 125,000 | 1,554,688 |
| Guilford Pharmaceuticals Inc. (1). . . . | (C) | 10,000 | 220,000 |
| Energy Research Corporation (1) -- Fuel cell energy . . . . . . . . . . . . | (C) | 55,000 | 1,471,250 |
| Princeton Video Image, Inc. (1)(2)(7) -- Real time sports and entertainment advertising -- 1.4% of fully diluted equity . . . . . . . . . . . . . . . . . | (C) | 150,200 | 966,536 |
| Total Publicly Traded Portfolio (cost: $3,579,097) . . . . . . . . . . . . . . . . . . . . . . . . | | | $4,792,659 |
| Private Placement Portfolio (Illiquid) -- 2.6% of total investments | | | |
| Exponential Business Development Company (1)(2)(5) -- Venture capital partnership focused on early stage companies Limited partnership interest . . . . . . | (A) | -- | $ 25,000 |

| | | | |
|---|---|---|---|
| MedLogic Global Corporation (1)(2) -- Medical cyanoacrylate adhesive -- 0.51% of fully diluted equity | | | |
| Series B Convertible Preferred Stock . . | (A) | 60,319 | |
| Common Stock . . . . . . . . . . . . . . . | (D) | 25,798 | 891,700 |
| Total Private Placement Portfolio (cost: $1,058,775) . . . . . . | | | $ 916,700 |
| Total Investments in Unaffiliated Companies (cost: $4,637,872) . . . . . . . . . . . | | | $5,709,359 |

The accompanying notes are an integral part of this schedule.

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SCHEDULE OF INVESTMENTS MARCH 31, 1998
(Unaudited)

| <S> | <C> Method of Valuation (3) | <C> Shares/ Principal | <C> Value |
|---|---|---|---|
| Investments in Non-Controlled Affiliates (12)(14) - -- 40.6% of total investments | | | |
| Publicly Traded Portfolio -- 8.6% of total investments | | | |
| Nanophase Technologies Corporation (1)(2)(6)(8) -- Manufactures and markets inorganic crystals of nanometric dimensions -- 5.08% of fully diluted equity Common Stock. . . . | (C) | 730,916 | $3,051,400 |
| Total Publicly Traded Portfolio (cost: $1,626,204) . . . . . . . | | | $3,051,400 |
| Private Placement Portfolio (Illiquid) -- 32.0% of total investments | | | |
| Genomica Corporation (1)(2)(5)(6)(9) -- Develops software that enables the study of complex genetic diseases -- 10.7% of fully diluted equity | | | |
| Common Stock . . . . . . . . . . . . . . . | (A) | 199,800 | |
| Series A Voting Convertible Preferred Stock. . . . . . . . . . . . . . . . . . . | (A) | 1,660,200 | $1,000,304 |
| NBX Corporation (1)(2)(6)(10) -- Exploits innovative distributed computing technology for use in small business telephone systems -- 14.8% of fully diluted equity Series A | | | |
| Convertible Preferred Stock. . . . . . . | (B) | 500,000 | |
| Series C Convertible Preferred Stock . . | (B) | 240,793 | |
| Series D Convertible Preferred Stock . . | (A) | 59,965 | 4,540,298 |
| Promissory Note -- 8% due March 16, 2001 . . . . . . . . . . . . . . . . . . . | (A) | $ 10,000 | 10,000 |
| PHZ Capital Partners Limited Partnership (2) -- Organizes and manages investment partnerships -- 20.0% of fully diluted equity | | | |
| Limited partnership interest . . . . . . | (D) | -- | 1,405,622 |
| Demand Promissory Note -- 8% . . . . . . | (A) | $ 500,000 | 500,000 |
| PureSpeech, Inc. (1)(2)(6) -- Develops and markets innovative speech recognition technology -- 8.0% of fully diluted equity | | | |
| Series A Convertible Preferred Stock . . | (D) | 190,476 | |
| Convertible Promissory Note. . . . . . . | (D) | $ 243,980 | 1,713,370 |
| Questech Corporation (1)(2)(6) -- Manufactures and markets proprietary decorative tiles and signs -- 15.1% of fully diluted equity | | | |
| Common Stock . . . . . . . . . . . . . . . | (D) | 565,792 | 2,263,168 |
| Warrants at $4.00 expiring 11/28/01. . . | (A) | 166,667 | 167 |
| Total Private Placement Portfolio (cost: $7,247,240). . . . . . | | | $11,432,929 |
| Total Investments in Non-Controlled Affiliates (cost: $8,873,444). . . . . . . . . . . . . . . . . . . . . . . . | | | $14,484,329 |

The accompanying notes are an integral part of this schedule.

</TABLE>



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SCHEDULE OF INVESTMENTS MARCH 31, 1998
(Unaudited)

| <S> | <C> Method of Valuation (3) | <C> Shares/ Principal | <C> Value |
|---|---|---|---|
| Private Placement Portfolio in Controlled Affiliates (12)(14) (Illiquid) - -- 10.5% of total investments | | | |
| BioSupplyNet, Inc. (1)(2)(6)(11) -- Expands commercially the print and World Wide Web product directories developed by Cold Spring Harbor Laboratory Press -- 44.4% fully diluted equity | | | |
| Series A Convertible Preferred Stock . . | (A) | 775,000 | $ 775,000 |
| Revolving Credit Facility (Note 6) . . . | (A) | $ 110,000 | 110,000 |
| MultiTarget, Inc. (1)(2)(6) -- Developing intellectual property related to localized treatment of cancer -- 37.5% of fully diluted equity | | | |
| Series A Convertible Preferred Stock . . | (A) | 375,000 | 210,000 |
| NeuroMetrix, Inc. (1)(2)(6) -- Developing devices for: 1) diabetics to monitor their blood glucose and 2) detection of carpal tunnel syndrome -- 29.0% of fully diluted equity | | | |
| Series A Convertible Preferred Stock . . | (B) | 175,000 | |
| Series B Convertible Preferred Stock . . | (B) | 125,000 | |
| Series C Convertible Preferred Stock . . | (A) | 229,620 | 2,648,100 |
| | | | ----------- |
| Total Private Placement Portfolio in Controlled Affiliates (cost: $2,605,000) . . . . . . . . . | | | $ 3,743,100 |
| U.S. Government Obligations -- 32.9% of total investments | | | |
| U.S. Treasury Bill dated 04/03/97 due date 04/02/98 -- 5.2% yield. . . . . . . . . | (K) | $ 250,000 | 249,963 |
| U.S. Treasury Bill dated 10/23/97 due date 04/23/98 -- 5.2% yield. . . . . . . . . | (K) | $ 7,550,000 | 7,525,387 |
| U.S. Treasury Bill dated 12/04/97 due date 06/04/98 -- 5.0% yield. . . . . . . . . | (K) | $ 4,000,000 | 3,964,360 |
| | | | ----------- |
| Total Investments in U.S. Government Obligations (cost: $11,738,477) . . . . . . . . . . . . . . . . . . . . . . | | | $11,739,710 |
| | | | ----------- |
| Total Investments -- 100% (cost: $27,854,793) . . . . . . . . . | | | $35,676,498 |
| | | | =========== |

The accompanying notes are an integral part of this schedule.

</TABLE>



SCHEDULE OF INVESTMENTS MARCH 31, 1998
(Unaudited)

Notes to Schedule of Investments

(1) Represents a non-income producing security. Equity investments that have not paid dividends within the last twelve months are considered to be non-income producing.
(2) Legal restrictions on sale of investment.
(3) See Footnote to Schedule of Investments for a description of the Method of Valuation A to L.
(4) These investments were made during 1998. Accordingly, the amounts shown on the schedule represent the gross additions in 1998.
(5) No changes in valuation occurred in these investments during the three months ended March 31, 1998.
(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 has not yet commenced its planned principal operations or has commenced such operations but has not realized significant revenue from them.
(7) Formerly named Princeton Electronic Billboard, Inc. As of March 31, 1998, the market price per share of Princeton Video Image, Inc. ("PVII")

was $8.125. As of May 8, 1998, the market price was $5.563 and the Company valued its holding at $674,656. The Company is subject to a lock-up agreement on the stock, which expires December 16, 1998.

(8) As of March 31, 1998, the market price per share of Nanophase Technologies Corporation ("NANX") was $5.375. As of May 8, 1998, the market price per share was $7.00,and the Company valued its holding at $4,054,757. The Company is subject to a lock-up agreement on the stock, which expires on May 26, 1998.

(9) Genomica Corporation was cofounded by the Company, Cold Spring Harbor Laboratory and Falcon Technology Partners, LP. Mr. G. Morgan Browne serves on the Board of Directors of the Company and is Administrative Director of Cold Spring Harbor Laboratory.

(10) Formerly named PowerVoice Technologies, Inc.

(11) BioSupplyNet, Inc. was cofounded by the Company, Cold Spring Harbor Laboratory and other investors. Mr. G. Morgan Browne serves on the Board of Directors and is Administrative Director of Cold Spring Harbor Laboratory.

(12) Investments in unaffiliated companies consist of investments in which Harris & Harris Group,Inc. (the "Company") owns less than 5 percent of the investee company. Investments in non-controlled affiliated companies consist of investments where the Company owns more than 5 percent but less than 25 percent of the investee company. Investments in controlled affiliated companies consist of investments where the Company owns more than 25 percent of the investee company.

(13) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is $4,745,549. The gross unrealized appreciation based on tax cost for these securities is $1,569,243. The gross unrealized depreciation based on the tax cost for these securities is $605,433.

(14) The percentage ownership of each investee company disclosed in the Schedule of Investments expresses the potential common equity interest in each such investee. The calculated percentage represents the amount of the issuer's common stock the Company owns or can acquire as a percentage of the issuer's total outstanding common stock plus common shares reserved for issued and outstanding warrants, convertible securities and stock options.

The accompanying notes are an integral part of this schedule.



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

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

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

Market value for securities traded on securities exchanges or on the Nasdaq National Market is the last reported sales price on the day of valuation. For other securities traded in the over-the-counter market and listed securities for which no sale was reported on that day, market value is the mean of the closing bid price and asked price on that day.

This method is the preferred method of valuation when there is an established public market for a company's securities, as that market provides the most objective basis for valuation.

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



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

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

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

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

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

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 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"). 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. As a BDC, the Company continues to be subject to such reporting requirements.

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification in 1998 as a RIC under Sub-Chapter M of the Code. As a RIC, the Company must, among other things, distribute at least 90 percent of its taxable net income and may either distribute or retain its taxable net realized capital gains on investments. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations - - Recent Developments.") There can be no assurance that the Company will qualify as a RIC or that if it does qualify, it will continue to qualify.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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 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



Income Taxes. Prior to January 1, 1998, the Company recorded income taxes using the liability method in accordance with the provision of Statement of Financial Accounting Standards No. 109. Accordingly, deferred tax liabilities had been established to reflect temporary differences between the recognition of income and expenses for financial reporting and tax purposes, the most significant difference of which relates to the Company's unrealized appreciation on investments.

The March 31, 1998 financial statements do not include a provision for deferred taxes on unrealized gains other than the provision for taxes on the unrealized gains as of December 31, 1997, net of the operating and capital loss carryforwards incurred by the Company through December 31, 1997. (See Note 5. Income Taxes.)

Reclassifications. Certain reclassifications have been made to the December 31, 1997 financial statements to conform to the March 31, 1998 presentation.

Estimates by Management. The preparation of the financial statements in conformity with Generally Accepted Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of March 31, 1998 and December 31,1997, and the reported amounts of revenues and expenses for the three months ended March 31, 1998 and March 31, 1997. Actual results could differ from these estimates.

NOTE 3. STOCK OPTION PLAN AND WARRANTS OUTSTANDING

On August 3, 1989, the shareholders of the Company approved the 1988 Long Term Incentive Compensation Plan. On June 30, 1994, the shareholders of the Company approved various amendments to the 1988 Long Term Incentive Compensation Plan: 1) to conform to the provisions of the Business Development Company regulations under the 1940 Act, which allow for the issuance of stock options to qualified participants; 2) to increase the reserved shares under the amended plan; 3) to call the plan the 1988 Stock Option Plan, as Amended and Restated (the "1988 Plan"); and 4) to make various other amendments. On October 20, 1995, the shareholders of the Company approved an amendment to the 1988 Plan authorizing automatic 20,000 share grants ofnon-qualified stock options to newly elected non-employee directors of the Company.

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 of January 1, 1998, the Company adopted the Harris & Harris Group, Inc. Employee Profit-Sharing Plan ("Plan") that provides for profit-sharing equal to 20 percent of net after-tax income, with the exception of unrealized gains as of September 30, 1997, on which gains the Company will not pay employee profit-sharing. For the three months ended March 31, 1998, the Company had accrued $225,045 under the Plan.



The Company accounted for the 1988 Plan under APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for the 1988 Plan been determined consistent with the fair value method required by FASB Statement No.123 ("FASB No. 123"), the Company's net realized (loss) income and net asset value per share would have been reduced to the following pro-forma amounts:

<TABLE>
<S> <C>

| | March 31, 1997 |
|---|---|
| Net Realized (Loss) Income: | |
| As Reported | $30,458 |
| Pro Forma | $(111,958) |
| Net Asset Value per share: | |
| As Reported | $3.28 |
| Pro Forma | $3.27 |

</TABLE>

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

<TABLE>
<S> <C>

| | March 31, 1997 |
|---|---|
| Stock volatility | 0.60 |
| Risk-free interest rate | 6.3% |
| Option term in years | 7 |
| Stock dividend yield | - - |

</TABLE>

The FASB No. 123 method of accounting has not been applied to options granted prior to January 1, 1995.



A summary of the status of the Company's 1988 Plan at March 31, 1997 and changes during the three months then ended is presented in the table and narrative below:

<TABLE>
<S> <C> <C>

| | March 31, 1997 | |
|---|---|---|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of period | 1,080,000 | $4.58 |
| Granted | 300,000 | $3.88 |
| Exercised | - - | - - |
| Forfeited | 200,000 | $5.37 |
| Expired | - - | - - |
| Canceled | - - | - - |
| Outstanding at end of period | 1,180,000 | $4.27 |
| Exercisable at end of period | 403,000 | $3.42 |
| Weighted average fair value of options granted | $2.50 | - - |

</TABLE>

NOTE 4. EMPLOYEE BENEFITS

The Company has an employment and severance contract ("Employment Contract") with its Chairman, Charles E. Harris, pursuant to which he is to receive compensation in the form of salary and other benefits. On January 1, 1998 Mr. Harris' Employment Contract was amended to reduce his salary to $200,000 and to allow him to participate in other business opportunities and investments. The term of the contract expires on December 31, 1999. Base salary is to be increased annually to reflect inflation and in addition may be increased by such amount as the Compensation Committee of the Board of Directors of the Company deems appropriate. In addition, Mr. Harris would be entitled, under certain circumstances, to receive severance pay under the employment and severance contracts.

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. The Company's contribution to the plan is determined by the Compensation Committee in the fourth quarter.

On June 30, 1994, the Company adopted a plan to provide medical and health coverage 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, 1998, the Company had a reserve of $232,415 for the plan.

NOTE 5. INCOME TAXES

For the three months ended March 31, 1998 and 1997, the Company's income tax benefit was allocated as follows:

<TABLE>

| <S> | <C> | <C> |
|---|---|---|
| | Three Months Ended March 31, 1998 | Three Months Ended March 31, 1997 |
| Investment operations | $ (365,712) | $ 198,881 |
| Realized (loss) gain on investments | (27,531) | (218,088) |
| Decrease in unrealized appreciation on investments | 808,957 | 911,479 |
| Total income tax benefit | $ 415,714 | $ 892,272 |
| The above tax benefit consists of the following: | | |
| Current -- Federal | $ (100,000) | $ (16,197) |
| Deferred -- Federal | 515,714 | 908,469 |
| Total income tax benefit | $ 415,714 | $ 892,272 |

</TABLE>

The Company's net deferred tax liability at March 31, 1998 and December 31, 1997 consists of the following:

<TABLE>

| <S> | <C> | <C> |
|---|---|---|
| | March 31, 1998 | December 31, 1997 |
| Unrealized appreciation on investments | $ 2,008,941 | $ 2,817,898 |
| Net operating loss and capital carryforward | (1,856,958) | (1,856,958) |
| Medical retirement benefits | - - | (81,345) |
| Other | - - | (211,898) |
| Net deferred income tax liability | $ 151,983 | $ 667,697 |

</TABLE>

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification in 1998 as a RIC under Sub-Chapter M of the Code. As a RIC, the Company annually must distribute at least 90 percent of its investment company taxable income as a dividend and may either distribute or retain its taxable net capital gains from investments. There can be no assurance that the Company will qualify as a RIC or that, if it does qualify, it will continue to qualify. To initially qualify as a RIC, the Company must pay a dividend to shareholders equal to the Company's pre-RIC 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). 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 "Management's Discussion and Analysis of Financial Condition and Results of Operation - Recent Developments.")

The Company incurred ordinary and capital losses for a total of approximately $5.3 million during its C Corporation taxable years that remain available for use and may be carried forward to its 1998 and subsequent taxable years. Ordinarily, a corporation that elects to qualify as a RIC may not use its loss carryforwards from C Corporation taxable years to offset

RIC investment company taxable income or net capital gains. In addition, 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 has filed a private ruling request with the Internal Revenue Service ("IRS") asking the IRS to rule that the Company can carry forward its C Corporation losses to offset any Built-In Gains resulting from sales of its C Corporation Assets, thereby enabling the Company to retain some or all of the proceeds from such sales without disqualifying itself as a RIC or incurring corporate level income tax. The Company intends to use the $5.3 million loss carryforward to reduce the taxes due to Built-In Gains. The increase in NAV per share as a result of including the ordinary and capital loss carryforwards in the March 31, 1998 financial statements is approximately $0.17.

In addition, because a RIC is not permitted to have, as of the close of any RIC taxable year, E&P accumulated during any C Corporation taxable year, the Company has also requested a ruling that its sale of C Corporation Assets with Built-In Gains during RIC taxable years will not generate C Corporation E&P. Although there is no guarantee that the IRS will rule favorably on the Company's request for rulings, the management of the Company believes that favorable rulings are likely.

The Company's net deferred income tax liability would have been approximately $525,000 had it continued to account for its taxes as a C Corporation.

NOTE 6. 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. Rent expense under this lease for the three months ended March 31, 1998 and 1997, was $38,808 and $39,497, respectively. Future minimum lease payments in each of the following years are: 1999 -- $176,030; 2000 -- $178,561; 2001 -- $178,561; 2002 -- $178,561; 2003 -- $101,946.

In December 1993, the Company and MIT announced the establishment by the Company of the Harris & Harris Group Senior Professorship at MIT. Prior to the arrangement for the establishment of this Professorship, the Company had made gifts of stock in start-up companies to MIT. These gifts, together with the contribution of $700,000 in cash in 1993, which was expensed by the Company in 1993, were used to establish this named chair. The Company contributed to MIT securities with a cost basis of $3,280, $20,000 and $20,000 in 1993, 1994, and 1995, respectively. These contributions will



be applied to the MIT Pledge at their market value at the time the shares become publicly traded or otherwise monetized in a commercial transaction and are free from restriction as to sale by MIT. At March 31, 1998, the Company would have to fund additional cash and/or property that would have to be valued at a total of approximately $750,000 by December 1998, in order for the Senior Professorship to become permanent.

In June 1997, the Company agreed to provide one of its investee companies with a $450,000 revolving line of credit, of which $110,000 had been used through March 31, 1998. The purpose of this line of credit, which will be secured by accounts receivable, is to provide for seasonal cash flow. To the extent that this line of credit is utilized, the Company will also receive warrants to purchase common stock.

In December 1997, the Company signed a Demand Promissory Note for a $4,000,000 line of credit with J.P. Morgan collateralized by the Company's U.S. Treasury obligations. In March 1998 the line of credit was increased to $6,000,000. As of December 31, 1997, the Company had borrowed $4,000,000 against the line of credit. From December 31, 1997 to January 2, 1998, the rate on the line of credit was prime (8.5 percent). From January 2, 1998 to April 2, 1998, the interest rate on the line of credit was libor plus 1.5 (7.3125 percent). In March 1998, the Company paid down $2,500,000; in April 1998, the Company paid the remaining balance.

On April 9, 1998 the Company announced that it had received under section 851(e) of the Code certification from the Securities and Exchange Commission for 1997, and accordingly, the Company's Board of Directors declared a one-time cash dividend of $0.75 per share (for a total of $8,019,728) to meet one of the Company's requirements for qualification for Sub-Chapter M tax treatment in 1998. The dividend will be paid on May 12, 1998. There can be no assurance that the Company will qualify for Sub-Chapter M tax treatment in 1998 or subsequent periods.

NOTE 7. SUBSEQUENT EVENTS

On April 15, 1998, the Company announced that the Board of Directors had approved the repurchase of up to 700,000 shares of Company stock in the open market. As of May 8, 1998, the Company had repurchased a total of 27,500 shares for a total of $83,875 or an average of $3.05 per share.

Also on April 15, 1998, the Company announced the close of the sale of PureSpeech, Inc. to Voice Control Systems, Inc. (Nasdaq National Market Symbol: "VCSI"). In this transaction, the Company is receiving 268,239 Voice Control Systems common shares, including 56,171 shares purchased for $82,953 through exercise of warrants on April 2, 1998. Ten percent of the shares of VCSI owned by the Company are subject to escrow for one year to cover breaches of representations or warranties by PureSpeech. All of the Company's VCSI shares are restricted under Rule 144, but the Company has a demand registration right.



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

The Company accounts for its operations under Generally Accepted Accounting Principles for investment companies. On this basis, the principal measure of its financial performance is captioned "Net (decrease) increase in net assets from operations," which is the sum of three elements. The first element is "Net operating loss," which is the difference between the Company's income from interest, dividends, and fees and its operating expenses, net of applicable income tax benefit. 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, net of increase (decrease) in deferred income taxes that would become payable if the unrealized appreciation were realized through the sale or other disposition of the investment portfolio.

"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 gain (decreases) increases.

Financial Condition

The Company's total assets and net assets were, respectively, $36,167,658 and $33,651,403 at March 31, 1998, compared to $39,273,784 and $33,654,934 at December 31, 1997. Net asset value per share was $3.15 at March 31, 1998 and December 31, 1997. The Company's shares outstanding were 10,692,971 as of March 31, 1998 and December 31, 1997.

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 or have no history of operations. At March 31, 1998, approximately 45 percent of the Company's $36.2 million in total assets consisted of investments at fair value in private businesses, of which net unrealized appreciation was approximately $5.2 million before taxes. At December 31, 1997, approximately 34 percent of the Company's $39.3 million in total assets consisted of investments at fair value in private businesses, of which net unrealized appreciation was approximately $2.5 million.



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

<TABLE>

| <S> | <C> March 31, 1998 | <C> December 31, 1997 |
|---|---|---|
| Investments, at cost | $ 27,854,793 | $ 30,500,498 |
| Unrealized appreciation | 7,821,705 | 8,158,732 |
| | ----------- | ----------- |
| Investments, at fair value | $ 35,676,498 | $ 38,659,230 |
| | =========== | =========== |

</TABLE>

The accumulated unrealized appreciation on investments net of deferred taxes is $5,812,764 at March 31, 1998, versus $5,340,834 at December 31, 1997.

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) to exercise warrants or options that were acquired in a prior financing; (3) to preserve the Company's proportionate ownership in a subsequent financing; or (4) attempt to preserve or enhance the value of the Company's investment. Such additional investments are referred to as "follow-on" investments. There can be no assurance that the Company will make follow-on investments or have sufficient funds to make additional investments. The failure to make such follow-on investments could jeopardize the viability of the investee company and the Company's investment or could result in a missed opportunity for the Company to participate to a greater extent in an investee's successful operations. The Company attempts to maintain adequate liquid capital to make follow-on investments in its private investee portfolio companies. The Company may elect not to make a follow-on investment either because it does not want to increase its concentration of risk or because it prefers other opportunities, even though the follow-on investment opportunity appears attractive.

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, 1998:

| | |
|---|---|
| Follow-on Investments: | Amount |
| MultiTarget, Inc. | $ 51,802 |
| Sub-total | $ 51,802 |
| Loans: | |
| BioSupplyNet, Inc. | $ 60,000 |
| NBX Corporation | 10,000 |
| Sub-total | $ 70,000 |
| Total | $ 121,802 |



Results of Operations

Investment Income and Expenses:

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 Obligations. The amount of interest income earned varies based upon the average balance of the Company's fixed-income portfolio and the average yield on this portfolio.

The Company had interest income from fixed-income securities of $192,291 and $136,287 for the three months ended March 31, 1998 and 1997, respectively. The increase is due to the additional funds the Company had available for investment in fixed-income securities in 1998 as a result of the funds borrowed against the JP Morgan line of credit.

Operating expenses were $371,450 and $720,599 for three months ended March 31, 1998 and 1997, respectively. The decrease is primarily due to: the reversal of $198,763 for the Company's profit-sharing plan accrual made in the fourth quarter of 1997, a decrease in salaries as a result of reduced staff and a decrease in overall expenses as a result of the Company's effort to cut expenses. The decreases were offset by the interest expense on the funds drawn on the JP Morgan line of credit. Most of the Company's operating expenses are related to employee and director compensation, office and rent expenses and consulting and professional fees (primarily legal and accounting fees).

Net operating losses before taxes were $160,879 and $573,443 for the three months ended March 31, 1998 and 1997, respectively.

For a discussion of the tax benefit and provision in the first quarter of 1998, see Note 5 of Notes to Financial Statements.

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 with certainty, the Company attempts to maintain adequate working capital to provide for fiscal periods when there are no such sales.

Realized Gains and Losses on Sales of Portfolio Securities:

During the three months ended March 31, 1998 and 1997, the Company sold various investments, realizing net gains of $78,661 and $623,108, respectively.

Unrealized Appreciation and Depreciation of Portfolio Securities:

Net unrealized appreciation on investments before taxes decreased by $337,027 during the three months ended March 31, 1998, from $8,158,732 to $7,821,705, primarily as a result of increased valuations on NeuroMetrix, Inc.; PureSpeech,Inc.; Energy Research Corporation and Fuisz Technologies Corporation. These gains were offset primarily by decreased valuations in Nanophase Technologies Corporation, Princeton Video Image, Inc. and MedLogic Global Corporation.

Net unrealized appreciation on investments before taxes decreased $2,604,225 during the three months ended March 31, 1997 from $6,667,589 to $4,063,364, owing primarily to decreased valuations on Harber Brothers Productions, Inc. and PureSpeech, Inc.

Liquidity and Capital Resources

The Company reported total cash, receivables and marketable securities (the primary measure of liquidity) at March 31, 1998 of $18,247,303 (net of $1,500,000 drawn from the JP Morgan line of credit) versus $21,693,067 (net of $4,000,000 drawn from the J.P. Morgan line of credit) at December 31, 1997. Included in marketable securities are the Company's holdings in Nanophase Technologies Corporation of $3,051,400 and Princeton Video Image, Inc. of $966,536. Both holdings are subject to lock-up agreements and are valued at March 31, 1998 at discounts from market value: a 22 percent discount in the case of Nanophase Technologies Corporation and a 21 percent discount in the case of Princeton Video Image, Inc.

As of March 31, 1998, the Company had a $6,000,000 line of credit in place with J.P. Morgan, of which the Company had borrowed $1,500,000. Management believes that its cash, receivables and marketable securities provide the Company with sufficient liquidity for its operations.

On May 12, 1998, the Company will pay out a one-time cash dividend of $0.75 per share for a total of $8,019,728, to meet one of the requirements for qualification for Sub-Chapter M tax treatment in 1998.

Recent Developments

The Company intends to elect to be treated as a RIC for federal income tax purposes for 1998 and to try to continue to maintain that status. (See Item 1. Financial Statements.) As a qualifying RIC, if the Company distributes to stockholders annually in a timely manner at least 90% of its "investment company taxable income," as defined in the Code (i.e., net investment income, including accrued original issue discount, and net short-term capital gains) (the "90% Distribution Requirement"), it will not be subject to federal income tax on the portion of its investment company taxable income and net capital gains (net long-term capital gain in excess of net short-term capital loss) distributed to stockholders. In addition, if the Company distributes in a timely manner 98% of its capital gain net income for each one-year period ending on December 31, and distributes 98% of its net ordinary income for each calendar year (as well as any income not distributed in prior years),



it will not be subject to the 4% nondeductible federal excise tax imposed with respect to certain undistributed income of RICs. The Company generally will endeavor to distribute to stockholders all of its investment company taxable income and its net capital gain, if any, for each taxable year so that such Company will not incur income and excise taxes on its earnings.

In order to qualify as a RIC for federal income tax purposes, the Company must, among other things: (a) continue to qualify as a BDC under the 1940 Act, (b) derive in each taxable year at least 90% of its gross income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or securities, or other income derived with respect to its business of investing in such stock or securities (the "90% Income Test"); and (c) adequately diversify its holdings pursuant to detailed rules set forth in section 851 of the Code.

If the Company acquires or is deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount, the Company will be required to include in income each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received in the same taxable year and to make distributions accordingly.

Although it does not presently expect to do so, the Company is authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, the Company is not permitted to make distributions to stockholders while the Company's debt obligations and other senior securities are outstanding unless certain "asset coverage" tests are met. Moreover, the Company's ability to dispose of assets to meet its distribution requirements may be limited by other requirements relating to its status as a RIC, including the diversification requirements. If the Company disposes of assets in order to meet distribution requirements, the Company may make such dispositions at times which, from an investment standpoint, are not advantageous.

If the Company fails to satisfy the 90% Distribution Requirement or otherwise fails to qualify as a RIC in any taxable year, it will be subject to tax in such year on all of its taxable income, regardless of whether the Company makes any distributions to its stockholders. In addition, in that case, all of the Company's distributions to its stockholders will be characterized as ordinary income (to the extent of the Company's current and accumulated earnings and profits). In contrast, as is explained below, if the Company qualifies as a RIC, a portion ofits distributions may be characterized as long-term capital gain in the hands of stockholders.

Other than distributions properly designated as "capital gain dividends" as is described below, dividends to stockholders of the investment company taxable income of the Company will be taxable as ordinary income to stockholders to the extent of the Company's current or accumulated earnings and profits, whether paid in cash or reinvested in additional shares. Distributions of the Company's net capital gain properly designated by the Company as "capital gain dividends" will be taxable to stockholders as a long-term capital gain regardless of the stockholder's holding period for his or her shares. Distributions in excess of the Company's



earnings and profits will first reduce the adjusted tax basis of the stockholder's shares and, after the adjusted basis is reduced to zero, will constitute capital gains to the stockholder. For a summary of the tax rates applicable to capital gains, including capital gains dividends, see discussion below.

To the extent that the Company retains any net capital gain, it may designate such retained gain as "deemed distributions" and pay a tax thereon for the benefit of its stockholders. In that event, the stockholders will be required to report their share of retained net capital gain on their tax returns as if it had been distributed to them and report a credit, or claim a refund, for the tax paid thereon by the Company. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for his or her shares. Since the Company expects to pay tax on net capital gain at its regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on net capital gain, the amount of tax that individual stockholders will be treated as having paid will exceed the amount of tax that such stockholders would be required to pay on net capital gain.

Stockholders who are not subject to federal income tax or tax on capital gains should be able to file a Form 990T or an income tax return on the appropriate form that allows them to recover the taxes paid on their behalf.

Any dividend declared by the Company in October, November, or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it had been received by the stockholders on December 31 of the year in which the dividend was declared.

Investors should be careful to consider the tax implications of buying shares just prior to a distribution. Even if the price of the shares includes the amount of the forthcoming distribution, the stockholder generally will be taxed upon receipt of the distribution and will not be entitled to offset the distribution against the tax basis in his or her shares.

A stockholder may recognize taxable gain or loss if he or she sells or exchanges his or her shares. Any gain arising from (or, in the case of distributions in excess of earnings and profits, treated as arising from) the sale or exchange of shares generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if the stockholder has held his or her shares for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of shares held for six months or less will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received with respect to such shares and, for this purpose, the special rules of Section 246(c)(3) and (4) of the Code generally apply in determining the holding period of shares. It is unclear how any such long-term capital loss offsets capital gains taxable at different rates. All or a portion of any loss realized upon a taxable disposition of shares of the Company may be disallowed if other shares of the Company are purchased within 30 days before or after the disposition.

In general, net capital gain (the excess of net long-term capital gain over net short-term capital loss) of non-corporate taxpayers is currently subject to a maximum federal income tax rate of 28% (subject to reduction in many situations) while other income may be taxed at rates as high as 39.6%. Capital gains derived from the disposition of assets held for more than 18 months generally are subject to federal income tax at the rate of 20%. Corporate taxpayers are currently subject to federal income tax on net capital gain at the maximum 35% rate also applied to ordinary income. Tax rates imposed by states and local jurisdictions on capital gain and ordinary income may differ.

The Company may be required to withhold U.S. federal income tax at the rate of 31% of all taxable dividends and distributions payable to stockholders who fail to provide the Company with their correct taxpayer identification number or to make required certifications, or regarding whom the Company has been notified by the IRS that they are subject to backup withholding. Backup withholding is not an additional tax, and any amounts withheld may be credited against a stockholder's U.S. federal income tax liability.

Federal withholding taxes at a 30% rate (or a lesser treaty rate) may apply to distributions to stockholders that are nonresident aliens or foreign partnerships, trusts, or corporations. Foreign investors should consult their tax advisors with respect to the possible U.S. federal, state, and local tax consequences and foreign tax consequences of an investment in the Company.

The Company will send to each of its stockholders, as promptly as possible after the end of each fiscal year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder's taxable income for such year as ordinary income and as long-term capital gain. In addition, the federal tax status of each year's distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder's particular situation. The Company's ordinary income dividends to its corporate shareholders may, if certain conditions are met, qualify for the dividends received deduction to the extent that the Company has received qualifying dividend income during the taxable year; capital gain dividends distributed by the Company are not eligible for the dividends received deduction.

If necessary for liquidity purposes, in lieu of distributing its taxable net capital gains, the Company may retain such net capital gains and elect to be deemed to have made a distribution of the gains, or part thereof, to the shareholders under the "designated undistributed capital gain" rules of section 852(b)(3) of the Code. In such a case, the Company would have to pay a 35 percent corporate level income tax on such "designated undistributed capital gain," but it would not have to distribute the excess of the retained "designated undistributed capital gain" over the amount of tax thereon in order to maintain its RIC status.

On May 12, 1998, the Company will distribute its cumulative E&P through December 31, 1997 for a total of approximately $8.0 million. As of March 31, 1998, the Company believes that it has sufficient current assets to make such distribution without jeopardizing its ability to pay its operating expenses as they may become due.



## Risks

There are significant risks inherent in the Company's venture capital business. The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth and have not attained profitability or have no history of operations. Because of the speculative nature and the lack of a public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities. The Company expects that some of its venture capital investments will be a complete loss or will be unprofitable and that some will appear to be likely to become successful but never realize their potential. The Company has been risk seeking rather than risk averse in its approach to venture capital and other investments. Neither the Company's investments nor an investment in the Company is intended to constitute a balanced investment program. The Company has in the past relied and continues to rely to a large extent upon proceeds from sales of investments rather than investment income to defray a significant portion of its operating expenses.

## Risks Relating to the Year 2000 Issue

The Company believes that the Year 2000 problem is not material to the Company. Many computer software systems in use today cannot recognize the Year 2000 and may revert to 1900 or some other date because of the way in which dates were encoded and calculated. The Company could be adversely affected if its computer system or those of its service providers do not properly process and calculate date-related information and data on and after January 1, 2000. The Company has been actively working on necessary changes to its computer systems to prepare for the Year 2000 and intends to obtain reasonable assurances from its service providers that they are taking comparable steps with respect to their computer systems. However, the steps the Company is taking and intends to take does not guarantee complete success or eliminate the possibility that interaction with outside computer systems may have an adverse impact on the Company.

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

Not Applicable



PART II. OTHER INFORMATION

Item 1. Legal Proceedings
Not Applicable

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

Item 3. Defaults Upon Senior Securities
Not Applicable

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

Item 5. Other Information
Not Applicable

Item 6. Exhibits and Reports on Form 8-K

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.

10.16* Demand Promissory Note - Line of Credit, Statement of Purpose for an Extension of Credit Secured by Margin Stock by and among Harris & Harris Group, Inc. And J.P. Morgan.

11.0* Computation of per share earnings. See Statement of Operations.

27.0* Financial Data Schedule.

(b) The Company did not file any reports on Form 8-K during the first quarter of 1998.



EXHIBIT INDEX

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

27. Financial Data Schedule



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.

By: /s/ Rachel M. Pernia
-------------------------
Rachel M. Pernia, Vice President
Treasurer, Controller and Principal
Accounting Officer

Date: May 15, 1998

WARNING: THE EDGAR SYSTEM ENCOUNTERED ERROR(S) WHILE PROCESSING THIS SCHEDULE.

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DEMAND PROMISSORY NOTE -- LINE OF CREDIT

Date: March 26, 1998

U.S. $6,000,000.00

FOR VALUE RECEIVED, Harris & Harris Group, Inc. (the "Borrower")promises to pay to the order of MORGAN GUARANTY TRUST COMPANY OF NEW YORK (the "Bank"), ON DEMAND at its office at 60 Wall Street, New York, New York 10260-0060, U.S.A., for the account of its Lending Office (as hereinafter defined), in lawful money of the United States of America in same day funds (or in such funds as may from time to time become customary for the settlement of international transactions in U.S. dollars), the lesser of (i) U.S. $6,000,000.00 or (ii) the then-outstanding principal amount of each loan (the "Loan" or "Loans") made by the Bank from time to time to the Borrower hereunder. The Borrower shall pay interest on the unpaid principal amount of each Loan until maturity on the dates and at a rate per annum as hereinafter set forth. As used herein, "Lending Office" means, (i) with regard to Loans bearing interest based on the Prime Rate (as hereinafter defined) (collectively, "Domestic Loans"), the office of the Bank located at 60 Wall Street, New York, New York or such other office as the Bank may designate, and (ii) with regard to Loans bearing interest based on the Eurodollar Rate (as hereinafter defined) (collectively, "Eurodollar Loans"), the Nassau (Bahamas) office of the Bank or such other office as the Bank may designate.

Interest based on the Prime Rate shall be computed on the basis of a year of 365 days (or 366 days in a leap year) and paid for actual days elapsed (including the first day but excluding the last day). Interest based on the Eurodollar Rate shall be computed on the basis of a year of 360 days and paid for the actual number of days elapsed (including the first day but excluding the last day).

Each Eurodollar Loan shall bear interest at a rate per annum (the "Eurodollar Rate") equal to the Adjusted Eurodollar Rate (as hereinafter defined) plus 1.500% (the Eurodollar Margin"), payable on the last day of the Interest Period applicable thereto and, if such Interest Period is longer than three months, at intervals of three months after the first day thereof. The "Adjusted Eurodollar Rate" applicable to any Interest Period (as hereinafter defined) means a rate per annum equal to the quotient obtained (rounded upwards, if necessary, to the next higher 1/100 of 1%) by dividing (i) the applicable London Interbank Offered Rate by (ii) 1.00 minus the Eurodollar Reserve Percentage. The "London Interbank Offered Rate" applicable to any Interest Period means the rate per annum at which deposits in U.S. dollars are offered to the Bank in the London interbank market at approximately 11:00 a.m. (London time) two business days prior to the first day of such Interest Period in an amount approximately equal to the principal amount of the Loan to which such Interest Period applies and for the period of time comparable to such Interest Period. The "Eurodollar Reserve Percentage" means for any day that percentage (expressed as a decimal) which is in effect on such day, as prescribed by the Board of Governors of the Federal Reserve System (or any successor) for determining the maximum reserve requirement for a member bank of the Federal Reserve System in New York City with deposits exceeding five billion dollars in respect of "Eurocurrency liabilities" (or in respect of any other category of liabilities which includes deposits by reference to which the interest rate on the Loans is determined or any category of extensions of credit or other assets which includes loans by a non-United States office of the Bank to United States residents). The Adjusted Eurodollar Rate shall be adjusted automatically on and as of the effective date of any change in the Eurodollar Reserve Percentage. As used herein, the term "Interest Period" means the period beginning on the date of each Eurodollar Loan and ending on the numerically corresponding day in the calendar month One or Three months after such date; provided, that if an Interest Period would otherwise end on a day which is not a business day it shall be extended to the next succeeding business day unless such business day falls in the next calendar month, in which case the Interest Period shall end on the next preceding business day; provided, further, that if the Bank shall not have received written notice to the contrary from the Borrower at least five business days prior to the end of an Interest Period the Borrower shall be deemed to have requested to select an Interest Period with a duration equal to that then ending. As used herein, the term "business day" means any day on which dealings in U.S. dollar deposits are carried on in the London interbank market and on which commercial banks are open for domestic and foreign exchange business in London and New York City. Notice by the Bank to the Borrower of the rate of interest so determined shall be binding and conclusive upon the Borrower in the absence of manifest error.

Each Domestic Loan shall bear interest payable on the last day of each month at a rate per annum for each day equal to the rate of interest publicly announced by the Bank in New York City from time to time as its Prime Rate (the "Prime Rate") for such day, plus 0.000%.

The Borrower shall pay interest on the unpaid principal amount of each Loan after the maturity thereof and, to the extent permitted by law, on accrued and unpaid interest until paid at a rate per annum equal to the sum of 2% plus the Prime Rate.

If after the date of this Note any applicable rule, executive order, decree, regulation or interpretation is amended, modified, enacted or promulgated by any government or governmental authority so as to (i) change the basis of taxation of payments to the Bank or the Lending Office of the Bank extending a Eurodollar Loan (the "Eurodollar Lending Office") in respect to the principal of and interest on any Eurodollar Loan (except for changes in the rate of taxation on the overall net income of the Bank by the United States of America or the Eurodollar Lending Office of the Bank by the jurisdiction in which such Lending Office is located), or (ii) impose, modify or deem applicable any reserve, special deposit or similar requirement against any of the assets of, deposits with or for the account of, or credit extended by the Bank's Eurodollar Lending Office, or (iii) impose on the Bank (or its Eurodollar Lending Office) or the London interbank market any other conditions affecting any Loan, the Loans or this Note, and the result of any of the foregoing is to increase the cost to the Bank (or its Eurodollar Lending Office) of agreeing to make or making, funding or maintaining any Loan evidenced by this Note or would have the effect of reducing the rate of return on the capital of the Bank or any entity controlling the Bank (its "Parent") as a consequence of agreeing to make any Loan, or to reduce the amount of any sum receivable by the Bank (or its Eurodollar Lending Office) on this Note, then the Borrower shall pay to the Bank or its Parent upon demand such amount as will compensate the Bank or its Parent for such additional cost or reduction in return.  A certificate of the Bank setting forth the basis for the determination of any amount necessary to compensate the Bank or its Parent as aforesaid shall be conclusive as to the determination of such amount in the absence of manifest error.

If, after the date of this Notice, the introduction of, or any change in, any applicable law, rule or regulation or in the interpretation or administration thereof by any governmental authority charged with the interpretation or administration thereof or compliance by the Bank (or its Eurodollar Lending Office) with any request or directive (whether or not having the force of law) of any such authority shall make it unlawful or impossible for the Bank (or its Eurodollar Lending Office) to make, maintain or fund its Eurodollar Loans, the Bank forthwith shall so notify the Borrower. Upon receipt of such notice, the Borrower shall prepay in full the then outstanding principal amount of each Eurodollar Loan, together with accrued interest thereon, either (a) on the last day of the Interest Period applicable thereto if the Bank may lawfully continue to maintain and fund such Loan to such day or (b) immediately if the Bank may not lawfully continue to fund and maintain such Loan to such day.

Eurodollar Loans may not be repaid at the Borrower's option on a date other than the last day of an Interest Period.  If, however, the Borrower makes any payment of principal of any Eurodollar Loan or any day other than the last day of the Interest Period applicable thereto, the Borrower shall reimburse the Bank on demand for any loss or expense incurred by it as a result of the timing of such payment, including (without limitation) any loss incurred in obtaining, liquidating or employing deposits from third parties, provided that the Bank shall have delivered to the Borrower a certificate as to the amount of such loss, which certificate shall be conclusive in the absence of manifest error.

Domestic Loans may be prepaid at any time without penalty or premium.

The Borrower hereby waives diligence, presentment, demand, protest and notice of any kind whatsoever.  The non-exercise by the Bank of its rights hereunder in any particular instance shall not constitute a waiver of any right in any subsequent instance.

The holder of this Note shall, and is hereby authorized by the Borrower to, endorse on the schedule forming a part hereof appropriate notations evidencing the date and the amount of each Loan made by the Bank, the date and amount of each payment of principal, whether such Loan is a Domestic or Eurodollar Loan and, in the case of Eurodollar Loans, the Eurodollar Rate applicable thereto.

If this Note is not paid in full when due the Borrower agrees to pay all costs and expenses of collection including reasonable attorney's fees.  The Borrower shall reimburse the Bank on demand for any transfer taxes, documentary taxes, assessments or charges that are imposed at any time on or in connection with this Note, any renewal hereof, the debt evidenced hereby or any advance made hereunder and shall indemnify the Bank against liability for any such tax (including any interest and penalties).

To secure payment of this Note, the Borrower hereby transfers, pledges, gives a security interest in and delivers to the Bank all present and future contents of the Borrower's

USA Treasurers held in Morgan Custody Account C88659

, all proceeds and products thereof, accessions thereto and substitutions therefor (the "Collateral").

Upon the nonpayment of any amount when due hereunder, the holder shall have the rights and remedies provided in the Uniform Commercial Code in force in New York at the date of execution of this Note and in addition to, in substitution for, in modification of, or in conjunction with those rights and remedies, the holder or its agents may, in its discretion, sell, assign and deliver all or any part of the Collateral at any broker's board or at public or private sale without notice or advertisement, and bid and become purchasers at any public sale or at any broker's board, and, if notice to the Borrower is required by law, give written notice to the Borrower five days prior to the date of public sale of the Collateral or prior to the date after which private sale of the Collateral will be made by mailing such notice to the address designated by the Borrower with the Borrower's signature below. The Borrower agrees that the proceeds of the disposition of the collateral may be applied by the holder to the satisfaction of the liabilities of the Borrower to the holder in any order of preference which the holder, in its sole discretion, chooses, and that the excess, if any, shall be returned to the Borrower, which shall continue liable to the holder for any deficiency remaining with interest thereon. The waiver or remedying of any default shall not operate as a waiver of the default remedies or any other prior or subsequent default.

The undersigned, if more than one, shall be jointly and severally liable hereunder and the term "Borrower" shall mean the undersigned or any one or more of them and their heirs, executors, administrators, successors and assigns.

THIS NOTE SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAW OF THE STATE OF NEW YORK. THE BORROWER HEREBY SUBMITS TO THE NONEXCLUSIVE JURISDICTION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK AND OF ANY NEW YORK STATE COURT SITTING IN NEW YORK CITY FOR PURPOSES OF ALL LEGAL PROCEEDINGS ARISING OUT OF OR RELATING TO THIS NOTE OR ANY AGREEMENT RECEIVED BY THE BANK IN CONNECTION HEREWITH. THE BORROWER IRREVOCABLY WAIVES, TO THE FULLEST EXTENT PERMITTED BY LAW, ANY OBJECTION WHICH THE BORROWER MAY NOW OR HEREAFTER HAVE TO THE LAYING OF THE VENUE OF ANY SUCH PROCEEDING BROUGHT IN SUCH A COURT AND ANY CLAIM THAT ANY SUCH PROCEEDING BROUGHT IN SUCH A COURT HAS BEEN IN AN INCONVENIENT FORUM. THE BORROWER HEREBY IRREVOCABLY WAIVES ANY AND ALL RIGHT TO TRIAL BY JURY IN ANY LEGAL PROCEEDING ARISING OUT OF OR RELATING TO THIS NOTE OR ANY AGREEMENT RECEIVED BY THE BANK IN CONNECTION HEREWITH.

By executing and delivering this Note to the Bank, the Borrower is deemed to have agreed to be bound by the Terms and Conditions of Advised Line of Credit and any changes or revisions made thereto pursuant to paragraph 7 thereof.

SIGNATURE:

/s/Mel P. Melsheimer
- ---------------------
Mel P. Melsheimer
President & COO
Harris & Harris Group, Inc.

Address: One Rockefeller Plaza
Suite 1430
New York, NY 10020

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Statement of Purpose for an Extension of Credit Secured by Margin Stock

Morgan Guaranty Trust Company of New York
____________________________________________
Name of Bank

(Federal Reserve Form U-1)

This form is required by law (15 U.S.C. Sections 78g and 78w; 12 CFR 221)

Instructions

1. This form must be completed when a bank extends credit in excess of $100,000 secured directly or indirectly, in whole or in part, by any margin stock.

2. The term "margin stock" is defined in Regulation U (12 CFR 221) and includes, principally: (1) stocks that are registered on a national securities exchange or that are on the Federal Reserve Board's List of Marginable OTC Stocks; (2) debt securities (bonds) that are convertible into margin stocks; (3) any over-the-counter security designated as

qualified for trading in the National Market System under a designation plan approved by the Securities and Exchange Commission (NMS security); and (4) shares of mutual funds, unless 95 per cent of the assets of the fund are continuously invested in U.S. government, agency, state, or municipal obligations.

3. Please print or type (if space is inadequate, attach separate sheet).

Part 1 To be completed by borrower(s).

1. What is the amount of the credit being extended? $6,000,000 = Six Million Dollars

2. Will any part of this credit be used to purchase or carry margin stock? Yes ____ No _X_

If the answer is "no", describe the specific purpose of the credit. WORKING CAPITAL

I (we) have read this form and certify that to the best of my (our) knowledge and belief the information given in true, accurate, and complete, and that the margin stock and any other securities collateralizing this credit are authentic, genuine, unaltered, and not stolen, forged, or counterfeit.

Signed:

/s/Mel P. Melsheimer
- --------------------
Mel P. Melsheimer 3/26/98

Harris & Harris Group, Inc.

This form should not be signed in blank.

A borrower who falsely certifies the purpose of a credit on this form or otherwise willfully or intentionally evades the provisions of Regulation U will also violate Federal Reserve Regulation X "Borrower of Securities Credit."