HARRIS & HARRIS GROUP INC /NY/
Form 10-Q
November 04, 2005

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 September 30, 2005

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

For the transition period from ____________ to _____________

Commission File Number: 0-11576

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)	(IRS Employer Identification No.)

111 West 57th Street, New York, New York	10019
(Address of Principal Executive Offices)	(Zip Code)

(212) 582-0900

(Registrant's telephone number, including area code)

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

Yes |X| No |_|

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

Yes |X| No |_|

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes |_| No |X|

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

Class	Outstanding at November 4, 2005

Common Stock, $0.01 par value per share	20,756,345 shares

Harris & Harris Group, Inc.
Form 10-Q, September 30, 2005

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

Harris & Harris Group, Inc.(R) (the "Company," "us," "our" and "we"), is an internally managed venture capital company that has elected to be treated as a business development company under the Investment Company Act of 1940 (the "1940 Act"). 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. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2004, contained in our Annual Report on Form 10-K for the year ended December 31, 2004.

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

Because of the specialized nature of our investment portfolio, we generally can satisfy the diversification requirements under Subchapter M of the Code only if we receive a certification from the Securities and Exchange Commission ("SEC") that we are "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 June 15, 2005, we received SEC certification for 2004, permitting us to qualify for RIC treatment for 2004 (as we had for the years 1999 through 2003). Although the SEC certification for 2004 was issued, there can be no assurance that we will qualify for or receive such certification for subsequent years (to the extent we need additional certification as a result of changes in our portfolio) or that we will actually qualify for Subchapter M treatment in subsequent years. In addition, under certain circumstances, even if we qualified for Subchapter M treatment in a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC.

HARRIS & HARRIS GROUP, INC.(R)
CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

ASSETS

	September 30, 2005 (Unaudited)	December 31, 2

Investments, at value (Cost: $109,470,584 at 9/30/05, $77,442,110 at 12/31/04)	$ 130,127,822	$ 76,244,682
Cash and cash equivalents	221,374	650,332
Restricted funds	1,653,040	1,591,971
Receivable from portfolio company	0	10,000
Interest receivable	168,612	58,960
Income tax receivable	11,016	2,480
Prepaid expenses	105,069	542,489
Other assets, net of reserve of $255,486 at 12/31/04 (Note 9)	236,248	260,537
Total assets	$ 132,523,181	$ 79,361,451
LIABILITIES & NET ASSETS		
Accounts payable and accrued liabilities	$ 3,346,238	$ 2,905,658
Accrued profit sharing (Note 4)	4,405,953	311,594
Deferred rent	29,828	34,930
Deferred income tax liability (Note 6)	1,364,470	1,364,470
Total liabilities	9,146,489	4,616,652
Net assets	$ 123,376,692	$ 74,744,799
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, 30,000,000 shares authorized at 9/30/05 and 25,000,000 shares authorized at 12/31/04; 22,585,085 issued at 9/30/05 and 19,077,585 issued at 12/31/04	225,852	190,776
Additional paid in capital (Note 8)	122,149,641	85,658,150
Accumulated net realized loss	(14,710,466)	(4,961,123
Accumulated unrealized appreciation (depreciation) of investments, including deferred tax liability of $1,540,044 at 9/30/05 and at 12/31/04 (Note 6)	19,117,196	(2,737,473
Treasury stock, at cost (1,828,740 shares at 9/30/05 and 12/31/04)	(3,405,531)	(3,405,531
Net assets	$ 123,376,692	$ 74,744,799
Shares outstanding	20,756,345	17,248,845
Net asset value per outstanding share	$ 5.94	$ 4.33

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended Sept. 30		Nine Month
	2005	2004	2005
Investment income:			
Interest from:			
Fixed-income securities	$ 315,089	$ 235,778	$ 743,57
Portfolio companies	0	17,803	(9,78
Other income	285	0	5,40
Total investment income	315,374	253,581	739,20
Expenses:			
Profit sharing	2,393,488	336,820	4,094,35
Salaries and benefits	673,064	419,384	1,855,36
Administration and operations	264,130	129,649	1,076,33
Professional fees	124,767	231,144	615,35
Rent	51,996	38,860	151,85
Directors' fees and expenses	64,089	63,188	204,83
Depreciation	17,637	10,958	49,53
Bank custody fees	0	2,351	8,59
Total expenses	3,589,171	1,232,354	8,056,23
Net operating loss	(3,273,797)	(978,773)	(7,317,03
Net realized (loss) income on investments:			
Realized (loss) income on investments	(240)	2,704	(2,427,46
Income tax benefit (provision) (Note 6)	13	1,482	(4,83
Net realized (loss) income on investments	(227)	4,186	(2,432,30
Net realized loss	(3,274,024)	(974,587)	(9,749,34
Net increase in unrealized appreciation / decrease in unrealized depreciation on investments:			
Investment sales	0	0	2,956,49
Investments held	10,610,947	2,731,943	18,898,17
Income tax benefit (provision) (Note 6)	0	(646,235)	
Net increase in unrealized appreciation / decrease in unrealized depreciation on investments	10,610,947	2,085,708	21,854,66
Net increase (decrease) in net assets resulting from operations:			
Total	$ 7,336,923	$ 1,111,121	$ 12,105,32

Per average outstanding share	$ .40	$ .06	$ .6
Average outstanding shares	18,593,166	17,023,845	17,701,87

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended Septe	
	2005	20
Cash flows from operating activities:		
Net increase (decrease) in net assets resulting from operations	$ 12,105,326	$ (3
Adjustments to reconcile net increase (decrease) in net assets resulting from operations to net cash used in operating activities:		
Net realized and unrealized gain on investments	(19,427,200)	(2,8
Depreciation	49,535	
Deferred income taxes	0	6
Changes in assets and liabilities:		
Accrued profit sharing	4,094,359	3
Funds in escrow	0	
Restricted funds	(61,069)	(1
Receivable from portfolio company	10,000	
Interest receivable	(109,652)	(1
Income tax receivable	(8,536)	
Prepaid expenses	437,420	(
Other assets	13,346	
Accounts payable and accrued liabilities	440,580	(1
Deferred rent	(5,102)	
Broker payable	0	
Net cash used in operating activities	(2,460,993)	(2,6
Cash flows from investing activities:		
Net purchase of short-term investments and marketable securities	(25,740,084)	(24,5

Proceeds from sale of investments	661,440	2,5
Investment in private placements and loans, net	(9,377,296)	(11,4
Purchase of fixed assets	(38,592)	(
Net cash used in investing activities	(34,494,532)	(33,5
Cash flows from financing activities:		
Proceeds from public offering, net	36,526,567	36,1
Net decrease in cash and cash equivalents:		
Cash and cash equivalents at beginning of the period	650,332	4
Cash and cash equivalents at end of the period	221,374	2
Net decrease in cash and cash equivalents	$ (428,958)	$ (1
Supplemental disclosures of cash flow information:		
Income taxes paid	$ 0	$

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

	Nine Months Ended September 30, 2005 (Unaudited)	Year Ended December 31, 2004
Changes in net assets from operations:		
Net operating loss	$ (7,317,035)	$ (3,408,779)
Net realized (loss) income on investments .	(2,432,308)	858,503
Net increase in unrealized appreciation on investments as a result of sales	2,956,491	915,118
Net increase (decrease) in unrealized appreciation on investments held	18,898,178	(430,956)
Net increase (decrease) in net assets resulting from operations	12,105,326	(2,066,114)

Changes in net assets from capital Stock transactions:		
Net proceeds from sale of stock	36,526,567	36,128,175
Net increase in net assets resulting from capital stock transactions	36,526,567	36,128,175
Net increase in net assets	48,631,893	34,062,061
Net assets:		
Beginning of the period	74,744,799	40,682,738
End of the period	$ 123,376,692	$ 74,744,799

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(Unaudited)

	Method of Valuation (3)
Investments in Unaffiliated Companies (7)(8) - 9.6% of net assets	
Private Placement Portfolio (Illiquid) - 9.6% of net assets	
AlphaSimplex Group, LLC (2) -- Investment management company headed by Dr. Andrew W. Lo, holder of the Harris & Harris Group Chair at MIT	
Limited Liability Company Interest..	(C)
Crystal IS, Inc. (1)(2)(5) - Develops a technology to grow single-crystal boules of aluminum nitride for gallium nitride electronics	
Series A Convertible Preferred Stock...	(A)
Exponential Business Development Company (1)(2) -- Venture capital partnership focused on early stage companies	

	Method of Valuation (3)
Limited Partnership Interest	(B)
Heartware, Inc. (1)(2)(5) -- Develops ventricular assist devices	
Series A-2 Non-Voting Preferred Stock	(B)
Molecular Imprints, Inc. (1)(2) -- Develops nanoimprint lithography capital equipment	
Series B Convertible Preferred Stock	(A)
Series C Convertible Preferred Stock	(A)
Nanosys, Inc. (1)(2)(5) -- Develops nanotechnology-enabled systems incorporating zero and one-dimensional inorganic nanometer-scale materials	
Series C Convertible Preferred Stock	(A)
Nantero, Inc. (1)(2)(5) -- Develops a high-density, nonvolatile, random access memory chip, using nanotechnology	
Series A Convertible Preferred Stock	(C)
Series B Convertible Preferred Stock	(C)
Series C Convertible Preferred Stock	(C)
NeoPhotonics Corporation (1)(2)(5) -- Develops and manufactures planar optical devices and components	
Common Stock	(C)
Series 1 Convertible Preferred Stock	(C)
Series 2 Convertible Preferred Stock	(C)
Warrants at $0.15 expiring 01/26/10	(C)
Warrants at $0.15 expiring 12/05/10	(C)

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(Unaudited)

	Method of Valuation (3)
Investments in Unaffiliated Companies (7)(8) - 9.6% of net assets (cont.)	
Private Placement Portfolio (Illiquid) - 9.6% of net assets (cont.)	

Optiva, Inc. (1)(2) -- Developed nanomaterials for
display industry applications
Series C Convertible Preferred Stock..(B)
Secured Convertible Bridge Note with 50% Preferred
Stock Warrant coverage..(B)

Polatis, Inc. (1)(2)(5) -- Develops optical networking components
by merging materials, MEMS and electronics technologies
Series A-1 Convertible Preferred Stock......................................(B)
Series A-2 Convertible Preferred Stock......................................(B)

Total Unaffiliated Private Placement Portfolio (cost: $13,869,543)...............................

Total Investments in Unaffiliated Companies (cost: $13,869,543)...................................

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(Unaudited)

Method of Valuation (3)

Investments in Non-Controlled Affiliated Companies (7)(9) - 38.9% of net assets

Publicly Traded Portfolio - 27.5% of net assets

NeuroMetrix, Inc. (1)(10) -- Develops and sells medical devices for
monitoring neuromuscular disorders
Common Stock..(D)

Total Publicly Traded Portfolio (cost: $4,411,374)..

Private Placement Portfolio (Illiquid) - 11.4% of net assets

Cambrios Technologies Corporation (1)(2)(5) -- Develops commercially relevant materials by evolving biomolecules to express control over nanostructure synthesis
Series B Convertible Preferred Stock...(A)

Chlorogen, Inc. (1)(2)(5) -- Develops patented chloroplast technology to produce plant-made proteins
Series A Convertible Preferred Stock...(A)

CSwitch, Inc. (1)(2)(5) -- Develops next-generation, system-on-a-chip solutions for communications-based platforms
Series A Convertible Preferred Stock...(A)

eLite Optoelectronics Inc. (1)(2)(4)(5) - Develops high-power light emitting diodes
Series B Convertible Preferred Stock...(A)

Experion Systems, Inc. (1)(2)(6) -- Develops and sells software to credit unions
Series A Convertible Preferred Stock...(B)
Series B Convertible Preferred Stock...(B)
Series C Convertible Preferred Stock...(B)
Series D Convertible Preferred Stock...(B)

Kereos, Inc. (1)(2)(4)(5) -- Develops molecular imaging agents and targeted therapeutics to image and treat cancer and cardiovascular disease
Series B Convertible Preferred Stock...(A)

NanoGram Corporation (1)(2)(5) -- Develops a broad suite of intellectual property utilizing nanotechnology
Series I Convertible Preferred Stock...(A)
Series II Convertible Preferred Stock..(A)

Nanomix, Inc. (1)(2)(5) -- Develops nanoelectronic sensors that integrate carbon nanotube electronics with silicon microstructures
Series C Convertible Preferred Stock...(A)

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(Unaudited)

	Method of Valuation (3)
Private Placement Portfolio (Illiquid) - 11.4% of net assets (cont.)	
NanoOpto Corporation (1)(2)(5) -- Develops discrete and integrated optical communications sub-components on a chip by utilizing nano-manufacturing technology	
Series A-1 Convertible Preferred Stock	(B)
Series B Convertible Preferred Stock	(B)
Series C Convertible Preferred Stock	(B)
Warrants at $0.4359 expiring 03/15/10	(B)
Nanopharma Corp. (1)(2)(5) -- Develops advanced polymers for drug delivery	
Series A Convertible Preferred Stock	(B)
Secured Convertible Bridge Note with 25% Warrants	(B)
Nextreme Thermal Solutions, Inc. (1)(2)(5) -- Manufactures thin-film, superlattice thermoelectric devices	
Series A Convertible Preferred Stock	(A)
Questech Corporation (1)(2) -- Manufactures and markets proprietary metal decorative tiles	
Common Stock	(C)
Warrants at $1.50 expiring 11/16/05	(B)
Warrants at $1.50 expiring 08/03/06	(B)
Warrants at $1.50 expiring 11/21/07	(B)
Warrants at $1.50 expiring 11/19/08	(B)
Warrants at $1.50 expiring 11/19/09	(B)
Solazyme, Inc. (1)(2)(5) -- Harnesses energy-harvesting machinery of photosynthetic microbes to produce industrial and pharmaceutical molecules	
Convertible Promissory Note	(A)
Starfire Systems, Inc. (1)(2)(5) -- Develops and produces ceramic-forming polymers	
Common Stock	(A)
Series A-1 Convertible Preferred Stock	(A)
Zia Laser, Inc. (1)(2)(4)(5) -- Manufactures quantum dot semiconductor lasers	
Series C Convertible Preferred Stock	(B)
Total Non-Controlled Private Placement Portfolio (cost: $20,516,103)	

Total Investments in Non-Controlled Affiliated Companies (cost: $24,927,477)....................

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(Unaudited)

	Method of Valuation (3)
U.S. Government and Government Agency Securities - 57.0% of net assets	
U.S. Treasury Bills -- due date 10/27/05	(J)
U.S. Treasury Bills -- due date 12/29/05	(J)
U.S. Treasury Notes -- due date 02/28/06, coupon 1.625%	(H)
U.S. Treasury Bills -- due date 03/02/06	(J)
U.S. Treasury Bills -- due date 03/16/06	(J)
U.S. Treasury Notes -- due date 03/31/06, coupon 1.5%........................	(H)
U.S. Treasury Notes -- due date 06/30/06, coupon 2.75%.......................	(H)
U.S. Treasury Notes -- due date 02/15/07, coupon 2.25%.......................	(H)
U.S. Treasury Notes -- due date 05/15/08, coupon 2.625%......................	(H)
U.S. Treasury Notes -- due date 03/15/09, coupon 2.625%......................	(H)

Total Investments in U.S. Government and Government Agency Securities (cost: $70,673,564)...

Total Investments (cost: $109,470,584)..

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

HARRIS & HARRIS GROUP, INC. (R)
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2005
(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 Valuation Procedures.

(4) Initial investment was made during 2005.

(5) 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.

(6) Experion Systems, Inc., was previously named MyPersonalAdvocate.com, Inc.

(7) Investments in unaffiliated companies consist of investments in which we own less than five percent of the voting shares of the portfolio company. Investments in non-controlled affiliated companies consist of investments in which we own five percent or more, but less than 25 percent, of the voting shares of the portfolio company or where we hold one or more seats on the portfolio company's Board of Directors. Investments in controlled affiliated companies consist of investments in which we own 25 percent or more of the voting shares of the portfolio company.

(8) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is $13,869,543. The gross unrealized appreciation based on the tax cost for these securities is $970,766. The gross unrealized depreciation based on the tax cost for these securities is $2,981,080.

(9) The aggregate cost for federal income tax purposes of investments in non-controlled affiliated companies is $24,927,477. The gross unrealized appreciation based on the tax cost for these securities is $29,454,085. The gross unrealized depreciation based on the tax cost for these securities is $6,440,126.

(10) The lock-up period on the sale of these shares expired on January 18, 2005.

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

HARRIS & HARRIS GROUP, INC. (R)
FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)

VALUATION PROCEDURES

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

1) Equity-Related Securities;

2) Investments in Intellectual Property or Patents or Research and Development in Technology or Product Development;

3) Long-Term Fixed-Income Securities;

4) Short-Term Fixed-Income Investments; and

5) All Other Investments.

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

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

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

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

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

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

EQUITY-RELATED SECURITIES

Equity-related securities are valued using one or more of the following basic methods of valuation:

A. Cost: The cost method is based on our original cost. This method is generally used in the early stages of a company's development until significant positive or negative events occur subsequent to the date of the original investment that dictate a change to another valuation method. Some examples of these events are: (1) a major recapitalization; (2) a major refinancing; (3) a significant third-party transaction; (4) the development of a meaningful public market for a company's common stock; and (5) significant positive or negative changes in a company's business.

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

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

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

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

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

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

method.

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

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

LONG-TERM FIXED INCOME SECURITIES

H. Readily Marketable: Long-term fixed-income securities for which market quotations are readily available are carried at market value as of the time of valuation using the most recent bid quotations when available.

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

SHORT-TERM FIXED-INCOME INVESTMENTS

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

ALL OTHER INVESTMENTS

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

For all other investments, the reported values shall reflect the Valuation Committee's judgment of fair values as of the valuation date using the outlined basic methods of valuation or any other method of valuation within the prescribed guidelines that the Valuation Committee determines after review and analysis is more appropriate for the particular kind of investment. They do not necessarily represent an amount of money that would be realized if we had to

sell such assets in an immediate liquidation. Thus, valuations as of any particular date are not necessarily indicative of amounts that we may ultimately realize as a result of future sales or other dispositions of investments we hold.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE 1. THE COMPANY

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

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

Harris & Harris Enterprises, Inc.SM ("Enterprises"), is a 100 percent wholly owned subsidiary of the Company. Enterprises is a partner in Harris Partners I, L.P.SM and is taxed under Subchapter C of the Code (a "C Corporation"). Harris Partners I, L.PSM, is a limited partnership and owns our interest in AlphaSimplex Group, LLC. The partners of Harris Partners I, L.P.SM, are Enterprises (sole general partner) and Harris & Harris Group, Inc.(R) (sole limited partner).

We filed for the 1999 tax year to elect treatment as a Regulated Investment Company ("RIC") under Subchapter M of the Internal Revenue Code of 1986 (the "Code") and qualified for the same treatment for the years 2000 through 2004. We intend to file for RIC certification under Section 851(e) of the Code for 2005, however, there can be no assurance that we will qualify as a RIC for 2005 or subsequent years. In addition, under certain circumstances, even if we qualified for Subchapter M treatment for a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC. As a RIC, we must, among other things, distribute at least 90 percent of our investment company taxable income and may either distribute or retain our realized net capital gains on investments.

NOTE 2. INTERIM FINANCIAL STATEMENTS

Our interim financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and pursuant to the requirements of reporting on Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of management, these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation

of our financial position, results of operations and cash flows for such periods. The results of operations for any interim period are not necessarily indicative of the results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Securities and Exchange Commission.

NOTE 3. 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 of America for investment companies and include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

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

Portfolio Investment Valuations. Investments are stated at "value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) the fair value as determined in good faith by, or under the direction of, the Board of Directors for all other assets. (See "Valuation Procedures" in the "Footnote to Consolidated Schedule of Investments.") At September 30, 2005, our financial statements included private venture capital investments valued at $25,935,206, the fair values of which were determined in good faith by, or under the direction, of the Board of Directors.

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. The Company ceases accruing interest when securities are determined to be non-income producing and writes off any previously accrued interest. In 2005, the Company wrote off $56,315 of previously accrued interest. Realized gains and losses on investment transactions are determined by specific identification for financial reporting and tax reporting.

Income Taxes. Prior to January 1, 1999, we recorded income taxes using the liability method in accordance with the provisions of Statement of Financial Accounting Standards No. 109. Accordingly, deferred tax liabilities had been established to reflect temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases; the most significant such difference relates to our unrealized appreciation on investments.

The September 30, 2005, consolidated statement of assets and liabilities includes 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 us through December 31, 1998.

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

Restricted Funds. The Company maintains a rabbi trust for the purposes of accumulating funds to satisfy the obligations incurred by us for the Supplemental Executive Retirement Plan ("SERP") under the employment agreement with Charles E. Harris. As of September 30, 2005, the Company had restricted funds of $1,653,040 and accrued liabilities of $1,653,040 for the SERP.

Use of Estimates. The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities as of September 30, 2005, and December 31, 2004, and the reported amounts of revenues and expenses for the three month and nine month periods ended September 30, 2005, and September 30, 2004. The most significant estimates relate to the fair valuations of certain of our investments. Actual results could differ from these estimates.

NOTE 4. EMPLOYEE PROFIT SHARING PLAN

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

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

For purposes of the 2002 Plan, our net realized income includes investment income, realized gains and losses, and operating expenses (including taxes paid or payable by us), but is calculated without including dividends paid or distributions made to shareholders, payments under the Plan, unrealized gains and losses, and loss carry-overs from other years, which we refer to as qualifying income. The proportion of net after-tax realized gains attributable to asset values as of September 30, 1997 is considered nonqualifying gain, which reduces qualifying income. As soon as practicable following the year-end audit, the Audit Committee will determine whether, and if so how much, qualifying income exists for a plan year. Once determined, 90 percent of the Payout Amount will be paid out to Plan participants pursuant to the distribution percentages set forth in the 2002 Plan. The remaining 10 percent will be paid out after we have filed our federal tax return for that plan year.

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

Under the 2002 Plan, awards previously granted to four current Participants (Messrs. Harris and Melsheimer and Ms. Shavin and Ms. Matthews, herein referred to as the "grandfathered participants") have been reduced by 10 percent with respect to "Non-Tiny Technology Investments" (as defined in the 2002 Plan) and by 25 percent with respect to "Tiny Technology Investments" (as defined in the 2002 Plan) and are permanent. These reduced awards are herein referred to as "grandfathered participations." The amount by which the awards

are reduced is allocable and reallocable each year by the Compensation Committee among current and new participants as awards under the 2002 Plan. The grandfathered participations will be honored by us whether or not the grandfathered participant is still employed by us or is still alive (in the event of death, the grandfathered participations will be paid to the grandfathered participant's estate), unless the grandfathered participant is dismissed for cause, in which case all future awards, including the grandfathered participations, will be immediately cancelled and forfeited. With regard to new investments and follow-on investments made after January 1, 2003, both current and new participants are required to be employed by us at the end of a plan year in order to participate in profit-sharing on our investments with respect to that year.

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

The 2002 Plan may be modified, amended or terminated by the Compensation Committee at any time. Notwithstanding the foregoing, the grandfathered participations may not be further modified. Nothing in the 2002 Plan precludes the Compensation Committee from naming additional participants in the 2002 Plan or, except for grandfathered participations, changing the Award Percentage of any Participant (subject to the overall percentage limitations contained in the 2002 Plan).

The grandfathered participations are set forth below:

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

Accordingly, an additional 2 percent of qualifying income with respect to grandfathered Non-Tiny Technology Investments, 5 percent of qualifying income with respect to grandfathered Tiny Technology Investments and the full 20 percent of qualifying income with respect to non-grandfathered investments is available for allocation and reallocation from year to year. Currently, under the 2002 Plan, the distribution amounts for non-grandfathered investments for each officer and employee are: Charles E. Harris, 8.43 percent; Douglas W. Jamison, 4.06 percent; Daniel V. Leff, 3.77 percent; Sandra M. Forman, 1.62 percent; Daniel B. Wolfe, 1.62 percent; and Jacqueline M. Matthews, 0.50 percent, which together equal 20 percent. In one case, for a former employee who left on July 27, 2001, any amount earned will be accrued and may subsequently be

paid to the participant. Currently, Douglas W. Jamison, Daniel V. Leff, Sandra M. Forman and Daniel B. Wolfe are allocated 0.7329229 percent, 0.6807388 percent, 0.2931692 percent and 0.2931692 percent, respectively, of the Non-Tiny Technology Grandfathered Participations and 1.8323072 percent, 1.701847 percent, 0.7329229 percent and 0.7329229 percent, respectively, of the Tiny Technology Grandfathered Participations.

We perform a calculation to determine the accrual for profit-sharing. We calculate 20 percent of qualifying income pursuant to the terms of the 2002 Plan and estimate the effect on qualifying income of selling all the portfolio investments that are valued above cost (i.e., are in an unrealized appreciation position). Although the accrual will fluctuate as a result of changes in qualifying income and changes in unrealized appreciation, payments are made only to the extent that qualifying income exists. At December 31, 2004, we had $311,594 accrued for profit sharing. At September 30, 2005, we had $4,405,953 accrued for profit sharing as a result of unrealized appreciation on investments still held. No actual profit sharing payments were made in 2004. At September 30, 2005, there was no qualifying income and, therefore, no payments are due.

NOTE 5. DISTRIBUTABLE EARNINGS

As of December 31, 2004, and September 30, 2005, there were no distributable earnings. The difference between the book basis and tax basis components of distributable earnings is primarily attributed to Built-In Gains existing at the time of our qualification as a RIC (see Note 6. "Income Taxes"), nondeductible deferred compensation and net operating losses.

NOTE 6. INCOME TAXES

Provided that a proper election is made, a corporation taxable under Subchapter C of the Code or a C Corporation that elects to qualify as a RIC continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC (the "Inclusion Period") from sales of assets that were held by the corporation on the effective date of the RIC election ("C Corporation Assets"), to the extent of any gain built into the assets on such date ("Built-In Gain"). If the corporation fails to make a proper election, it is taxable on its Built-In Gain as of the effective date of its RIC election. We had Built-In Gains at the time of our qualification as a RIC and made the election to be taxed on any Built-In Gain realized during the Inclusion Period. Prior to 1999, we incurred ordinary and capital losses from operations. After our election of RIC status, those losses remained available to be carried forward to subsequent taxable years. The Company's capital loss carryforwards expire in 2011. We have previously used loss carryforwards to offset Built-In Gains. As of December 31, 2004, and September 30, 2005, we had $501,640 of pre-1999 loss carryforwards remaining and $4,663,457 of unrealized Built-In Gains remaining. For the three and nine month periods ending September 30, 2004, the company incurred deferred income tax expense of $646,235 related to the increase in unrealized appreciation on investments.

Our net deferred tax liability at September 30, 2005, and December 31, 2004, consisted of the following:

	September 30, 2005	December 31, 2004
Tax on unrealized Built-In Gains	$ 1,540,044	$ 1,540,044

Net operating loss and capital carryforward	(175,574)	(175,574)
Net deferred income tax liability	$ 1,364,470	$ 1,364,470

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

To the extent that we retain capital gains and declare a deemed dividend to shareholders, the dividend is taxable to the shareholders. We would pay tax on behalf of shareholders, at the corporate rate, on the distribution, and the shareholders would receive a tax credit equal to their proportionate share of the tax paid. We last took advantage of this rule for 2001.

We pay federal, state and local taxes on behalf of our wholly owned subsidiary, Harris & Harris Enterprises, Inc., which is taxed as a C Corporation. For the three months ended September 30, 2005, and 2004, our income tax (benefit) provision was ($13) and $1,482, respectively. For the nine months ended September 30, 2005, and 2004, our income tax provision was $4,839 and $6,426, respectively.

NOTE 7. ASSET ACCOUNT LINE OF CREDIT

On November 19, 2001, we established an asset account line of credit. Any borrowings under the asset account line of credit will be secured by government and government agency securities. Currently, under the asset account line of credit, we may borrow up to $8,000,000. The asset account line of credit may be increased to up to 95 percent of the current value of the government and government agency securities with which we secure the line. The asset account line of credit bears interest at the Broker Call Rate, which is the interest rate that banks charge to brokers to finance margin loans to investors, plus 50 basis points. Our outstanding balance under the asset account line of credit at both September 30, 2005, and December 31, 2004, was $0. On November 1, 2005, we terminated this asset line of credit.

NOTE 8. CAPITAL TRANSACTIONS

In 2004, we registered with the Securities and Exchange Commission for the sale of up to 7,000,000 shares of our common stock from time to time. In July of 2004, we sold 3,450,000 common shares for gross proceeds of $36,501,000; net proceeds of the offering, after offering costs of $372,825, were $36,128,175. In September of 2005, we completed the sale of an additional 3,507,500 shares for gross proceeds of $37,091,813; net proceeds of the offering, after offering costs of $565,246, were $36,526,567.

NOTE 9. OTHER

At December 31, 2004, we had a total of $255,486 of funds in escrow as a result of the merger of NanoGram Devices Corporation and a wholly owned subsidiary of Wilson Greatbatch Technologies, Inc. The funds were held for one year, until March 16, 2005, in an interest-bearing escrow account to secure the indemnification obligations of the former stockholders of NanoGram Devices Corporation. During 2004, we set up, by a charge to realized income from

investments, a reserve of 100 percent of the $255,486. On March 16, 2005, we received the entire $255,486, released the reserve and realized the income.

NOTE 10. SUBSEQUENT EVENTS

On October 24, 2005, we made a $500,000 follow-on investment in a privately held portfolio company.

On November 1, 2005, we terminated our $8,000,000 asset line of credit.

On November 4, 2005, we made a $3,000,000 initial investment in a privately held company.

HARRIS & HARRIS GROUP, INC.
FINANCIAL HIGHLIGHTS
(Unaudited)

	Three Months Ended Sept. 30		Nine Mo
	2005	2004	2005
Per Share Operating Performance			
Net asset value per share, beginning of period	$ 4.61	$ 2.85	$
Net operating loss	(0.18)	(0.05)	
Net realized income (loss) income on investments	0	0	
Net increase in unrealized appreciation on investments	0.58	0.12	
Total from investment operations ...	0.40	0.07	
Net decrease as a result of deemed dividend shareholder tax credit .	0	0	
Total distributions	0	0	
Net increase as a result of stock offering	0.93	1.52	
Total increase from capital stock transactions	0.93	1.52	
Net asset value per share, end			

of period	$ 5.94	$ 4.44	$
Stock price per share, end of period	$ 11.10	$ 10.34	$
Total return based on stock price (1) ...	(6.8)%	(15.5)%	
Supplemental Data:			
Net assets, end of period	$ 123,376,692	$ 39,266,216	$ 123,37
Ratio of expenses to average net assets (1)	3.5%	2.1%	
Ratio of net operating loss to average net assets (1)	(3.2)%	(1.7)%	
Cash dividends paid per share	$ 0	$ 0	$
Deemed dividend per share	$ 0	$ 0	$
Number of shares outstanding, end of period	20,756,345	17,248,845	20,75

(1) Not annualized.

The accompanying notes are an integral part of this schedule.

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

The information contained in this section should be read in conjunction with our unaudited September 30, 2005, Consolidated Financial Statements, and our audited December 31, 2004, Consolidated Financial Statements, and notes thereto.

Background and Overview

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

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

In 1992, we sold our insurance brokerage and trust company subsidiaries to their respective managements and registered as an investment company under the 1940 Act, commencing operations as a closed-end, non-diversified investment

company. In 1995, we elected to become a business development company subject to the provisions of Sections 55 through 65 of the 1940 Act. Throughout our corporate history, we have made early stage venture capital investments in a variety of industries. We define venture capital investments as investments in start-up firms and small businesses with exceptional growth potential. In 1994, we made our first tiny technology investment. From August 2001 through September 2005, all 24 of our initial investments have been exclusively in tiny technology.

Since our investment in Otisville in 1983, we have made a total of 66 venture capital investments, including four private placement investments in securities of publicly traded companies. We have sold 40 of these 66 investments, realizing total proceeds of $108,496,803 on our invested capital of $42,562,069. Seventeen of these 40 investments were profitable. As measured from first dollar in to last dollar out, the average and median holding periods for these 40 investments were 3.5 years and 3.2 years, respectively. As measured by the 131 separate rounds of investment within these 40 investments, the average and median holding periods for the 131 separate rounds of investment were 2.7 years and 2.4 years, respectively. At September 30, 2005, we valued the 26 venture capital investments remaining in our portfolio at $59,800,665, or 48.5 percent of our net assets, including net unrealized appreciation of $21,003,645. At September 30, 2005, from first dollar in, the average and median holding periods for these 26 venture capital investments were 3.1 years and 2.3 years, respectively. As measured by the 69 separate rounds of investment within these 26 investments, the average and median holding periods for the 69 separate rounds of investment were 2.7 years and 1.6 years, respectively.

We have invested a substantial portion of our assets in venture capital investments of private, development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth, have little or no history of operations and are developing unproven technologies. At September 30, 2005, $25,935,206, or 21.0 percent, of our net assets consisted of private venture capital investments at fair value, net of unrealized depreciation of $8,450,440. At December 31, 2004, $18,508,138, or 24.8 percent, of our net assets at fair value consisted of private venture capital investments, net of unrealized depreciation of $9,577,094.

At September 30, 2005, $33,865,459, or 27.5 percent of our net assets, consisted of common shares of NeuroMetrix, Inc., a publicly traded venture capital investment, (Nasdaq: NURO), valued at market value, of which unrealized appreciation was $29,454,085. Prior to January 18, 2005, our ownership interest in NeuroMetrix, Inc., was not in freely tradable securities, and prior to March 31, 2005, the fair value of our investment in NeuroMetrix, Inc., was determined in good faith by our Valuation Committee within guidelines established by our Board of Directors.

We value our private venture capital investments each quarter as determined in good faith by our Valuation Committee, within guidelines established by our Board of Directors in accordance with the 1940 Act. (See "Footnote to Consolidated Schedule of Investments" contained in "Consolidated Financial Statements.")

We have discretion in the investment of our capital. However, we invest primarily in illiquid equity securities of private companies. Generally, these investments take the form of preferred stock, are subject to restrictions on resale and have no established trading market. Our principal objective is to achieve long-term capital appreciation. Therefore, a significant portion of our investment portfolio provides little or no income in the form of dividends or

interest. We earn interest income from fixed-income securities, including U.S. government and government agency securities. The amount of interest income we earn varies with the average balance of our fixed-income portfolio and the average yield on this portfolio. Interest income is secondary to capital gains and losses in our results of operations.

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

Net Operating Income / (Loss) - the difference between our income from interest, dividends, and fees and our operating expenses.

Net Realized Income / (Loss) on Investments - the difference between the net proceeds of sales of portfolio securities and their stated cost, plus income from interests in limited liability companies.

Net Increase / (Decrease) in Unrealized Appreciation or Depreciation on Investments - the net unrealized change in the value of our investment portfolio.

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

Results of Operations

Three months ended September 30, 2005, as compared with the three months ended September 30, 2004

In the three months ended September 30, 2005, we had a net increase in net assets resulting from operations of $7,336,923, as compared with a net increase in net assets resulting from operations of $1,111,121 in the three months ended September 30, 2004.

Investment Income and Expenses:

We had net operating losses of $3,273,797 and $978,773 for the three months ended September 30, 2005, and September 30, 2004, respectively.

Operating expenses were $3,589,171 and $1,232,354 for the three months ended September 30, 2005, and September 30, 2004, respectively. The increase in expenses for the three months ended September 30, 2005, as compared with the three months ended September 30, 2004, is primarily a result of the increase to the profit sharing plan provision of $2,056,668 resulting from an increase of $11,079,932 in the valuation of our investment in NeuroMetrix, Inc., during the three months ended September 30, 2005. An increase in administrative and operations expense of $134,481, or 103.7 percent, is primarily owing to the increases in the cost of directors' and officers' liability insurance.

Realized Income and Losses on Investments:

During the three months ended September 30, 2005, we realized net losses on investments of $240, and during the three months ended September 30, 2004, we realized net income on investments of $2,704, before taxes.

Unrealized Appreciation or Depreciation on Investments:

During the three months ended September 30, 2005, net unrealized appreciation on total investments increased by $10,610,947, or 105.6 percent, from net unrealized appreciation of $10,046,292 at June 30, 2005. During the three months ended September 30, 2004, net unrealized depreciation on total investments decreased by $2,731,943, or 89.4 percent, from $3,056,850 at June 30, 2004, to $324,907 at September 30, 2004.

During the three months ended September 30, 2005, net unrealized appreciation on our venture capital investments increased by $10,636,184, owing to an increase in the valuation of our investment in NeuroMetrix, Inc., of $11,079,932, and decreases in the valuations of Zia Laser, Inc., NeoPhotonics Corporation and Polatis, Inc. of $375,000, $63,248, and $5,500, respectively.

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

Nine months ended September 30, 2005, as compared with the nine months ended September 30, 2004

In the nine months ended September 30, 2005, we had a net increase in net assets resulting from operations of $12,105,326, as compared with a net decrease in net assets resulting from operations of $305,401 for the nine months ended September 30, 2004.

Investment Income and Expenses:

For the nine months ended September 30, 2005, and September 30, 2004, respectively, we had net operating losses of $7,317,035 and $2,503,222.

For the nine months ended September 30, 2005, and September 30, 2004, respectively, operating expenses were $8,056,235 and $2,892,570. The increase in expenses for the nine months ended September 30, 2005, as compared with the nine months ended September 30, 2004, is primarily related to an increase of $3,757,539 in the profit sharing expense resulting from an increase of $20,751,637 in the valuation of our investment in NeuroMetrix, Inc., during the first nine months of 2005. Salaries and benefits increased by $470,799, or 34.0 percent, primarily as a result of the addition of four full-time employees, and secondarily to increases in salary and benefits for existing employees. Administration and operations increased by $600,611, or 126.3 percent, as a result of increased expenses owing to proxy solicitation for non-routine matters ($84,435) and increases in the cost of our directors' and officers' liability insurance ($356,342). Professional fees increased by $226,272, or 58.2 percent, owing to expenses associated with the implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

Realized Income and Losses on Investments:

During the nine months ended September 30, 2005, we realized losses of $2,427,469 as compared with realized income of $798,673 for the nine months ended September 30, 2004, before taxes.

During the nine months ended September 30, 2005, we realized losses on the sale of investments including $1,358,286 on Agile Materials & Technologies, Inc., and $1,091,209 on Nanotechnologies, Inc. We also realized a loss of $294,245 on our investment in Optiva, Inc. These realized losses were partially offset by the realized gain of $255,486 on the sale of our investment in NanoGram Devices Corporation.

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

Unrealized Appreciation or Depreciation on Investments:

During the nine months ended September 30, 2005, net unrealized appreciation on total investments increased by $21,854,669, from net unrealized depreciation of $1,197,429 at December 31, 2004, to net unrealized appreciation of $20,657,240 at September 30, 2005. During the nine months ended September 30, 2004, net unrealized depreciation on total investments decreased by $2,051,809, or 86.3 percent, from $2,376,716 at December 31, 2003, to $324,907 at September 30, 2004.

During the nine months ended September 30, 2005, we recorded a net increase of $21,878,292 in unrealized appreciation of our venture capital investments, primarily as a result of an increase in unrealized appreciation of NeuroMetrix, Inc., of $20,751,637. In addition, unrealized appreciation increased primarily as a result of the realization of losses on the sale of our investments in Agile Materials and Technologies, Inc., of $1,364,081, Nanotechnologies, Inc., of $917,410 and on our investment in Optiva, Inc., of $675,000. Changes in valuation resulted primarily in increased appreciation on our investment in Nantero, Inc., of $813,771 and decreased appreciation on our investments in Zia Laser, Inc., of $1,125,000 and in Nanopharma Corporation of $563,097.

During the nine months ended September 30, 2004, we recorded a net increase of $2,226,234 in unrealized depreciation of our venture capital investments, primarily as a result of an increase in unrealized depreciation of Nanotechnologies, Inc., of $638,840 and Optiva, Inc., of $625,000, offset by the realization of the loss of $915,108 on the sale of our shares of Series D Convertible Preferred stock in NeoPhotonics Corporation.

Financial Condition

As at September 30, 2005

At September 30, 2005, our total assets and net assets were $132,523,181 and $123,376,692, respectively, compared with $79,361,451 and $74,744,799 at December 31, 2004, respectively.

At September 30, 2005, net asset value per share was $5.94, as compared with $4.33 at December 31, 2004. At September 30, 2005, our shares outstanding increased to 20,756,345 versus 17,248,845 at December 31, 2004.

Significant developments in the nine months ended September 30, 2005, included the receipt of gross proceeds of $37,091,813, less costs of $565,246, for a total of $36,526,567, pursuant to the issuance of 3,507,500 new shares of our common stock; in addition, the value of our venture capital investments increased by $28,178,705, from $31,621,960 at December 31, 2004, to $59,800,665 at September 30, 2005, primarily as a result of the increase in value of our investment in NeuroMetrix, Inc., from $13,113,822 at December 31, 2004, to $33,865,459 at September 30, 2005, and three new and nine follow-on investments.

The following table is a summary of additions to our portfolio of venture capital investments during the nine months ended September 30, 2005:

New Investments	Amount
eLite Optoelectronics, Inc.	$ 1,000,000
Kereos, Inc.	$ 800,000
Zia Laser, Inc.	$ 1,500,000
Follow-on Investments	
Cambrios, Inc.	$ 511,006
Kereos, Inc.	$ 160,000
Molecular Imprints, Inc.	$ 2,500,000
Nanomix, Inc.	$ 250,000
NanoOpto Corporation	$ 411,741
Nanopharma Corp.	$ 183,000
Nantero, Inc.	$ 571,329
NeoPhotonics Corporation	$ 999,999
Starfire Systems, Inc.	$ 500,000
Total	$ 9,387,075

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The following tables summarize the values of our portfolios of venture capital investments and U.S. government and government agency securities, as compared with their cost, at September 30, 2005 and December 31, 2004:

	September 30, 2005	December 31, 2004
Venture capital investments, at cost	$ 38,797,020	$ 32,496,605
Unrealized appreciation (depreciation)(1)	21,003,645	(874,645)
Venture capital investments, at fair value	$ 59,800,665	$ 31,621,960

	September 30, 2005	December 31, 2004
U.S. government and agency		

obligations, at cost	$ 70,673,564	$ 44,945,505
Unrealized depreciation(1)..	(346,407)	(322,783)
U.S. government and agency obligations, at fair value	$ 70,327,157	$ 44,622,722

1)At September 30, 2005, the accumulated unrealized appreciation on investments, net of deferred taxes, was $19,117,196. At December 31, 2004, the accumulated unrealized depreciation on investments, including deferred taxes, was $2,737,473.

The following table summarizes the value composition of our venture capital investment portfolio at September 30, 2005 and December 31, 2004. NeuroMetrix, Inc., accounted for 99.6 percent and 97.6 percent of the "Other Venture Capital Investments" at September 30, 2005, and December 31, 2004, respectively.

Category	September 30, 2005	December 31, 2004
Tiny Technology	43.2%	57.5%
Other Venture Capital Investments	56.8%	42.5%
Total Venture Capital Investments	100.0%	100.0%

The following table summarizes the fair value composition of our venture capital investment portfolio that was still privately held at September 30, 2005, and December 31, 2004. NeuroMetrix, Inc., became a publicly held company in July 2004.

Category	September 30, 2005	December 31, 2004
Tiny Technology	99.52%	98.2%
Other Privately Held Venture Capital Investments	.48%	1.8%
Total Private Venture Capital Investments	100.0%	100.0%

Liquidity

Our primary sources of liquidity are cash and U.S. government and government agency securities, receivables and freely marketable non-government securities, net of short-term indebtedness. Our secondary sources of liquidity are restricted securities of companies that are publicly traded. At September 30, 2005, NeuroMetrix, Inc., is our only publicly traded, freely marketable, non-government security. NeuroMetrix became a publicly traded company in July 2004, and our common shares of NeuroMetrix were contractually restricted until January 18, 2005. We intend to sell our shares in NeuroMetrix at any time in the future, through one or more transactions.

At September 30, 2005, and December 31, 2004, our total net primary liquidity was $104,593,618 and $45,353,691, respectively, and our secondary liquidity was $0 and $13,133,822, respectively.

The increase in our primary liquidity and decrease in our secondary liquidity from December 31, 2004, to September 30, 2005, is primarily owing to the receipt of proceeds from our stock offering in 2005, reclassification of our common shares of NeuroMetrix, Inc., from secondary liquidity to primary liquidity, as they were no longer restricted at September 30, 2005, and an increase in the market value of those shares. The increase in our total liquidity is primarily owing to the proceeds from the stock offering, an increase in the value of our investment in NeuroMetrix, Inc., offset by the investments made in venture capital portfolio companies and the use of funds for net operating expenses. NeuroMetrix's common stock is thinly traded, which could negatively impact our liquidity.

Capital Resources

In 2004, we registered with the Securities and Exchange Commission for the sale of up to 7,000,000 shares of our common stock from time to time. In July 2004, we sold 3,450,000 common shares for gross proceeds of $36,501,000; net proceeds of the offering, after offering costs of $372,825, were $36,128,175. In September 2005, we completed the sale of 3,507,500 common shares, for total gross proceeds of $37,091,813. Net proceeds, after offering costs of $565,246, were $36,526,567. We intend to use, and have been using, the net proceeds of the offering to make new investments in tiny technology as well as follow-on investments in our existing venture capital investments, and for working capital. Through September 30, 2005, we have used $17,351,279 for these purposes.

Critical Accounting Policies

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

Valuation of Portfolio Investments

As a business development company, we invest primarily in illiquid securities, including debt and equity securities of private companies. The investments are generally subject to restrictions on resale and generally have no established trading market. We value all of our private equity investments at fair value as determined in good faith by our Valuation Committee. The Valuation Committee, comprised of three or more independent Board members, reviews and approves the valuation of our investments within the guidelines established by the Board of Directors. Fair value is generally defined as the amount for which an investment could be sold in an orderly disposition over a reasonable time.

Generally, to increase objectivity in valuing our assets, external measures of value, such as public markets or third party transactions, are utilized whenever possible. Valuation is not based on long-term work-out value, nor immediate liquidation value, nor incremental value for potential changes that may take place in the future.

Recent Developments

On October 24, 2005, we made a $500,000 follow-on investment in a privately held portfolio company.

On November 1, 2005, we terminated our $8,000,000 asset line of credit.

On November 4, 2005, we made a $3,000,000 initial investment in a privately held company.

RISK FACTORS

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

Risks related to the companies in our portfolio.

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

We have invested a substantial portion of our assets in privately held development stage or start-up companies. These businesses tend to lack management depth, to have limited or no history of operations and to have not attained profitability. Tiny technology companies are especially risky, involving scientific, technological and commercialization risks. Because of the speculative nature of these investments, these securities have a significantly greater risk of loss than traditional investment securities. Some of our venture capital investments are likely to be complete losses or unprofitable, and some will never realize their potential. We have been and will continue to be risk seeking rather than risk averse in our approach to venture capital and other investments. Neither our investments nor an investment in our shares of common stock are intended to constitute a balanced investment program.

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

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

Our portfolio companies may not successfully develop their products.

The technology of our portfolio companies is new and in many cases unproven. Their potential products require significant and lengthy product development efforts. To date, many of our portfolio companies have not developed any commercially available products. If our portfolio companies are not able to develop successful tiny technology-enabled products, they will be unable to generate product revenue or build sustainable or profitable businesses.

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

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

Our portfolio companies may not currently have the ability to manufacture nanotechnology-enabled products in volume and will not be able to sell products without developing volume manufacturing capabilities.

The manufacture of our portfolio companies' potential nanotechnology-enabled products is unproven and will require long lead times to establish adequate facilities. Some of the potential products may require our portfolio companies to manufacture large volumes of materials in order to meet commercial demand that are substantially larger than their current capabilities. Our portfolio companies may not be able to develop commercial scale manufacturing capabilities or produce products cost effectively. If our portfolio companies are unable to manufacture economically or to produce their products in commercial quantities that meet acceptable performance and quality specifications, we could suffer financial losses in our portfolio.

Even if our portfolio companies develop commercially acceptable products, they may not be able to manufacture their products in a profitable, cost effective manner.

Even if the technology and products of our portfolio companies gain commercial acceptance, they may not be able to manufacture their products in a profitable manner. Even if our portfolio companies are able to manufacture their products on a commercial scale, the cost of manufacturing their products may be higher than they expect. If manufacturing costs and royalty obligations are not significantly less than the prices at which they can sell their products, it would lead to financial losses in our portfolio.

Our portfolio companies may not successfully market their products.

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

Our portfolio companies will need to achieve commercial acceptance of their products to obtain product revenue and achieve profitability and may not be able to do so.

Even if the products of our portfolio companies are technologically feasible, these early-stage companies may not successfully develop commercially viable products on a timely basis, if at all. It could be at least several years before many of our portfolio companies develop initial products that are commercially available and, during this period, superior competitive technologies may be introduced or customer needs may change resulting in some products being unsuitable for commercialization. The revenue growth and achievement of profitability by our portfolio companies will depend substantially on their ability to introduce new products into the marketplace that are widely accepted by customers. If they are unable to achieve commercial acceptance of their products in a cost-effective manner, the value of our portfolio could be significantly adversely affected.

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

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

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

Our portfolio companies work with new technologies, which could have potential environmental and health impacts. Tiny technology in general and nanotechnology in particular are currently the subject of health and environmental impact research. If health or environmental concerns about tiny technology or nanotechnology were to arise, whether or not they had any basis in fact, our portfolio companies might incur additional research, legal and regulatory expenses, might have difficulty raising capital or marketing their products.

Public perception of ethical and social issues regarding nanotechnology may limit or discourage the use of nanotechnology-enabled products, which could reduce our portfolio companies' revenues and harm our business.

Nanotechnology has received both positive and negative publicity and is the subject increasingly of public discussion and debate. Government authorities could, for social or other purposes, prohibit or regulate the use of nanotechnology. Ethical and emotional concerns about nanotechnology could adversely affect acceptance of the potential products of our portfolio companies or lead to new government regulation of nanotechnology-enabled products. For example, debate regarding the production of materials that could cause harm to the environment or the health of individuals could raise concerns in the public's perception of nanotechnology, not all of which may be rational or scientifically based.

Risks related to the illiquidity of our investments.

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

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

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

Our business of making private equity investments and positioning our portfolio companies for liquidity events may be adversely affected by current and future capital markets and economic conditions. The public equity markets currently provide less opportunity for liquidity events than at times in the past when there was more robust demand for initial public offerings, even for more mature technology companies than those in which we typically invest. The potential for public market liquidity could further decrease and could lead to an inability to realize potential gains or could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets. Recent government reforms affecting publicly traded companies, stock markets, investment banks and securities research practices have made it more difficult for privately held companies to complete successful initial public offerings of their equity securities, and such reforms have increased the expense and legal exposure of being a public company. Slowdowns in initial public offerings also have an adverse effect on the frequency and prices of acquisitions of privately held companies. The lack of merger and/or acquisition opportunities for privately held companies also has an adverse effect on the ability of these companies to raise capital from private sources. Public equity market response to company offerings of nanotechnology-enabled products is uncertain. An inability to engage in liquidity events could negatively affect our liquidity, our reinvestment rate in new and follow-on investments and the value of our portfolio.

Even if our portfolio companies complete initial public offerings, the returns on our investments may be uncertain.

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

Risks related to our Company.

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

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

In the venture capital industry, even when a portfolio of early stage, high-technology venture capital investments proves to be profitable over the portfolio's lifetime, it is common for the portfolio's value to undergo a so-called "J-curve" valuation pattern. This means that when reflected on a graph, the portfolio's valuation would appear in the shape of the letter "J," declining from the initial valuation prior to increasing in valuation. This J-curve valuation pattern results from write-downs and write-offs of portfolio investments that appear to be unsuccessful, prior to write-ups for portfolio investments that prove to be successful. Even if our venture capital investments prove to be profitable in the long run, such J-curve valuation patterns could have a significant adverse effect on the value of our shares of common stock in the interim. As we continue to make additional tiny technology investments, this J-curve pattern may not be relevant for the portfolio as a whole because the individual J-curves for each investment, or series of investments, may overlap with previous investments at different stages of their J-curves.

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