

HARRIS & HARRIS GROUP INC /NY/  
Form 10-Q  
August 07, 2008

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

Form 10-Q

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

For the quarterly period ended June 30, 2008

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.

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(Exact Name of Registrant as Specified in Its Charter)

New York  
(State or Other Jurisdiction of  
Incorporation or Organization)

13-3119827  
(I.R.S. Employer Identification No.)

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

10019  
(Zip Code)

(212) 582-0900

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(Registrant's Telephone Number, Including Area Code)

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

Yes  No

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

Class	Outstanding at August 7, 2008
Common Stock, \$0.01 par value per share	25,859,573 shares

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**Harris & Harris Group, Inc.**  
**Form 10-Q, June 30, 2008**

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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.<sup>®</sup> (the "Company," "us," "our" and "we"), is an internally managed venture capital company that has elected to operate 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, 2007, contained in our Annual Report on Form 10-K for the year ended December 31, 2007.

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"). We filed for the 1999 tax year to elect treatment as a RIC. 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 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 May 30, 2008, we received SEC certification for 2007, permitting us to qualify for RIC treatment for 2007 (as we had for the years 1999 through 2006) pursuant to Section 851(e) of the Code. Although the SEC certification for 2007 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 2007, we qualified for RIC treatment even without certification. 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. Because Subchapter M does not permit deduction of operating expenses against long-term capital gains, it is not clear that the Company and its shareholders have paid less taxes since 1999 than they would have paid had the Company remained a C Corporation.

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES</b>
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**June 30, 2008    December 31, 2007**  
**(Unaudited)**

**ASSETS**

Investments, in portfolio securities at value (cost: \$88,459,760 and \$82,677,528, respectively)	\$	92,335,524	\$	78,110,384
Investments, in U.S. Treasury obligations at value (cost: \$60,984,874 and \$59,552,933, respectively)		61,425,025		60,193,593
Cash and cash equivalents		688,119		330,009
Restricted funds (Note 9)		53,871		2,667,020
Receivable from portfolio company		21,500		524
Interest receivable		573,686		647,337
Prepaid expenses		263,363		488,667
Other assets		425,895		455,798
<b>Total assets</b>	<b>\$</b>	<b>155,786,983</b>	<b>\$</b>	<b>142,893,332</b>

**LIABILITIES & NET ASSETS**

Accounts payable and accrued liabilities (Note 9)	\$	1,996,853	\$	4,515,463
Deferred rent		11,290		14,525
<b>Total liabilities</b>		<b>2,008,143</b>		<b>4,529,988</b>
<b>Net assets</b>	<b>\$</b>	<b>153,778,840</b>	<b>\$</b>	<b>138,363,344</b>

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, 45,000,000 shares authorized at 6/30/08 and 12/31/07; 27,688,313 issued at 6/30/08 and 25,143,313 issued at 12/31/07		276,884		251,434
Additional paid in capital (Note 7)		178,252,063		160,927,691
Accumulated net realized loss		(25,660,491)		(15,483,766)
Accumulated unrealized appreciation (depreciation) of investments		4,315,915		(3,926,484)
Treasury stock, at cost (1,828,740 shares at 6/30/08 and 12/31/07)		(3,405,531)		(3,405,531)
<b>Net assets</b>	<b>\$</b>	<b>153,778,840</b>	<b>\$</b>	<b>138,363,344</b>
<b>Shares outstanding</b>		<b>25,859,573</b>		<b>23,314,573</b>
<b>Net asset value per outstanding share</b>	<b>\$</b>	<b>5.95</b>	<b>\$</b>	<b>5.93</b>

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



<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED STATEMENTS OF OPERATIONS</b> <b>(Unaudited)</b>
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	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
<b>Investment income:</b>				
<b>Interest from:</b>				
Fixed-income securities	\$ 464,456	\$ 637,701	\$ 1,040,758	\$ 1,290,199
Miscellaneous income	3,169	0	3,169	0
<b>Total investment income</b>	<b>467,625</b>	<b>637,701</b>	<b>1,043,927</b>	<b>1,290,199</b>
<b>Expenses:</b>				
Salaries, benefits and stock-based compensation (Note 5)	2,461,802	2,644,284	4,895,097	5,179,050
Administration and operations	283,361	357,178	585,216	738,043
Professional fees	201,866	335,067	340,098	517,262
Rent	59,748	58,813	117,602	118,320
Directors' fees and expenses	79,169	112,157	184,315	253,353
Depreciation	13,819	15,908	27,804	31,221
Custodian fees	6,143	5,961	12,696	11,735
<b>Total expenses</b>	<b>3,105,908</b>	<b>3,529,368</b>	<b>6,162,828</b>	<b>6,848,984</b>
<b>Net operating loss</b>	<b>(2,638,283)</b>	<b>(2,891,667)</b>	<b>(5,118,901)</b>	<b>(5,558,785)</b>
<b>Net realized gain (loss) from investments:</b>				
Realized gain (loss) from investments	3,912	(8,213)	(5,010,958)	(8,887)
Income tax expense (Note 6)	668	0	46,866	84,905
<b>Net realized gain (loss) from investments</b>	<b>3,244</b>	<b>(8,213)</b>	<b>(5,057,824)</b>	<b>(93,792)</b>
<b>Net decrease (increase) in unrealized depreciation on investments:</b>				
Change as a result of investment sales	0	0	5,014,653	0
Change on investments held	3,989,748	(1,193,764)	3,227,746	(4,831,227)
<b>Net decrease (increase) in unrealized depreciation on investments</b>	<b>3,989,748</b>	<b>(1,193,764)</b>	<b>8,242,399</b>	<b>(4,831,227)</b>
<b>Net increase (decrease) in net assets resulting from operations</b>	<b>\$ 1,354,709</b>	<b>\$ (4,093,644)</b>	<b>\$ (1,934,326)</b>	<b>\$ (10,483,804)</b>
<b>Per average basic and diluted outstanding share</b>	<b>\$ 0.06</b>	<b>\$ (0.19)</b>	<b>\$ (0.08)</b>	<b>\$ (0.49)</b>

Average outstanding shares	23,622,210	21,721,591	23,468,392	21,500,810
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The accompanying notes are an integral part of these consolidated financial statements.

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED STATEMENTS OF CASH FLOWS</b> <b>(Unaudited)</b>
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	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
<b>Cash flows used in operating activities:</b>		
Net decrease in net assets resulting from operations	\$ (1,934,326)	\$ (10,483,804)
Adjustments to reconcile net decrease in net assets resulting from operations to net cash used in operating activities:		
Net realized and unrealized (gain) loss on investments	(3,231,441)	4,840,114
Depreciation of fixed assets and amortization of premium or discount on U.S. government securities	82,877	89,891
Stock-based compensation expense	2,966,325	3,422,637
Changes in assets and liabilities:		
Restricted funds	2,613,149	(175,533)
Receivable from portfolio company	(20,976)	0
Receivable from broker	0	668,340
Interest receivable	73,651	40,216
Prepaid expenses	225,304	(294,798)
Other assets	3,894	20,647
Accounts payable and accrued liabilities	(2,518,610)	228,888
Accrued profit sharing	0	(261,661)
Deferred rent	(3,235)	(3,401)
Net cash used in operating activities	(1,743,388)	(1,908,464)
<b>Cash flows from investing activities:</b>		
Purchase of short and long-term investments and marketable securities	(66,940,804)	(27,600,155)
Sale of short and long-term investments and marketable securities	65,395,679	18,353,983
Investment in private placements and loans	(10,847,095)	(10,043,027)
Proceeds from sale of investments	112,234	0
Purchase of fixed assets	(2,013)	(13,804)
Net cash provided by (used in) investing activities	(12,281,999)	(19,303,003)
<b>Cash flows from financing activities:</b>		
Proceeds from stock option exercises (Note 5)	0	8,360,029
Proceeds from stock offering (Note 7)	14,383,497	12,993,168
Net cash provided by financing activities	14,383,497	21,353,197
<b>Net increase (decrease) in cash and cash equivalents:</b>		
Cash and cash equivalents at beginning of the period	330,009	2,071,788
Cash and cash equivalents at end of the period	688,119	2,213,518

Net increase (decrease) in cash and cash equivalents	\$	358,110	\$	141,730
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**Supplemental disclosures of cash flow information:**

Income taxes paid	\$	46,325	\$	84,706
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The accompanying notes are an integral part of these consolidated financial statements.

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<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS</b>
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	Six Months Ended June 30, 2008 (Unaudited)	Year Ended December 31, 2007
<b>Changes in net assets from operations:</b>		
Net operating loss	\$ (5,118,901)	\$ (11,827,543)
Net realized (loss) gain on investments	(5,057,824)	30,162
Net decrease in unrealized depreciation on investments sold	5,014,653	0
Net decrease in unrealized depreciation on investments held	3,227,746	5,080,936
<b>Net decrease in net assets resulting from operations</b>	<b>(1,934,326)</b>	<b>(6,716,445)</b>
<b>Changes in net assets from capital stock transactions:</b>		
Issuance of common stock upon the exercise of stock options	0	9,996
Issuance of common stock on offering	25,450	13,000
Additional paid-in capital on common stock issued	14,358,047	23,075,683
Stock-based compensation expense	2,966,325	8,050,807
<b>Net increase in net assets resulting from capital stock transactions</b>	<b>17,349,822</b>	<b>31,149,486</b>
<b>Net increase in net assets</b>	<b>15,415,496</b>	<b>24,433,041</b>
<b>Net assets:</b>		
Beginning of the period	138,363,344	113,930,303
End of the period	\$ 153,778,840	\$ 138,363,344

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

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Unaffiliated Companies (2)(3) – 13.18% of net assets at value</b>			
<b>Private Placement Portfolio (Illiquid) – 13.18% of net assets at value</b>			
BioVex Group, Inc. (4)(5)(6)(7) — Developing novel biologics for treatment of cancer and infectious disease			
Series E Convertible Preferred Stock	(M)	2,799,552	\$ 2,500,000
Exponential Business Development Company (4)(5) — Venture capital partnership focused on early stage companies			
Limited Partnership Interest	(M)	1	2,219
Molecular Imprints, Inc. (4)(5) — Manufacturing nanoimprint lithography capital equipment			
Series B Convertible Preferred Stock	(M)	1,333,333	2,173,333
Series C Convertible Preferred Stock	(M)	1,250,000	2,037,500
Warrants at \$2.00 expiring 12/31/11	(I)	125,000	117,250
			4,328,083
Nanosys, Inc. (4)(5)(6) — Developing zero and one-dimensional inorganic nanometer-scale materials and devices			
Series C Convertible Preferred Stock	(M)	803,428	2,370,113
Series D Convertible Preferred Stock	(M)	1,016,950	3,000,003
			5,370,116
Nantero, Inc. (4)(5)(6) — Developing a high-density, nonvolatile, random access memory chip, enabled by carbon nanotubes			
Series A Convertible Preferred Stock	(M)	345,070	1,046,908
Series B Convertible Preferred Stock	(M)	207,051	628,172
Series C Convertible Preferred Stock	(M)	188,315	571,329
			2,246,409

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

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Unaffiliated Companies (2) (3) – 13.18% of net assets at value (cont.)</b>			
<b>Private Placement Portfolio (Illiquid) – 13.18% of net assets at value (cont.)</b>			
NeoPhotonics Corporation (4)(5) — Developing and manufacturing optical devices and components			
Common Stock	(M)	716,195	\$ 93,106
Series 1 Convertible Preferred Stock	(M)	1,831,256	919,989
Series 2 Convertible Preferred Stock	(M)	741,898	456,710
Series 3 Convertible Preferred Stock	(M)	2,750,000	2,750,000
Series X Convertible Preferred Stock	(M)	2,000	400,000
Warrants at \$0.15 expiring 01/26/10	(I)	16,364	785
Warrants at \$0.15 expiring 12/05/10	(I)	14,063	675
			4,621,265
Polatis, Inc. (4)(5)(6)(8) — Developing MEMS-based optical networking components			
Series A-1 Convertible Preferred Stock	(M)	16,775	0
Series A-2 Convertible Preferred Stock	(M)	71,611	132,653
Series A-4 Convertible Preferred Stock	(M)	4,774	8,768
Series A-5 Convertible Preferred Stock	(M)	16,438	135,105
			276,526
PolyRemedy, Inc. (4)(5)(6)(9) —Developing a robotic manufacturing platform for wound treatment patches			
Series B-1 Convertible Preferred Stock	(M)	287,647	244,500
Starfire Systems, Inc. (4)(5)(6) — Producing ceramic-forming polymers			
Common Stock	(M)	375,000	90,000
Series A-1 Convertible Preferred Stock	(M)	600,000	600,000
			690,000
<b>Total Unaffiliated Private Placement Portfolio (cost: \$21,879,892)</b>			<b>\$ 20,279,118</b>
<b>Total Investments in Unaffiliated Companies (cost: \$21,879,892)</b>			<b>\$ 20,279,118</b>

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

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<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Non-Controlled Affiliated Companies</b>			
<b>(2) (10) – 42.69% of net assets at value</b>			
<b>Private Placement Portfolio (Illiquid) – 42.69% of net assets at value</b>			
Adesto Technologies Corporation (4)(5)(6) — Developing semiconductor-related products enabled at the nanoscale			
Series A Convertible Preferred Stock	(M)	6,547,619	\$ 2,200,000
Ancora Pharmaceuticals, Inc. (4)(5)(6) — Developing synthetic carbohydrates for pharmaceutical applications			
Series B Convertible Preferred Stock	(M)	1,663,808	1,600,000
BridgeLux, Inc. (4)(5)(11) — Manufacturing high-power light emitting diodes			
Series B Convertible Preferred Stock	(M)	1,861,504	2,792,256
Series C Convertible Preferred Stock	(M)	2,130,699	3,196,050
Series D Convertible Preferred Stock	(M)	666,667	1,000,001
Warrants at \$0.7136 expiring 02/02/17	(I)	98,340	137,774
Warrants at \$0.7136 expiring 04/26/17	(I)	65,560	92,177
			7,218,258
Cambrios Technologies Corporation (4)(5)(6) — Developing nanowire-enabled electronic materials for the display industry			
Series B Convertible Preferred Stock	(M)	1,294,025	1,294,025
Series C Convertible Preferred Stock	(M)	1,300,000	1,300,000
			2,594,025
CFX Battery, Inc. (4)(5)(6)(12) — Developing batteries using nanostructured materials			
Series A Convertible Preferred Stock	(M)	1,208,262	946,528

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

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Non-Controlled Affiliated Companies</b>			
<b>(2)(10) – 42.69% of net assets at value (cont.)</b>			
<b>Private Placement Portfolio (Illiquid) – 42.69% of net assets at value (cont.)</b>			
Crystal IS, Inc. (4)(5)(6) — Developing single-crystal aluminum nitride substrates for optoelectronic devices			
Series A Convertible Preferred Stock	(M)	391,571	\$ 305,425
Series A-1 Convertible Preferred Stock	(M)	1,300,376	1,014,294
Warrants at \$0.78 expiring 05/05/13	(I)	15,231	9,276
Warrants at \$0.78 expiring 05/12/13	(I)	2,350	1,431
Warrants at \$0.78 expiring 08/08/13	(I)	4,396	2,717
			1,333,143
CSwitch Corporation (4)(5)(6)(13) — Developing next-generation, system-on-a-chip solutions for communications-based platforms			
Series A-1 Convertible Preferred Stock	(M)	6,863,118	3,431,559
Unsecured Convertible Bridge Note (including interest)	(M)	\$ 1,516,673	1,550,619
			4,982,178
D-Wave Systems, Inc. (4)(5)(6)(14) — Developing high-performance quantum computing systems			
Series B Convertible Preferred Stock	(M)	2,000,000	2,179,676
Series C Convertible Preferred Stock	(M)	678,264	739,198
			2,918,874
Ensemble Discovery Corporation (4)(5)(6) — Developing DNA Programmed Chemistry for the discovery of new classes of therapeutics and bioassays			
Series B Convertible Preferred Stock	(M)	1,449,275	2,000,000
Innovalight, Inc. (4)(5)(6) — Developing solar power products enabled by silicon-based nanomaterials			
Series B Convertible Preferred Stock	(M)	16,666,666	5,718,216
Series C Convertible Preferred Stock	(M)	5,810,577	1,993,568
			7,711,784

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



<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Non-Controlled Affiliated Companies</b>			
<b>(2)(10) – 42.69% of net assets at value (cont.)</b>			
<b>Private Placement Portfolio (Illiquid) – 42.69% of net assets at value (cont.)</b>			
Kereos, Inc. (4)(5)(6) — Developing emulsion-based imaging agents and targeted therapeutics to image and treat cancer and cardiovascular disease			
Series B Convertible Preferred Stock	(M)	545,456	\$ 90,371
Kovio, Inc. (4)(5)(6) — Developing semiconductor products using printed electronics and thin-film technologies			
Series C Convertible Preferred Stock	(M)	2,500,000	3,125,000
Series D Convertible Preferred Stock	(M)	800,000	1,000,000
			4,125,000
Mersana Therapeutics, Inc. (4)(5)(6)(15) — Developing advanced polymers for drug delivery			
Series A Convertible Preferred Stock	(M)	68,451	136,902
Series B Convertible Preferred Stock	(M)	866,500	1,733,000
Warrants at \$2.00 expiring 10/21/10	(I)	91,625	109,309
			1,979,211
Metabolon, Inc. (4)(5)(6) — Discovering biomarkers through the use of metabolomics			
Series B Convertible Preferred Stock	(M)	2,173,913	1,765,535
Series B-1 Convertible Preferred Stock	(M)	869,565	706,214
Warrants at \$1.15 expiring 3/25/15	(I)	434,783	291,739
			2,763,488
NanoGram Corporation (4)(5)(6) — Developing a broad suite of intellectual property utilizing nanoscale materials			
Series I Convertible Preferred Stock	(M)	63,210	124,524
Series II Convertible Preferred Stock	(M)	1,250,904	2,464,281
Series III Convertible Preferred Stock	(M)	1,242,144	2,447,024
Series IV Convertible Preferred Stock	(M)	432,179	851,393
			5,887,222

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



<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Non-Controlled Affiliated Companies</b>			
<b>(2)(10) – 42.69% of net assets at value (cont.)</b>			
<b>Private Placement Portfolio (Illiquid) – 42.69% of net assets at value (cont.)</b>			
Nanomix, Inc. (4)(5)(6) — Producing nanoelectronic sensors that integrate carbon nanotube electronics with silicon microstructures			
Series C Convertible Preferred Stock	(M)	977,917 \$	235,683
Series D Convertible Preferred Stock	(M)	6,802,397	485,457
			721,140
Nextreme Thermal Solutions, Inc. (4)(5)(6) — Developing thin-film thermoelectric devices for cooling and energy conversion			
Series A Convertible Preferred Stock	(M)	1,750,000	1,750,000
Unsecured Convertible Bridge Note (including interest)	(M)	\$ 777,580	783,928
			2,533,928
Questech Corporation (4)(5) — Manufacturing and marketing proprietary metal and stone decorative tiles			
Common Stock	(M)	655,454	139,208
Warrants at \$1.50 expiring 11/19/08	(I)	5,000	0
Warrants at \$1.50 expiring 11/19/09	(I)	5,000	70
			139,278
Siluria Technologies, Inc. (4)(5)(6) — Developing next-generation nanomaterials			
Series S-2 Convertible Preferred Stock	(M)	482,218	160,723
Solazyme, Inc. (4)(5)(6) — Developing algal biodiesel, industrial chemicals and special ingredients based on synthetic biology			
Series A Convertible Preferred Stock	(M)	988,204	4,994,383
Series B Convertible Preferred Stock	(M)	495,246	2,502,973
Unsecured Convertible Bridge Note (including interest)	(M)	\$ 2,000,000	2,245,685
			9,743,041

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



<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Non-Controlled Affiliated Companies</b>			
<b>(2)(10) – 42.69% of net assets at value (cont.)</b>			
<b>Private Placement Portfolio (Illiquid) – 42.69% of net assets at value (cont.)</b>			
Xradia, Inc. (4)(5) — Designing, manufacturing and selling ultra-high resolution 3D x-ray microscopes and fluorescence imaging systems			
Series D Convertible Preferred Stock	(M)	3,121,099	\$ 4,000,000
Zia Laser, Inc. (4)(5)(16) — Developed quantum dot semiconductor lasers			
Series C Convertible Preferred Stock	(M)	1,500,000	0
<b>Total Non-Controlled Private Placement Portfolio (cost: \$57,591,270)</b>			<b>\$ 65,648,192</b>
<b>Total Investments in Non-Controlled Affiliated Companies (cost: \$57,591,270)</b>			<b>\$ 65,648,192</b>

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

<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>Investments in Controlled Affiliated Companies</b>			
<b>(2)(17) – 4.17% of net assets at value</b>			
<b>Private Placement Portfolio (Illiquid) – 4.17% of net assets at value</b>			
Evolved Nanomaterial Sciences, Inc. (4)(5)(18) — Developed nanoscale-enhanced approaches for the resolution of chiral molecules			
Series A Convertible Preferred Stock	(M)	5,870,021	\$ 0
Laser Light Engines, Inc. (4)(5)(6)(9) — Manufacturing solid-state light sources for digital cinema and large venue projection displays			
Series A Convertible Preferred Stock	(M)	7,499,062	2,000,000
Phoenix Molecular Corporation (4)(5)(6) — Developing technology to enable the separation of difficult-to-separate materials			
Common Stock	(M)	1,000	10
Unsecured Convertible Bridge Note (including interest)	(M)	\$ 100,000	103,588
			103,598
SiOnyx, Inc. (4)(5)(6) — Developing silicon-based optoelectronic products enabled by its proprietary "Black Silicon"			
Series A Convertible Preferred Stock	(M)	233,499	135,686
Series A-1 Convertible Preferred Stock	(M)	2,966,667	1,723,930
Series A-2 Convertible Preferred Stock	(M)	4,207,537	2,445,000
			4,304,616
<b>Total Controlled Private Placement Portfolio (cost: \$8,988,598)</b>			<b>\$ 6,408,214</b>
<b>Total Investments in Controlled Affiliated Companies (cost: \$8,988,598)</b>			<b>\$ 6,408,214</b>
<b>Total Private Placement Portfolio (cost: \$88,459,760)</b>			<b>\$ 92,335,524</b>

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



<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b>
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	Method of Valuation (1)	Shares/ Principal	Value
<b>U.S. Government and Agency Securities (19) - 39.95% of net assets at value</b>			
U.S. Treasury Bill — due date 07/24/08	(M)	\$ 7,100,000	\$ 7,093,184
U.S. Treasury Notes — due date 09/15/08, coupon 3.125%	(M)	4,775,000	4,787,702
U.S. Treasury Notes — due date 01/15/09, coupon 3.25%	(M)	3,000,000	3,019,920
U.S. Treasury Notes — due date 02/15/09, coupon 4.50%	(M)	5,100,000	5,169,309
U.S. Treasury Notes — due date 04/15/09, coupon 3.125%	(M)	3,000,000	3,018,060
U.S. Treasury Notes — due date 07/15/09, coupon 3.625%	(M)	3,000,000	3,040,080
U.S. Treasury Notes — due date 10/15/09, coupon 3.375%	(M)	3,000,000	3,040,560
U.S. Treasury Notes — due date 01/15/10, coupon 3.625%	(M)	3,000,000	3,056,730
U.S. Treasury Notes — due date 04/15/10, coupon 4.00%	(M)	3,000,000	3,076,410
U.S. Treasury Notes — due date 06/30/10, coupon 2.875%	(M)	1,250,000	1,256,150
U.S. Treasury Notes — due date 07/15/10, coupon 3.875%	(M)	3,000,000	3,075,480
U.S. Treasury Notes — due date 09/15/10, coupon 3.875%	(M)	2,000,000	2,051,880
U.S. Treasury Notes — due date 10/15/10, coupon 4.25%	(M)	2,000,000	2,070,780
U.S. Treasury Notes — due date 12/15/10, coupon 4.375%	(M)	2,000,000	2,077,040
U.S. Treasury Notes — due date 03/31/11, coupon 4.750%	(M)	2,000,000	2,098,600
U.S. Treasury Notes — due date 06/30/11, coupon 5.125%	(M)	2,000,000	2,125,620
U.S. Treasury Notes — due date 09/30/11, coupon 4.500%	(M)	2,000,000	2,090,320
U.S. Treasury Notes — due date 12/31/11, coupon 4.625%	(M)	2,000,000	2,101,260
U.S. Treasury Notes — due date 10/31/12, coupon 3.875%	(M)	2,000,000	2,050,940
U.S. Treasury Notes — due date 02/15/13, coupon 3.875%	(M)	5,000,000	5,125,000
<b>Total Investments in U.S. Government and Agency Securities (cost: \$60,984,874)</b>		<b>\$</b>	<b>61,425,025</b>
<b>Total Investments (cost: \$149,444,634)</b>		<b>\$</b>	<b>153,760,549</b>

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

<p style="text-align: center;"><b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008</b> <b>(Unaudited)</b></p>
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Notes to Consolidated Schedule of Investments

- (1) See Footnote to Consolidated Schedule of Investments on page 17 for a description of the Valuation Procedures.
- (2) 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 but do not control the company. Investments in controlled affiliated companies consist of investments in which we own 25 percent or more of the voting shares of the portfolio company or otherwise control the company.
- (3) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is \$21,879,892. The gross unrealized appreciation based on the tax cost for these securities is \$1,732,194. The gross unrealized depreciation based on the tax cost for these securities is \$3,332,968.
- (4) Legal restrictions on sale of investment.
- (5) 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.
- (6) These investments are development stage companies. A development stage company is defined as a company that is devoting substantially all of its efforts to establishing a new business, and either it has not yet commenced its planned principal operations, or it has commenced such operations but has not realized significant revenue from them.
- (7) With our purchase of Series E Convertible Preferred Stock of BioVex, we received a warrant to purchase a number of shares of common stock of BioVex as determined by dividing 624,999.99 by the price per share at which the common stock is offered and sold to the public in connection with the initial public offering. The ability to exercise this warrant is therefore contingent on BioVex completing successfully an initial public offering before the expiration date of the warrant on September 27, 2012. The exercise price of this warrant shall be 110 percent of the initial public offering price.
- (8) Continuum Photonics, Inc., merged with Polatis, Ltd., to form Polatis, Inc.
- (9) Initial investment was made during 2008.
- The accompanying notes are an integral part of this consolidated schedule.

**HARRIS & HARRIS GROUP, INC.**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF JUNE 30, 2008**  
**(Unaudited)**

- (10) The aggregate cost for federal income tax purposes of investments in non-controlled affiliated companies is \$57,591,270. The gross unrealized appreciation based on the tax cost for these securities is \$17,069,201. The gross unrealized depreciation based on the tax cost for these securities is \$9,012,279.
- (11) BridgeLux, Inc., was previously named eLite Optoelectronics, Inc.
- (12) On February 28, 2008, Lifco, Inc., merged with CFX Battery, Inc. The surviving entity is CFX Battery, Inc.
- (13) With our investments in secured convertible bridge notes issued by CSwitch, we received two warrants to purchase a number of shares of the class of stock sold in the next financing of CSwitch equal to \$529,322 and \$985,835, respectively, the principal of the notes, divided by the lowest price per share of the class of stock sold in the next financing of CSwitch. The ability to exercise these warrants is, therefore, contingent on CSwitch completing successfully a subsequent round of financing. The warrants will expire five years from the date of the close of the next round of financing. The cost basis of these warrants is \$529 and \$986, respectively.
- (14) D-Wave Systems, Inc., is located and is doing business primarily in Canada. We invested in D-Wave Systems, Inc., through D-Wave USA, a Delaware company. Our investment is denominated in Canadian dollars and is subject to foreign currency translation. See "Note 3. Summary of Significant Accounting Policies."
- (15) Mersana Therapeutics, Inc., was previously named Nanopharma Corp.
- (16) On November 30, 2006, the assets of Zia Laser, Inc., were acquired by Innolume Inc., in exchange for shares of Innolume, Inc. On July 1, 2008, Innolume repurchased these shares for \$122,000. The Company received its pro rata portion of this amount, which was \$21,500.
- (17) The aggregate cost for federal income tax purposes of investments in controlled affiliated companies is \$8,988,598. The gross unrealized appreciation based on the tax cost for these securities is \$219,616. The gross unrealized depreciation based on the tax cost for these securities is \$2,800,000.
- (18) On September 30, 2007, Evolved Nanomaterial Sciences, Inc., filed for Chapter 7 bankruptcy. On July 9, 2008, the bankruptcy trustee sold the intellectual property assets of Evolved Nanomaterial Sciences, Inc., for a sum that was substantially less than the liabilities of the company. Harris & Harris Group, therefore, does not expect to receive any cash from the proceeds of this sale.
- (19) The aggregate cost for federal income tax purposes of our U.S. government securities is \$60,984,874. The gross unrealized appreciation on the tax cost for these securities is \$657,153. The gross unrealized depreciation on the tax cost of these securities is \$217,002.

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

<p style="text-align: center;"><b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS</b> <b>(Unaudited)</b></p>
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## VALUATION PROCEDURES

### I. Determination of Net Asset Value

The 1940 Act requires periodic valuation of each investment in the portfolio of the Company to determine its 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 Board of Directors is responsible for (1) determining overall valuation guidelines and (2) ensuring that the investments of the Company are valued within the prescribed guidelines.

The Valuation Committee, comprised of all of the independent Board members, is responsible for reviewing and approving the valuation of the Company's assets within the guidelines established by the Board of Directors. The Valuation Committee receives information and recommendations from management.

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.

### II. Approaches to Determining Fair Value

Statement of Financial Accounting Standards No. 157, "Fair Value Measurements," ("SFAS No. 157") defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). In effect, SFAS No. 157 applies fair value terminology to all valuations, whereas the 1940 Act applies market value terminology to readily marketable assets and fair value terminology to other assets.

The main approaches to measuring fair value utilized are the market approach and the income approach.

· Market Approach (M): The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. For example, the market approach often uses market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range each appropriate multiple falls requires judgment considering factors specific to the measurement (qualitative and quantitative).

· **Income Approach (I):** The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present value amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multi-period excess earnings method, which is used to measure the fair value of certain assets.

SFAS No. 157 classifies the inputs used to measure fair value by these approaches into the following hierarchy:

· **Level 1:** Unadjusted quoted prices in active markets for identical assets or liabilities.

· **Level 2:** Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.

· **Level 3:** Unobservable inputs for the asset or liability.

Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

### III. Investment Categories

The Company's investments can be classified into five broad categories for valuation purposes:

· Equity-related securities;  
· Long-term fixed-income securities;  
· Short-term fixed-income securities;  
· All other securities; and

· Investments in intellectual property, patents, research and development in technology or product development.

The Company applies the methods for determining fair value discussed above to the valuation of investments in each of these five broad categories as follows:

#### A. EQUITY-RELATED SECURITIES

Equity-related securities, including warrants, are fair valued using the market or income approaches. The following factors may be considered when the market approach is used to fair value these types of securities:

- Readily available public market quotations;
- The cost of the Company's investment;
- Transactions in a company's securities or unconditional firm offers by responsible parties as a factor in determining valuation;
  - The financial condition and operating results of the company;
  - The long-term potential of the business and technology of the company;
  - The values of similar securities issued by companies in similar businesses;
- Multiples to revenue, net income or EBITDA that similar securities issued by companies in similar businesses receive;
- 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; and
- The rights and preferences of the class of securities we own as compared with other classes of securities the portfolio company has issued.

When the income approach is used to value warrants, the Company uses the Black-Scholes-Merton formula.

## **B. LONG-TERM FIXED-INCOME SECURITIES**

**1. Readily Marketable:** Long-term fixed-income securities for which market quotations are readily available are valued using the most recent bid quotations when available.

**2. Not Readily Marketable:** Long-term fixed-income securities for which market quotations are not readily available are fair valued using the market approach. The factors that may be considered when valuing these types of securities by the market approach include:

- Credit quality;
- Interest rate analysis;
- Quotations from broker-dealers;
- Prices from independent pricing services that the Board believes are reasonably reliable; and
- Reasonable price discovery procedures and data from other sources.

### **C. SHORT-TERM FIXED-INCOME SECURITIES**

Short-term fixed-income securities are valued using the market approach 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.

### **D. ALL OTHER SECURITIES**

All other securities are reported at fair value as determined in good faith by the Valuation Committee using the approaches for determining valuation as described above.

For all other securities, the reported values shall reflect the Valuation Committee's judgment of fair values as of the valuation date using the outlined basic approaches of valuation discussed in Section II. 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.

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

Such investments are fair valued using the market approach. The Company may consider factors specific to these types of investments when using the market approach including:

- The cost of the Company's investment;
- Investments in the same or substantially similar intellectual property or patents or research and development in technology or product development or offers by responsible third parties;
- The results of research and development;
- Product development progress;
- Commercial prospects;
- Term of patent;
- Projected markets; and
- Other subjective factors.

<p style="text-align: center;"><b>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</b> <b>(Unaudited)</b></p>
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**NOTE 1. THE COMPANY**

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

We elected to become a BDC on July 26, 1995, after receiving the necessary shareholder 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 Exchange Act of 1934 (the "1934 Act") as an operating company and, while an operating company, operated directly and through subsidiaries.

Harris & Harris Enterprises, Inc.,<sup>SM</sup> is a 100 percent wholly owned subsidiary of the Company. Harris & Harris Enterprises, Inc., is a partner in Harris Partners I, L.P.,<sup>SM</sup> and is taxed under Subchapter C of the Code (a "C Corporation"). Harris Partners I, L.P. is a limited partnership and is used to hold certain interests in portfolio companies. The partners of Harris Partners I, L.P., are Harris & Harris Enterprises, Inc., (sole general partner) and Harris & Harris Group, Inc., (sole limited partner). Harris & Harris Enterprises, Inc., pays taxes on any non-passive investment income generated by Harris Partners I, L.P. For the period ended June 30, 2008, there was no non-passive investment income. The Company consolidates the results of its subsidiaries for financial reporting purposes.

**NOTE 2. INTERIM FINANCIAL STATEMENTS**

Our interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and in conformity with generally accepted accounting principles applicable to interim financial information. Accordingly, they do not include all information and disclosures necessary for a presentation of our financial position, results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. In the opinion of management, these financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of our financial position, results of operations and cash flows for such periods. The results of operations for any interim period are not necessarily indicative of the results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

**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 inter-company accounts and transactions have been eliminated in consolidation.

**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 June 30, 2008, and December 31, 2007, and the reported amounts of revenues and expenses for the three months and six months ended June 30, 2008, and 2007. Actual results could differ from these estimates, and the differences could be material. The most significant estimates relate to the fair valuations of certain of our investments.

**Cash and Cash Equivalents.** Cash and cash equivalents includes demand deposits and money market instruments with maturities of less than three months. Cash and cash equivalents are carried at cost which approximates value.

**Portfolio Investment Valuations.** Investments are stated at "value" as defined in the 1940 Act and in the applicable regulations of the SEC. 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 June 30, 2008, our financial statements include private venture capital investments valued at \$92,335,524, the fair values of which were determined in good faith by, or under the direction, of the Board of Directors. Upon sale of investments, the values that are ultimately realized may be different from what is presently estimated. The difference could be material. Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company would resolve any inconsistencies between Section 2(a)(41) of the 1940 Act and SFAS No. 157 in accordance with the requirements of Section 2(a)(41). The adoption of SFAS No. 157 did not have a material impact on the fair value measurements of the Company's investments.

**Foreign Currency Translation.** The accounting records of the Company are maintained in U.S. dollars. All assets and liabilities denominated in foreign currencies are translated into U.S. dollars based on the rate of exchange of such currencies against U.S. dollars on the date of valuation. For the six months ended June 30, 2008, included in the net decrease in unrealized depreciation on investments was a \$57,229 loss resulting from foreign currency translation.

**Securities Transactions.** Securities transactions are accounted for on the date the transaction for the purchase or sale of the securities is entered into by the Company (i.e., trade date).

**Interest Income Recognition.** Interest income, adjusted for amortization of premium and accretion of discount, is recorded on accrual basis. The Company ceases accruing interest when securities are determined to be non-income producing and writes off any previously accrued interest.

**Realized Gain or Loss and Unrealized Appreciation or Depreciation of Portfolio Investments.** Realized gain or loss is recognized when an investment is disposed of and is computed as the difference between the Company's cost basis in the investment at the disposition date and the net proceeds received from such disposition. Realized gains and losses on investment transactions are determined by specific identification. Unrealized appreciation or depreciation is computed as the difference between the fair value of the investment and the cost basis of such investment.

**Stock-Based Compensation.** The Company has a stock-based employee compensation plan. The Company accounts for the plan in accordance with the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment," ("SFAS No. 123(R)"). See "Note 5. Stock-Based Compensation" for further discussion.

**Income Taxes.** As we intend to qualify as a RIC under Subchapter M of the Internal Revenue Code, the Company does not provide for income taxes. Our taxes are accounted for in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," and FIN 48, "Accounting for Uncertainty in Income Taxes." The Company recognizes interest and penalties in income tax expense.

We pay federal, state and local income taxes on behalf of our wholly owned subsidiary, Harris & Harris Enterprises, Inc., 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.

**Property and Equipment.** Property and equipment are included in "Other Assets" and are carried at cost, less accumulated depreciation of \$364,152. Depreciation is provided using the straight-line method over the estimated useful lives of the premises and equipment.

**Concentration of Credit Risk.** The Company places its cash and cash equivalents with financial institutions and, at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit.

#### **NOTE 4. FAIR VALUE MEASUREMENTS**

At June 30, 2008, our financial assets were categorized as follows in the fair value hierarchy for SFAS No. 157 purposes:

**Fair Value Measurement at Reporting Date Using:**

<b>Description</b>	<b>June 30, 2008</b>			
	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	
U.S. Government Securities	\$ 61,425,025	\$ 0	\$ 61,425,025	\$ 0
Portfolio Companies	\$ 92,335,524	\$ 0	\$ 0	\$ 92,335,524
<b>Total</b>	<b>\$ 153,760,549</b>	<b>\$ 0</b>	<b>\$ 61,425,025</b>	<b>\$ 92,335,524</b>

The following chart shows the components of change in the financial assets categorized as Level 3, for the three months ended June 30, 2008.

**Fair Value Measurements  
Using Significant  
Unobservable Inputs (Level 3)**

**Portfolio Companies**

Beginning Balance, April 1, 2008	\$ 83,097,863
Total realized losses included in changes in net assets	0
Total unrealized gains included in changes in net assets	4,791,705
Purchases and interest on bridge notes	4,467,456
Disposals	(21,500)
Ending Balance, June 30, 2008	\$ 92,335,524

The amount of total gains for the period included in changes in net assets attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$ 4,791,705
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The following chart shows the components of change in the financial assets categorized as Level 3, for the six months ended June 30, 2008.

**Fair Value Measurements  
Using Significant  
Unobservable Inputs (Level 3)**

**Portfolio Companies**

Beginning Balance, January 1, 2008	\$	78,110,384
Total realized losses included in changes in net assets		(5,014,653)
Total unrealized gains included in changes in net assets		8,442,908
Purchases and interest on bridge notes		10,924,099
Disposals		(127,214)
Ending Balance, June 30, 2008	\$	92,335,524
The amount of total gains for the period included in changes in net assets attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$	3,428,255

**NOTE 5. STOCK-BASED COMPENSATION**

On March 23, 2006, the Board of Directors of the Company voted to terminate the Employee Profit-Sharing Plan and to establish the Harris & Harris Group, Inc. 2006 Equity Incentive Plan (the "Stock Plan"), subject to shareholder approval. This proposal was approved at the May 4, 2006, Annual Meeting of Shareholders. The Stock Plan provides for the grant of equity-based awards of stock options to our officers, employees and directors (subject to receipt of an exemptive order described below) and restricted stock (subject to receipt of an exemptive order described below) to our officers and employees who are selected by our Compensation Committee for participation in the plan and subject to compliance with the 1940 Act.

On July 11, 2006, the Company filed an application with the SEC regarding certain provisions of the Stock Plan, and on June 29, 2007, the Company responded to comments from the SEC on the application. In the event that the SEC provides the exemptive relief requested by the application, and we receive any additional stockholder approval required by the SEC, the Compensation Committee may, in the future, authorize awards of stock options under the Stock Plan to non-employee directors of the Company and authorize grants of restricted stock to employees.

A maximum of 20 percent of our total shares of our common stock issued and outstanding are available for awards under the Stock Plan. Under the Stock Plan, no more than 25 percent of the shares of stock reserved for the grant of the awards under the Stock Plan may be restricted stock awards at any time during the term of the Stock Plan. If any shares of restricted stock are awarded, such awards will reduce on a percentage basis the total number of shares of stock for which options may be awarded. If the Company does not receive exemptive relief from the SEC to issue restricted stock, all shares granted under the Stock Plan may be subject to stock options. No more than 1,000,000 shares of our common stock may be made subject to awards under the Stock Plan to any individual in any year.

On March 19, 2008, the Compensation Committee of the Board of Directors and the full Board of Directors of the Company approved a grant of individual Non-Qualified Stock Option ("NQSO") awards for certain officers and employees of the Company. The terms and conditions of the stock options granted were set forth in award agreements between the Company and each award recipient entered into on that date. Options to purchase a total of 348,032 shares of stock were granted with vesting periods ranging from March 2009 to March 2012 and with an exercise price of \$6.18, which was the closing volume weighted average price of our shares of common stock on March 19, 2008. Upon exercise, the shares would be issued from our previously authorized but unissued shares.

The Company accounts for the Stock Plan in accordance with the provisions of SFAS No. 123(R), which requires that we determine the fair value of all share-based payments to employees, including the fair value of grants of employee stock options, and record these amounts as an expense in the Statement of Operations over the vesting period with a corresponding increase to our additional paid-in capital. At June 30, 2008 and December 31, 2007, the increase to our operating expenses was offset by the increase to our additional paid-in capital, resulting in no net impact to our net asset value. Additionally, the Company does not record the tax benefits associated with the expensing of stock options, because the Company currently intends to qualify as a RIC under Subchapter M of the Code.

An option's expected term is the estimated period between the grant date and the exercise date of the option. As the expected term period increases, the fair value of the option and the non-cash compensation cost will also increase. The expected term assumption is generally calculated using historical stock option exercise data. The Company does not have historical exercise data to develop such an assumption. In cases where companies do not have historical data and where the options meet certain criteria, SEC Staff Accounting Bulletin 107 ("SAB 107") provides the use of a simplified expected term calculation. Accordingly, the Company calculated the expected terms using the SAB 107 simplified method.

Expected volatility is the measure of how the stock's price is expected to fluctuate over a period of time. An increase in the expected volatility assumption yields a higher fair value of the stock option. Expected volatility factors for the stock options were based on the historical fluctuations in the Company's stock price over a period commensurate with the expected term of the option, adjusted for stock splits and dividends.

The expected dividend yield assumption is traditionally calculated based on a company's historical dividend yield. An increase to the expected dividend yield results in a decrease in the fair value of option and resulting compensation cost. Although the Company has declared deemed dividends in previous years, most recently in 2005, the amounts and timing of any future dividends cannot be reasonably estimated. Therefore, for purposes of calculating fair value, the Company has assumed an expected dividend yield of zero percent.

The risk-free interest rate assumptions are based on the annual yield on the measurement date of a zero-coupon U.S. Treasury bond the maturity of which equals the option's expected term. Higher assumed interest rates yield higher fair values.

The amount of non-cash, stock-based compensation expense recognized in the Consolidated Statements of Operations is based on the fair value of the awards the Company expects to vest, recognized over the vesting period on a straight-line basis for each award, and adjusted for actual options vested and pre-vesting forfeitures. The forfeiture rate is estimated at the time of grant and revised, if necessary, in subsequent periods if the actual forfeiture rate differs from the estimated rate and is accounted for in the current period and prospectively.

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes-Merton option pricing model as permitted by SFAS No. 123(R). The assumptions used in the calculation of fair value of the stock options granted on March 19, 2008, using the Black-Scholes-Merton model for the contract term was as follows:

Type of Award	Term	Number of Options Granted	Expected Term in Yrs	Expected Volatility Factor	Expected Dividend Yield	Risk-free Interest Rates	Weighted Average Fair Value Per Share
Non-qualified stock options	9.78 Years	348,032	6.14	57.1%	0%	2.62%	\$ 3.45
<b>Total</b>		<b>348,032</b>					<b>\$ 3.45</b>

For the three months and six months ended June 30, 2008, the Company recognized \$1,499,345 and \$2,966,325 of compensation expense in the Consolidated Statements of Operations. As of June 30, 2008, there was approximately \$6,264,749 of unrecognized compensation cost related to unvested stock option awards. This cost is expected to be recognized over a weighted-average period of approximately two years.

For the three months and six months ended June 30, 2008, no stock options were exercised.

For the three months and six months ended June 30, 2008, the calculation of the net decrease in net assets resulting from operations per share excludes the stock options because such options were anti-dilutive. The options may be dilutive in future periods in which there is a net increase in net assets resulting from operations, in the event that there is a significant increase in the average stock price in the stock market or in the event of significant decreases in the amount of unrecognized compensation cost.

A summary of the changes in outstanding stock options is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Yrs)	Aggregate Intrinsic Value
Options Outstanding at January 1, 2008	3,967,744	\$ 10.54	\$ 4.77		
Granted	348,032	\$ 6.18	\$ 3.45	9.50	
Exercised	0	\$ 0	\$ 0		
Forfeited or Expired	(451,898).	\$ 10.12	\$ 2.63		
Options Outstanding at June 30, 2008	3,863,878	\$ 10.20	\$ 4.90	5.05	\$ 0
Options Exercisable at June 30, 2008	1,773,733	\$ 10.43	\$ 5.33	5.14	\$ 0
Options Exercisable and Expected to be Exercisable at June 30, 2008	3,793,030	\$ 10.19	\$ 4.86	4.99	\$ 0

The aggregate intrinsic value in the table above with respect to options outstanding, exercisable and expected to be exercisable, is calculated as the difference between the Company's closing stock price of \$6.00 on the last trading day of the second quarter of 2008 and the exercise price, multiplied by the number of in-the-money options. This represents the total pre-tax intrinsic value that would have been received by the option holders had all options been fully vested and all option holders exercised their awards on June 30, 2008.

Unless earlier terminated by our Board of Directors, the Stock Plan will expire on May 4, 2016. The expiration of the Stock Plan will not by itself adversely affect the rights of plan participants under awards that are outstanding at the time the Stock Plan expires. Our Board of Directors may terminate, modify or suspend the plan at any time, provided that no modification of the plan will be effective unless and until any required shareholder approval has been obtained. The Compensation Committee may terminate, modify or amend any outstanding award under the Stock Plan at any time, provided that in such event, the award holder may exercise any vested options prior to such termination of the Stock Plan or award.

#### **NOTE 6. INCOME TAXES**

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 2007. However, there can be no assurance that we will qualify as a RIC for 2008 or subsequent years.

In the case of a RIC which furnishes capital to development corporations, there is an exception to the rule relating to the diversification of investments required to qualify for RIC treatment. This exception is available only to registered management investment companies which the SEC determines to be 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 ("SEC Certification"). We have received SEC Certification since 1999, including for 2007, but it is possible that we may not receive SEC Certification in future 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.

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.

For federal tax purposes, the Company's 2004 through 2007 tax years remain open for examination by the tax authorities under the normal three year statute of limitations. Generally, for state tax purposes, the Company's 2003 through 2007 tax years remain open for examination by the tax authorities under a four year statute of limitations.

For the six months ended June 30, 2008, we paid \$15,798 in federal, state and local income taxes. During the second quarter of 2008, we paid \$0 in federal, state and local income taxes. At June 30, 2008, we had \$0 accrued for federal, state and local taxes payable by the Company.

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 June 30, 2008, and 2007, our income tax expense (benefit) for Harris & Harris Enterprises, Inc., was \$668 and \$0, respectively. For the six months ended June 30, 2008, and 2007, our income tax expense (benefit) for Harris & Harris Enterprises, Inc., was \$31,068 and \$0, respectively.

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.

#### **NOTE 7. CAPITAL TRANSACTIONS**

On June 25, 2007, we completed the sale of 1,300,000 shares of our common stock for gross proceeds of \$14,027,000; net proceeds of this offering, after placement agent fees and offering costs of \$1,033,832, were \$12,993,168.

On June 20, 2008, we completed the sale of 2,545,000 shares of our common stock for gross proceeds of \$15,651,750; net proceeds of this offering, after placement agent fees and offering costs of \$1,268,253, were \$14,383,497.

#### **NOTE 8. CHANGE IN NET ASSETS PER SHARE**

The following table sets forth the computation of basic and diluted per share net increases in net assets resulting from operations for the three and six months ended June 30, 2008, and June 30, 2007.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2008	2007	2008	2007
Numerator for increase (decrease) in net assets per share	\$ 1,354,709	\$ (4,093,644)	\$ (1,934,326)	\$ (10,483,804)
Denominator for basic and diluted weighted average shares	23,622,210	21,721,591	23,468,392	21,500,810
Basic and diluted net increase (decrease) in net assets per share resulting from operations	\$ 0.06	\$ (0.19)	\$ (0.08)	\$ (0.49)

#### **NOTE 9. EMPLOYEE BENEFITS**

We have established a rabbi trust for the purpose of accumulating funds to satisfy the obligations incurred by us under Mr. Harris's Supplemental Executive Retirement Plan ("SERP"), which amounted to \$53,871 and \$2,667,020 at June 30, 2008, and December 31, 2007, respectively, and is included in accounts payable and accrued liabilities. The restricted funds for the SERP Account totaled \$53,871 and \$2,667,020 at June 30, 2008, and December 31, 2007, respectively. Mr. Harris's rights to benefits pursuant to this SERP will be no greater than those of a general creditor of us.

During the three months ended June 30, 2008, Mr. Harris received a \$2,889,717 distribution from the SERP Account. Any subsequent balance of the SERP Account will be paid on July 31, 2009.

#### **NOTE 10. COMMITMENTS AND CONTINGENCIES**

We may have a contingent liability arising out of a possible violation of Section 5 of the Securities Act of 1933 (the "Securities Act") in connection with the distribution of a management presentation to prospective purchasers of our common stock. After effectiveness of the registration statement with respect to the shares of common stock sold in the offering that closed on June 20, 2008, our placement agent electronically mailed to certain potential purchasers of our common stock in the offering a copy of the management presentation used in connection with the offering. This mailing may have constituted a prospectus that did not meet the requirements of the Securities Act, in which case the mailing may have caused us to violate Section 5 of the Securities Act. If the mailing were held by a court to be in violation of Section 5 of the Securities Act, we believe that purchasers in the offering who received the mailing from the placement agent may have the right, for a period of one year from the date of their purchase of the common stock, to bring an action for rescission of their purchase of common stock. We cannot assure you, however, that this right would be limited to those purchasers. If successful in such action, such investors could require us to repurchase the shares sold to purchasers in this offering at the original purchase price, plus statutory interest from the date of purchase. The placement agent has agreed to indemnify us for losses that we may incur as a result of the electronic mailing of the management presentation used in connection with the offering to potential purchasers in the offering.



**NOTE 11. SUBSEQUENT EVENTS**

On July 25, 2008, we made an \$800,000 follow-on investment in Nextreme Thermal Solutions, Inc.

On July 31, 2008, we made a \$1,000,000 follow-on investment in a privately held tiny technology portfolio company.

On August 5, 2008, we made a \$200,000 follow-on investment in a privately held tiny technology portfolio company.

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<b>HARRIS &amp; HARRIS GROUP, INC.</b> <b>FINANCIAL HIGHLIGHTS</b> <b>(Unaudited)</b>
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	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
<b>Per Share Operating Performance</b>				
Net asset value per share, beginning of period	\$ 5.86	\$ 5.27	\$ 5.93	\$ 5.42
Net operating (loss)*	(0.13)	(0.13)	(0.23)	(0.26)
Net realized income (loss) on investments*	(0.00)	(0.00)	(0.22)	(0.00)
Net (increase) decrease in unrealized depreciation as a result of sales*	(0.00)	(0.00)	0.21	(0.00)
Net (increase) decrease in unrealized depreciation on investments held*	0.17	(0.06)	0.14	(0.23)
Total from investment operations*	0.04	(0.19)	(0.10)	(0.49)
Net increase as a result of stock-based compensation expense	0.06	0.08	0.13	0.16
Net increase as a result of net proceeds of stock offering, after expenses	(0.01)	0.26	(0.01)	0.26
Net increase as a result of proceeds from exercise of options	0.00	0.12	0.00	0.19
Total increase from capital stock transactions	0.05	0.46	0.12	0.61
Net asset value per share, end of period	\$ 5.95	\$ 5.54	\$ 5.95	\$ 5.54
Stock price per share, end of period	\$ 6.00	\$ 11.20	\$ 6.00	\$ 11.20
Total return based on stock price (1)	(15.85)%	(13.31)%	(31.74)%	(7.36)%

**Supplemental Data:**

Net assets, end of period	\$ 153,778,840	\$ 128,222,333	\$ 153,778,840	\$ 128,222,333
Ratio of expenses to average net assets (1)	2.1%	2.9%	4.3%	5.8%

Ratio of net operating (loss) to average net assets <sup>(1)</sup>		(1.8)%		(2.4)%		(3.6)%		(4.7)%
Cash dividend paid per share	\$	0	\$	0	\$	0	\$	0
Deemed dividend per share	\$	0	\$	0	\$	0	\$	0
Number of shares outstanding, end of period		25,859,573		23,141,924		25,859,573		23,141,924

\*Based on Average Shares Outstanding

<sup>(1)</sup> Not annualized

The accompanying notes are an integral part of this schedule.

## **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 the Company's unaudited June 30, 2008 Consolidated Financial Statements and the Company's audited 2007 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 also made him the control person of 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.

In 1992, we 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. 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 June 30, 2008, \$92,335,524, or 60.04 percent, of our net assets at fair value consisted of private venture capital investments, net of unrealized appreciation of \$3,875,764. At December 31, 2007, \$78,110,384, or 56.5 percent, of our net assets at fair value consisted of private venture capital investments, net of unrealized depreciation of \$4,567,144.

Since our investment in Otisville in 1983 through June 30, 2008, we have made a total of 82 venture capital investments, including four private placement investments in securities of publicly traded companies. We have exited 47 of these 82 investments, realizing total proceeds of \$143,895,288 on our invested capital of \$56,349,559. As measured from first dollar in to last dollar out, the average and median holding periods for these 47 investments were 3.77 years and 3.20 years, respectively. As measured by the 165 separate rounds of investment within these 47 investments, the average and median holding periods for the 165 separate rounds of investment were 2.93 years and 2.64 years, respectively.

In 1994, we made our first tiny technology investment. From August 2001 through June 30, 2008, all 40 of our initial investments have been in tiny technology. From August 2001 through June 30, 2008, we have invested a total (before any subsequent write-ups, write-downs or dispositions) of \$97,482,345 in tiny technology.

We currently have 32 active tiny technology companies in our portfolio, including one tiny technology investment made prior to 2001. At June 30, 2008, from first dollar in, the average and median holding periods for these 32 active tiny technology investments were 3.30 years and 3.12 years, respectively.

In our Form 10-Q for the quarter ended March 31, 2008, we stated, "Two of our portfolio companies have been considering with their advisors the possibility of filing for initial public offerings (IPOs) in 2008. There can be no assurance that either of them will file for an IPO in 2008, and a variety of factors, including stock market and general business conditions, could lead either or both of them to terminate such considerations." In the quarter ended June 30, 2008, there were no venture capital-backed IPOs in the United States. Until stock market conditions for IPOs improve, we believe the likelihood of any of our portfolio companies filing for IPOs has been reduced substantially.

The following is a summary of our initial and follow-on investments in tiny technology from 2001 to the present. We consider a "round led" to be a round where we issued the term sheet, were the new investor or led a set of new investors in an investee company. Typically, but not always, the lead investor negotiates the price and terms of a deal with the investee company.

	2001	2002	2003	2004	2005	2006	2007	YTD 6/30/08
Total Incremental Investments	\$ 489,999	\$ 6,240,118	\$ 3,812,600	\$ 14,837,846	\$ 16,251,339	\$ 24,408,187	\$ 20,595,161	\$ 10,847,095
No. of New Investments	1	7	5	8	4	6	7	2
No. of Follow-On Investment Rounds	0	1	5	21	13	14	20	13
No. of Rounds Led	0	1	0	2	0	7	3	3