



**DAVIDSON COMPANIES
AND SUBSIDIARIES**

**Report of Independent Auditors
and Consolidated Statements
of Financial Condition**

September 30, 2011 and 2010

MOSS ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Davidson Companies

We have audited the accompanying consolidated statements of financial condition of Davidson Companies and subsidiaries as of September 30, 2011 and 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Davidson Companies and subsidiaries as of September 30, 2011 and 2010, in conformity with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Seattle, Washington
December 9, 2011

DAVIDSON COMPANIES AND SUBSIDIARIES
Consolidated Statements of Financial Condition
September 30, 2011 and 2010

<u>Assets</u>	<u>2011</u>	<u>2010</u>
Cash and cash equivalents	\$ 37,280,599	47,466,250
Receivables:		
Customers, net	116,479,392	116,256,999
Brokers, dealers and clearing organizations	1,650,506	18,724,583
Related parties	1,388,685	1,211,179
Income taxes	4,113,369	—
Other	7,569,034	7,933,097
Securities	52,779,541	32,377,328
Investments	4,113,481	3,936,903
Equipment and leasehold improvements (less accumulated depreciation and amortization of \$25,932,642 in 2011 and \$22,838,434 in 2010)	11,772,561	11,019,093
Notes receivable, net	26,768,659	28,133,919
Goodwill and intangible assets, net	3,743,926	3,133,283
Deferred tax asset, net	7,004,979	8,516,924
Other assets	12,052,297	7,473,272
Total assets	\$ 286,717,029	286,182,830
<u>Liabilities and Shareholders' Equity</u>		
Liabilities:		
Checks in advance of deposits	\$ 8,510,068	9,196,458
Loans payable to bank	2,000,000	2,000,000
Notes payable	6,601,257	7,115,266
Payables:		
Customers	49,865,399	51,312,096
Brokers, dealers and clearing organizations	23,658,265	16,378,228
Related parties	426,236	381,234
Securities sold, not yet purchased	5,185	939,114
Income taxes payable	—	1,410,742
Accrued employee compensation	34,178,420	41,097,506
Other payables and accrued liabilities	14,381,915	10,688,959
Total liabilities	139,626,745	140,519,603
Commitments and contingencies		
Shareholders' equity:		
Common stock (No par value. Authorized 20,000,000 shares: 8,201,997 and 8,478,961 shares issued and outstanding in 2011 and 2010, respectively)	—	4,814,111
Retained earnings	147,090,284	140,849,116
Total shareholders' equity	147,090,284	145,663,227
Total liabilities and shareholders' equity	\$ 286,717,029	286,182,830

See accompanying notes to consolidated statements of financial condition.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

(1) Summary of Significant Accounting Policies

Organization

Davidson Companies (Davidson or the Company) is a holding company incorporated in Montana providing financial services to its customers throughout the nation from its offices primarily located in the Pacific Northwest and Rocky Mountain regions. The four wholly-owned subsidiaries of Davidson are D.A. Davidson & Co., a securities broker-dealer; Davidson Trust Co., a trust company; Davidson Investment Advisors, Inc., an investment advisor; and Davidson Fixed Income Management, Inc., a fixed-income investment advisor. Davidson and its subsidiaries are hereinafter collectively referred to as the Company.

The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the "FASB". The FASB sets generally accepted accounting principles (GAAP) that the Company follows to ensure consistent reporting of financial condition, results of operations, and cash flows. References to GAAP issued by the FASB in these footnotes are to the *FASB Accounting Standards Codification*, sometimes referred to as the Codification or ASC.

(a) *Basis of Presentation*

The consolidated financial statements include the accounts of Davidson and its wholly-owned subsidiaries. All material intercompany balances and transactions are eliminated in consolidation.

(b) *Revenue Recognition*

Revenues from customer securities transactions are reported on a trade date basis. Proprietary securities transactions are reported on a trade date basis and the related gains or losses are recorded in trading revenue. Amounts receivable and payable for proprietary securities transactions that have not reached their contractual settlement date are recorded net on the statement of financial condition. Marketable securities and securities not readily marketable are valued at fair value with the related gains and losses recorded in trading revenue. Investment banking revenues include management fees earned from securities offerings in which the Company acts as an underwriter or agent and fees earned from providing financial advisory services. Investment banking management fees and sales commissions are recorded on offering date and underwriting fees are recognized at the time the underwriting is completed and the gain or loss is readily determinable. Advisory and administrative fees are recorded as earned, with billed but not paid amounts reflected as accounts receivable and amounts received but not earned reflected as deferred fee income. Investment company administrative 12b-1 fees are recorded when received.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

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(c) *Securities Lending Activities*

Securities borrowed and securities loaned are recorded at the amount of cash collateral advanced or received. Securities borrowed transactions require the Company to deposit cash with the lender. With respect to securities loaned, the Company receives cash in an amount generally in excess of the fair value of securities loaned. The Company monitors the fair value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary.

(d) *Securities*

Securities at September 30, 2011 and 2010 consist of bonds, stocks and other investments. Securities are bought and held principally as inventory for the purpose of sales in the near term. Securities are recorded at fair value with realized and unrealized gains and losses included in trading revenue.

Fair value is defined 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. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

The valuation techniques used are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs create the following hierarchy:

- Level 1 securities include inputs based on quoted prices in active markets for identical securities, which provides the most reliable fair value measurement. This category generally includes actively traded equity securities, mutual funds and US government obligations.
- Level 2 securities include inputs other than quoted prices in active markets, which are either directly or indirectly observable as of the measurement date. These observable inputs include quoted prices for similar securities, and bond pricing models based on interest rates, credit risk, and remaining maturity for similar securities. This category generally includes corporate bonds, municipal bonds and government agency mortgage backed bonds.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

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- Level 3 securities do not have observable pricing inputs as of the measurement date. These securities are valued based on management's best estimate of fair value, which may include significant judgment or estimation. Factors that may be considered in the valuation estimate include the cost, terms and liquidity of the security, the financial condition and operating results of the issuer, market prices of similar securities, pricing models based on estimated cash flows and yields, the values established in the financial statements of limited partnership investments, and other factors generally applicable to the valuation of securities. This category includes certain sanitation improvement district obligations, auction rate preferred securities and limited partnership investments owned by the Company.

See footnote 4 for further information regarding Securities Owned and Sold, Not Yet Purchased.

(e) ***Investments***

Debt securities owned by Davidson Trust Co. are accounted for as held-to-maturity securities and are stated at amortized cost with the premium or discount amortization accounted for in investment income. Fair value was \$4,213,916 and \$4,053,760 as of September 30, 2011 and 2010, respectively.

(f) ***Income Taxes***

Davidson and its subsidiaries file consolidated federal and combined state income tax returns. The Company is no longer subject to U.S. federal, state, and local income tax examinations by authorities for fiscal years ending on and prior to September 30, 2003.

The Company accounts for income taxes in accordance with the *Income Taxes* topic of the FASB ASC. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. When applicable, a valuation allowance is established to reduce any deferred tax asset when it is determined that it is more likely than not that some portion of the deferred tax asset will not be realized.

The Company records uncertain tax positions when the effect of the outcome is considered probable and reasonably estimable. As of September 30, 2011 and 2010, the Company has not made any accruals for uncertain tax positions.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

(g) *Cash and Cash Equivalents*

Cash equivalents consist primarily of money market funds which invest in United States Treasury bills, notes and commercial paper with original maturities of 90 days or less and amounted to \$23,944,578 and \$39,944,492 at September 30, 2011 and 2010, respectively. The Company has cash deposit accounts with financial institutions in which the balances may exceed the Federal Deposit Insurance Corporation (FDIC) insured limit. The Company has not experienced any losses in such accounts and management believes it is not exposed to any significant risk.

(h) *Receivables from and Payables to Customers*

Accounts receivable from and payable to customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for receivables.

(i) *Equipment and Leasehold Improvements*

Equipment and leasehold improvements are recorded at cost. Depreciation is provided on a straight-line or accelerated basis using estimated useful lives of the assets. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease. Estimated useful lives range from 2 to 10 years.

(j) *Goodwill and Other Intangible Assets*

Goodwill represents the excess of consideration given over fair value of net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. As of September 30, 2011 and 2010, the balance of goodwill was \$2,395,337.

The Company is required to identify the related reporting unit that pertains to any goodwill balance and to test goodwill for impairment by comparing the fair value of the reporting unit to the carrying amount of the reporting unit. The Company has identified its related reporting unit as its equity capital markets business and has allocated goodwill accordingly. The Company estimated the fair value of the reporting unit and determined that the unit's fair value exceeds its carrying value, and consequently, no impairment is evident at September 30, 2011 and 2010.

In connection with the March 2009 acquisition of the assets and operations of Ruan Securities, the Company recorded an intangible asset of \$1,348,060 identifiable with the Ruan customer base, which is being amortized over the estimated useful life of seven years. In connection with the December 2010 acquisition of the operations of Silversteep Partners, LLC, the Company recorded an intangible asset of \$1,200,000 identifiable with the Silversteep customer base, which is being amortized over the estimated useful life of three years. The balance of these intangible assets was \$1,348,589 and \$737,946 as of September 30, 2011 and 2010, respectively.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

(k) Allowance for Doubtful and Impaired Receivables

The Company provides an allowance for losses on doubtful and impaired customer accounts and notes receivable based on management's evaluation of existing accounts outstanding and historical experience related to such activity. A receivable is considered impaired when, based upon current information and events, it is probable that the Company will be unable to collect, on a timely basis, all principal and interest according to the contractual terms of the receivable's original agreement. When a specific receivable is determined to be doubtful or impaired, the allowance for receivables is increased through a charge to expense for the amount of the estimated loss or impairment.

The Company's investment in impaired customer accounts and notes receivable (for which there is no related allowance for credit losses) totaled \$597,500 and \$620,000 at September 30, 2011 and 2010, respectively. Allowances for estimated losses and impairment on customer accounts and notes receivable totaled \$309,783 and \$439,240 at September 30, 2011 and 2010, respectively.

(l) Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates. The Company considers its more significant estimates to include the accrual for legal claims, reserves for claims under the Company's self-insured employee medical plan, the valuation of Level 3 securities, and allowances for doubtful and impaired receivables.

(m) Stock-Based Compensation

The Company's stock option plan provides for the granting of common stock options to officers, key employees and directors of the Company. The Company accounts for its share-based compensation in accordance with the *Stock Compensation* topic of the FASB ASC, which requires recognition of expense related to the fair value of share-based compensation.

Compensation cost recognized for the years ended September 30, 2011 and 2010 includes compensation cost for all share-based compensation granted subsequent to October 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of the *Stock Compensation* topic, recognized using the straight-line attribution method.

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(n) Long-Lived Assets

The Company's long-lived assets, such as property, plant and equipment, and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Recoverability of an asset to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. At September 30, 2011 and 2010 there were no long-lived assets that were considered impaired.

(o) Advertising

The Company expenses its advertising costs as incurred.

(p) Notes Receivable

Notes receivable consist of unsecured loans to Company employees. These notes earn interest at rates consistent with current market rates and are repaid over a term of three to ten years. Repayment is generally made with the employees' bonus compensation.

(q) Recent Accounting Pronouncements

The Company did not adopt any new accounting pronouncements that would impact the Company's financial position for the years ended September 30, 2011 and 2010.

(r) Reclassifications

Certain reclassifications have been made to prior year balances to provide a presentation consistent with the current year.

(s) Subsequent Events

The Company has evaluated events subsequent to September 30, 2011 through December 9, 2011, which is the date the financial statements were available to be issued. No events were noted that would require disclosure in the footnotes to the financial statements.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

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(2) Net Capital Requirements

D.A. Davidson & Co. is subject to the Uniform Net Capital Rule (15c3-1) pursuant to the Securities Exchange Act of 1934. The Company has elected to use the alternative method permitted by Rule 15c3-1 which requires that it maintain net capital in excess of the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions as defined in the Formula Reserve Requirements under SEC Rule 15c3-3. At September 30, 2011, the Company's net capital of \$63,024,915 was 53.8% of aggregate debit items and net capital exceeded the required capital of \$2,342,322 by \$60,682,593, as reported in the Company's FOCUS report filed with the Financial Industry Regulatory Authority on October 25, 2011.

(3) Receivables from and Payables to Brokers, Dealers and Clearing Organizations

Amounts receivable from and payable to brokers, dealers and clearing organizations consist of the following:

	<u>Receivable</u>	<u>Payable</u>
September 30, 2011:		
Securities failed-to-deliver/receive	\$ 1,442,995	3,406,465
Unsettled proprietary trades	—	19,068,463
Other	207,511	1,183,337
	<u>\$ 1,650,506</u>	<u>23,658,265</u>
September 30, 2010:		
Securities failed-to-deliver/receive	\$ 13,670,778	14,361,105
Unsettled proprietary trades	1,372,553	—
Other	3,681,252	2,017,123
	<u>\$ 18,724,583</u>	<u>16,378,228</u>

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

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(4) Securities Owned and Sold, Not Yet Purchased

The following table summarizes Securities Owned and Sold, Not Yet Purchased as of September 30, 2011 and 2010:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
September 30, 2011:				
Securities Owned:				
Equity Securities	\$ 3,506,384	—	—	3,506,384
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	—	19,339,963	—	19,339,963
Debt securities issued by states of the United States and political subdivisions of the states	—	14,068,812	6,403,919	20,472,731
Corporate debt securities	—	3,081,319	—	3,081,319
Mortgage-backed securities	—	3,194,464	—	3,194,464
Certificates of Deposit	—	2,109,169	—	2,109,169
Auction Rate Preferred Securities	—	—	541,500	541,500
Limited Partnerships	—	—	534,011	534,011
	<u>\$ 3,506,384</u>	<u>41,793,727</u>	<u>7,479,430</u>	<u>52,779,541</u>
Securities Sold, Not Yet Purchased:				
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	\$ —	782	—	782
Debt securities issued by states of the United States and political subdivisions of the states	—	4,403	—	4,403
	<u>\$ —</u>	<u>5,185</u>	<u>—</u>	<u>5,185</u>
September 30, 2010:				
Securities Owned:				
Equity Securities	\$ 3,147,281	—	—	3,147,281
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	—	2,001,567	—	2,001,567
Debt securities issued by states of the United States and political subdivisions of the states	—	8,461,232	7,310,492	15,771,724
Corporate debt securities	—	1,741,494	—	1,741,494
Mortgage-backed securities	—	1,393,966	—	1,393,966
Certificates of Deposit	—	625,072	—	625,072
Auction rate preferred securities	—	—	7,038,000	7,038,000
Limited partnerships	—	—	658,224	658,224
	<u>\$ 3,147,281</u>	<u>14,223,331</u>	<u>15,006,716</u>	<u>32,377,328</u>
Securities Sold, Not Yet Purchased:				
Equity Securities	\$ 425,478	—	—	425,478
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	—	513,636	—	513,636
	<u>\$ 425,478</u>	<u>513,636</u>	<u>—</u>	<u>939,114</u>

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Following is a reconciliation of Level 3 assets for which significant unobservable inputs were used to determine fair value:

	Level 3 Beginning Balance	Purchase of Investments	Sale/ Redemption of Investments	Realized Gain/(Loss)	Change in Unrealized Gain/(Loss)	Level 3 Ending Balance
2011						
Securities Owned:						
Debt securities issued by states of the United States and political subdivisions of the states	\$ 7,310,492	11,681,389	(12,588,024)	245,364	(245,302)	6,403,919
Auction rate preferred securities	7,038,000	—	(6,525,000)	—	28,500	541,500
Limited partnerships	658,224	—	(134,310)	(29,315)	39,412	534,011
	<u>\$ 15,006,716</u>	<u>11,681,389</u>	<u>(19,247,334)</u>	<u>216,049</u>	<u>(177,390)</u>	<u>7,479,430</u>
2010						
Securities Owned:						
Debt securities issued by states of the United States and political subdivisions of the states	\$ 6,051,314	12,028,489	(10,439,835)	92,316	(421,792)	7,310,492
Auction rate preferred securities	9,418,000	125,000	(2,525,000)	—	20,000	7,038,000
Limited partnerships	904,532	—	(39,417)	—	(206,891)	658,224
	<u>\$ 16,373,846</u>	<u>12,153,489</u>	<u>(13,004,252)</u>	<u>92,316</u>	<u>(608,683)</u>	<u>15,006,716</u>

(5) Loans Payable to Banks

The Company has two revolving lines of credit totaling \$80,000,000, secured by certain Company or customer margin assets, and one unsecured revolving line of credit for \$10,000,000. The revolving lines of credit bear interest based on the federal funds rate plus 0.625% for the secured lines and plus 1.0% for the unsecured line. One of the revolving lines of credit has a maturity date of January 31, 2012; the others have no expiration date. There were no outstanding borrowings under these lines of credit at September 30, 2011 or 2010.

The Company has a non-revolving line of credit for \$20,000,000, secured by two-thirds of the capital stock of D.A. Davidson & Co., which bears interest at varying rates tied to the LIBOR rate plus 2.0%-3.0% or the prime rate plus 0.0%-0.75%, as applicable. Borrowings of up to \$20,000,000 may be made through December 31, 2011. Payments are due in equal quarterly principal payments, plus interest, commencing March 31, 2012, through December 31, 2021. As of September 30, 2011, \$2,000,000 was outstanding under this line of credit. The credit line contains covenants under which the Company must maintain specified levels of net worth and maintain specified financial ratios. At September 30, 2011, the Company was in compliance with its financial loan covenants.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

(6) Notes Payable

Notes payable consist of unsecured loans to former shareholders, resulting from repurchases of Company stock. These loans total \$6,601,257 at September 30, 2011, bear interest at 6.00%, and are due in annual installments through September 2015, of which \$2,881,773, \$2,534,721, \$624,755, and \$560,008 is due in fiscal years 2012, 2013, 2014, and 2015, respectively. Notes payable at September 30, 2010 consist of 24 unsecured notes to former shareholders totaling \$7,115,266.

(7) Employee Benefit Plans

Employees participate in the Company's retirement savings and profit sharing plan and employee stock ownership plan. Each plan is a defined contribution plan covering all employees who have completed a year of service. Participants become 100% vested in the employer contribution account after six years of service. Investments of the employee stock ownership plan consist entirely of common stock of Davidson, which is appraised twice annually including as of the end of each plan year by an independent certified business appraiser to determine the current fair market value.

Participants may contribute to the Company's retirement savings and profit sharing plan under the retirement savings portion of the plan. Contributions are based on a participant's choice of a percentage up to limits established by the plan.

For the year ended September 30, 2011, the ESOP received an allocation of 134,302 shares of common stock valued at \$18.52 per share. As of September 30, 2011, the number of shares of Davidson stock held by the ESOP is 3,182,784 with an established fair market value of \$58,945,160. At September 30, 2010, the ESOP held 3,441,955 shares of Davidson stock.

ESOP participants may require the Company to purchase their ESOP shares at the established fair market value upon the termination of their employment or under diversification provisions of the ESOP. During the years ended September 30, 2011 and 2010, the Company purchased 360,503 and 117,415 shares of Davidson stock from the ESOP for \$8,158,913 and \$2,387,348, respectively.

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(8) Income Taxes

Differences between the financial statement carrying amounts and the tax bases of assets and liabilities that give rise to significant portions of deferred tax assets and liabilities are as follows:

	<u>2011</u>	<u>2010</u>
Deferred tax assets:		
Employee compensation and benefits	\$ 6,773,862	7,497,078
Equipment and leasehold improvements, principally differences in depreciation	119,681	661,856
Accrued expenses	871,672	510,249
State taxes	-	51,760
Capital loss carryovers	326,455	418,639
Other	294,100	301,162
Total deferred tax assets	<u>8,385,770</u>	<u>9,440,744</u>
Deferred tax liabilities:		
Prepaid expenses	1,160,065	923,820
State taxes	220,726	-
Total deferred tax liabilities	<u>1,380,791</u>	<u>923,820</u>
Net deferred tax asset	<u>\$ 7,004,979</u>	<u>8,516,924</u>

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the existence of, or generation of, taxable income in the periods in which those temporary differences are deductible. Management considers the scheduled reversal of deferred tax liabilities, taxes paid in carryback years, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and estimates of future taxable income over the periods in which the deferred tax assets are deductible, at September 30, 2011, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

(9) Related Party Transactions

Related parties consist of significant shareholders, directors, principal officers, the Company's retirement savings and profit sharing plan and the ESOP. Included in accrued employee compensation at September 30, 2011 and 2010 was \$598,190 and \$1,384,870, respectively, due to the retirement savings and profit sharing plan.

The Company rents its Great Falls office space, at terms which it considers to be fair market value, from a partnership whose partners include the Chairman of the Company and his immediate family.

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(10) Stock Based Compensation

The Company's stock option plan (the Plan) provides for the granting of Davidson common stock options to officers, key employees and directors of the Company. All options currently outstanding vest or are earned over periods ranging from one to four years.

Stock options are as follows:

	<u>Options Outstanding</u>		
	<u>Weighted Average Remaining Contractual Life</u>	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding at September 30, 2011	9 months	<u>249,628</u>	<u>\$ 19.31</u>
Exercisable at September 30, 2011	8 months	<u>196,565</u>	<u>\$ 18.97</u>

Proceeds received on exercises of stock options were \$2,469,576 and \$2,156,364 for the years ended September 30, 2011 and 2010, respectively. Options issued are incentive stock options, which generally do not provide any tax benefit for the Company. The Company expects all its outstanding options to vest.

As of September 30, 2011 and 2010, there was \$76,448 and \$228,546 of total unrecognized compensation cost related to options granted since October 1, 2008. Those costs are expected to be recognized over the remaining weighted average vesting period of 2.3 (2011 options), 1.4 (2010 options) and 0.7 (2009 options) years as of September 30, 2011.

The Company has compensation agreements with certain employees which provide for the issuance of its stock in future years upon satisfaction of vesting requirements. In addition, the Company awards restricted stock grants in which its shares are issued subject to forfeiture if vesting conditions are not satisfied. There was \$5,462,408 and \$5,721,977 of total unrecognized compensation related to these share-based awards as of September 30, 2011 and September 30, 2010, respectively. Those costs are expected to be recognized over the remaining weighted average vesting period of 3.1 years as of September 30, 2011 and 2.8 years as of September 30, 2010.

The Company also has a non-compensatory employee stock purchase plan, which allows employees to purchase stock of the Company at a discount subject to certain limits specified by the plan.

(11) Off-Balance-Sheet Risk

In the normal course of business, the Company enters into when-issued underwriting and purchase commitments. Transactions relating to such commitments open at September 30, 2011, and subsequently settled, had no material effect on the financial statements.

The Company's normal business activities involve the execution, settlement and financing of various securities transactions. These activities may expose the Company to credit and market risks in the event the customer or counterparty is unable to fulfill its contractual obligations. Such risks may be increased by volatile trading markets.

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The Company's customer securities activities are transacted on either a cash or margin basis. In margin transactions, the Company extends credit to its customers, subject to various regulatory and internal margin requirements, collateralized by cash and securities in the customers' accounts. A portion of the Company's customer activity includes the sale of securities not yet purchased and the writing of option contracts, substantially all of which are transacted on a margin basis. Customer transactions may expose the Company to significant off-balance sheet risk in the event margin requirements are not sufficient to fully cover losses that customers may incur. In the event customers fail to satisfy their obligations, the Company may be required to purchase or sell financial instruments at prevailing market prices to fulfill the customers' obligations. The Company seeks to control the risk associated with its customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. The Company monitors required margin levels daily and, pursuant to such guidelines, requires customers to deposit additional collateral or to reduce positions when necessary.

(12) Commitments and Contingencies

The Company conducts its operations from leased facilities. The following is a schedule by year of future minimum rental payments required under leases that have remaining non-cancelable lease terms in excess of one year as of September 30, 2011:

	Related Party	Third Party
2012	\$ 985,130	7,007,611
2013	999,907	5,816,082
2014	187,922	4,309,372
2015	—	3,310,723
2016	—	2,470,100
Thereafter	—	2,903,230
	<u>\$ 2,172,959</u>	<u>25,817,118</u>

The Company has a partially self-insured plan for eligible employee medical and dental expenses. Stop loss insurance is maintained for individual claims in excess of \$125,000 for each policy year. In addition, the Company has an aggregate stop loss in place of \$9,037,817 at September 30, 2011. The Company is also self-insured for employee short-term disability coverage. The maximum coverage period is fifty weeks. Benefits are subject to certain weekly compensation limits.

The Company is involved in various claims and litigation. In the opinion of management, following consultation with legal counsel, the ultimate liability or disposition thereof is not expected to have a material adverse effect on the financial condition, results of operations or liquidity of the Company.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

In December 2008, Davidson Fixed Income Management, Inc. (DFIM) entered into standby capital agreements (SCAs) with two local government investment pools (LGIPs) for which it serves as investment adviser. Although DFIM was not required to provide support to the LGIPs, it elected to enter into the SCAs to maintain the confidence of its clients, to maintain its reputation in the marketplace, and to support the AAA credit rating of the LGIPs. Under the original terms of the SCAs, DFIM agreed to provide up to \$3.6 million in contributions to the LGIPs if the LGIPs recognized a loss from their investments in the Reserve Primary Fund which caused their net asset value to fall below a specified level. On December 8, 2010, DFIM increased its level of support to \$4.7 million. During the year ended September 30, 2011, DFIM expensed \$2.0 million and released \$1.1 million from the escrowed funds to the LGIPs pursuant to the agreements. At September 30, 2011 and 2010, the balance of this liability was \$3,600,000 and \$2,675,000, respectively, collateralized by short term investments held by the LGIPs in custodial accounts.

The Company generally has agreements with its shareholders restricting the transfer of shares of stock of the Company and governing the sale and purchase of shares upon termination of employment, permanent disability, or death of a shareholder (Option Event). Under the terms of these share purchase agreements, the Company has an option to repurchase its stock from a shareholder upon the occurrence of an Option Event. The Company is allowed to satisfy its repurchase option by paying 25% of the fair value of the shares in cash and issuing an unsecured promissory note for the 75% balance, payable in equal installments of principal over four years, plus 6% interest on the unpaid balance. If a shareholder qualifies based on their employment tenure, instead of the promissory note, the shareholder may elect to be paid for the 75% balance of their shares in equal share amounts over four years based on the fair value of the shares at each subsequent purchase date (Installment Sale).

ASC Topic 480 Distinguishing Liabilities from Equities establishes standards for how an entity classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an entity classify an equity financial instrument as a liability if it contains a mandatorily redeemable feature which requires the entity to redeem the instrument by transferring its assets at a specified or determinable date.

Adoption of a provision of the *Distinguishing Liabilities from Equities* topic has been deferred indefinitely for mandatorily redeemable financial instruments of nonpublic entities, with the exception of those instruments that are mandatorily redeemable upon fixed dates for amounts that are either fixed or determinable. If the deferred provisions are adopted, amounts associated with common stock outstanding that must be repurchased by the Company would be reclassified from shareholders' equity to liabilities.

In accordance with the Installment Sale election described above, the Company was committed to redeem 9,052 and 8,339 shares as of September 30, 2011 and 2010, respectively, for determined amounts due upon fixed dates preceding the next scheduled determination of an appraised value. These shares and corresponding redemption amounts at fair value are recorded as liabilities rather than shareholders' equity. The Company was additionally committed to redeem 11,615 and 5,677 outstanding shares as of September 30, 2011 and 2010, respectively, at amounts to be determined in the future based on the appraised value of the shares on the annual anniversary of the redemptions over the next four years. Such amounts will be reclassified from shareholders' equity to liabilities as the amount to be paid is determined.

DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2011 and 2010

In addition to the Installment Sale elections, the Company has agreements in place with two shareholders which obligate the Company to redeem their shares upon their request at the then current appraised value, the dates and amounts of which are not currently determinable. Shares outstanding and recorded in shareholders' equity pursuant to these obligations were 107,497 and 110,767 as of September 30, 2011 and 2010, respectively.