

MOSSES ADAMS

**DAVIDSON COMPANIES  
AND SUBSIDIARIES**

**Independent Auditor's Report and  
Consolidated Statement of  
Financial Condition**

**September 30, 2008 and 2007**

**INDEPENDENT AUDITOR'S REPORT**

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, 2008 and 2007. 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 audit 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 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 statements of financial condition referred to above present fairly, in all material respects, the financial position of Davidson Companies and subsidiaries as of September 30, 2008 and 2007, in conformity with accounting principles generally accepted in the United States of America.



Seattle, Washington  
December 16, 2008

**DAVIDSON COMPANIES AND SUBSIDIARIES**

Consolidated Statements of Financial Condition

September 30, 2008 and 2007

<u>Assets</u>	<u>2008</u>	<u>2007</u>
Cash and cash equivalents	\$ 80,755,007	86,607,343
Certificates of deposit	300,000	1,000,000
Receivables:		
Customers, net	92,358,922	66,195,755
Brokers, dealers and clearing organizations	6,395,819	2,952,081
Related parties	2,606,605	1,266,545
Income taxes	2,496,134	746,113
Other	5,064,024	4,489,932
	<u>108,921,504</u>	<u>75,650,426</u>
Securities at market value	20,449,404	35,399,450
Equipment and leasehold improvements (less accumulated depreciation and amortization of \$18,306,126 in 2008 and \$17,197,254 in 2007)	11,303,887	10,891,506
Notes receivable, net	17,395,582	13,151,249
Multi-family housing depositor certificates	—	12,080,000
Goodwill, net	2,395,337	2,395,337
Deferred tax asset, net	6,291,171	7,361,017
Other assets	11,122,878	6,277,658
	<u>48,508,855</u>	<u>52,156,767</u>
	<u>\$ 258,934,770</u>	<u>250,813,986</u>
 <b><u>Liabilities and Shareholders' Equity</u></b> 		
Liabilities:		
Checks in advance of deposits	\$ 6,738,292	—
Secured loan	1,625,111	1,762,445
Unsecured loans	3,190,056	2,664,582
Payables:		
Customers	50,282,231	51,520,986
Brokers, dealers and clearing organizations	12,676,613	16,720,186
Related parties	446,768	387,439
Securities sold, not yet purchased at market value	538,166	1,470,828
Multi-family housing custody receipts	—	12,080,000
Accrued payroll and profit sharing	38,312,854	38,833,135
Accounts payable and accrued liabilities	9,625,437	7,839,638
Total liabilities	<u>123,435,528</u>	<u>133,279,239</u>
Commitments and contingencies		
Shareholders' equity:		
Common stock (No par value. Authorized 20,000,000 shares: 8,827,512 and 8,563,517 shares issued and outstanding in 2008 and 2007, respectively)	12,178,263	10,454,599
Retained earnings	<u>123,320,979</u>	<u>107,080,148</u>
Total shareholders' equity	<u>135,499,242</u>	<u>117,534,747</u>
	<u>\$ 258,934,770</u>	<u>250,813,986</u>

See accompanying notes to consolidated statements of financial condition.

## DAVIDSON COMPANIES AND SUBSIDIARIES

Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

### (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 six 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 adviser; Davidson Travel, Inc., a travel agency; Davidson Fixed Income Management, Inc., a fixed-income investment adviser; and Davidson Funding Company 1, a special purpose entity that facilitates the financing of multi-family housing bonds. Davidson and its subsidiaries are hereinafter collectively referred to as the Company.

#### (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*

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 and underwriting. 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 are valued at market value, and securities not readily marketable are valued at fair value as determined by the Company with the related gains and losses recorded in trading and underwriting. 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.

#### (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 market value of securities loaned. The Company monitors the market value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary.

#### (d) *Securities*

Securities at September 30, 2008 and 2007 consist of bonds, stocks and other investments. The Company classifies its investments as trading securities. Securities are bought and held principally as inventory for the purpose of sales in the near term. Securities are recorded at fair value, or estimated fair value, with unrealized gains and losses included in investment income.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

(e) ***Income Taxes***

Davidson and its subsidiaries file consolidated federal and combined state income tax returns.

The Company accounts for income taxes under the asset and liability method. 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.

(f) ***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 \$69,865,700 and \$80,640,127 at September 30, 2008 and 2007, respectively. The Company places its cash in high quality credit institutions. At times, cash balances may exceed Federal Deposit Insurance Corporation (FDIC) insurance limits.

(g) ***Receivable From and Payable 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.

(h) ***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.

(i) ***Goodwill and Other Intangible Assets***

Goodwill represents the excess of costs 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 in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* (SFAS 144). As of September 30, 2008 and 2007, the balance of goodwill was \$2,395,337.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

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 goodwill. 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, 2008 and 2007.

**(j) 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 \$672,500 and \$700,000 at September 30, 2008 and 2007, respectively. Allowances for estimated losses and impairment on customer accounts and notes receivable totaled \$960,158 and \$1,262,483 at September 30, 2008 and 2007, respectively.

**(k) 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 securities that are not readily marketable, allowances for doubtful and impaired receivables, and the volatility of its stock used in computing the SFAS 123R value of stock options granted.

**(l) Stock-Based Compensation**

On October 1, 2006, the Company adopted the provisions of SFAS No. 123R, *Share-Based Payment* (SFAS 123R), which requires recognition of expense related to the fair value of share-based compensation. As a nonpublic entity that used the minimum value method of measuring equity share options and similar instruments for pro forma disclosure purposes under SFAS No. 123, the Company adopted SFAS 123R using the prospective transition method. Under the prospective transition method, SFAS 123R applies to new awards and to awards modified, repurchased, or cancelled after the required effective date. Any awards outstanding at the date of initial application are accounted for using the accounting principles originally applied to those awards (the provisions of Opinion 25 and its related interpretive guidance).

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

#### **(m) Impairment of Long-Lived Assets**

In accordance with SFAS 144, long-lived assets such as property, plant and equipment, and intangibles subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an asset is deemed impaired and an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. At September 30, 2008 and 2007, there were no long-lived assets that were considered impaired.

#### **(n) Advertising**

The Company expenses its advertising costs as incurred.

#### **(o) Recent Accounting Pronouncements**

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is currently effective for the Company's fiscal year beginning October 1, 2008. However, the FASB is currently considering postponing the effective date of FIN 48 for non-public companies. The Company is currently assessing the impact that FIN 48 may have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurement. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. SFAS 157 will be effective for the Company's fiscal year beginning October 1, 2008. The Company does not expect that SFAS 157 will have a significant effect on its financial statements.

#### **(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. Under the alternate method, D.A. Davidson & Co. is required to maintain a net capital amount in excess of the greater of \$250,000 or 2% of aggregate debit balances as defined in the Formula for Reserve Requirements under SEC Rule 15c3-3. At September 30, 2008, D.A. Davidson & Co.'s net capital of \$71,380,427 was 79.1% of aggregate debit items and net capital exceeded the required capital of \$1,804,124 by \$69,576,303.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

The net capital computation included in D.A. Davidson & Co.'s FOCUS report and filed with the Financial Industry Regulatory Authority on October 23, 2008 reported net capital of \$69,524,928, which differed from the amount above due to period end adjustments for deferred tax assets, net income, stock compensation and other items.

#### (3) Receivables From and Payable to Brokers, Dealers and Clearing Organizations

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

	<b>Receivable</b>	<b>Payable</b>
<b>September 30, 2008:</b>		
Deposits for securities borrowed/loaned	\$ 64,000	–
Securities failed-to-deliver/receive	1,695,172	10,496,888
Unsettled proprietary trades	2,899,631	–
Other	1,737,016	2,179,725
	\$ 6,395,819	12,676,613
<b>September 30, 2007:</b>		
Deposits for securities borrowed/loaned	\$ 947,600	–
Securities failed-to-deliver/receive	984,181	2,044,961
Unsettled proprietary trades	–	8,557,885
Other	1,020,300	6,117,340
	\$ 2,952,081	16,720,186

The Company held securities belonging to counterparties as collateral under stock borrow agreements, with the right to re-pledge or sell the assets, with fair market values of \$59,720 and \$919,739 as of September 30, 2008 and 2007, respectively.

#### (4) Securities Owned and Sold, Not Yet Purchased

Securities owned and sold, not yet purchased, consist of trading and investment securities at market values, as follows:

		<b>2008</b>		<b>2007</b>	
		<b>Owned</b>	<b>Sold, Not Yet Purchased</b>	<b>Owned</b>	<b>Sold, Not Yet Purchased</b>
Bonds	\$	15,361,074	79,082	26,431,312	1,169,679
Stocks		3,681,526	459,084	7,551,735	301,149
Other		1,406,804	–	1,416,403	–
	\$	20,449,404	538,166	35,399,450	1,470,828

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

Other securities include private investments that are not readily marketable. Securities not readily marketable also includes certain non-rated municipal bonds and warrants, totaling \$5,139,942 and \$7,850,771 as of September 30, 2008 and 2007, respectively, for which there is no market on a securities exchange or independent publicly quoted market. The Company records its investments in securities which are not readily marketable at estimated fair value.

#### (5) Secured and Unsecured Loans

The Company has one revolving line of credit totaling \$40,000,000, 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 at an intra-day federal funds rate plus .625% for the secured line and 1.0% for the unsecured line. The lines of credit do not have an expiration date and there were no outstanding borrowings under these lines of credit at September 30, 2008 or 2007.

The Company has one secured loan resulting from the purchase of the Company aircraft. Balances of \$1,625,111 and \$1,762,445 were outstanding at September 30, 2008 and 2007, respectively, bearing interest at 6.03%, due in monthly installments of \$11,444, plus interest and maturing in August 2012 with a principal balance due of \$1,110,111.

Unsecured loans at September 30, 2008 consist of 24 unsecured notes, resulting from repurchases of Company stock with balances of \$3,190,056 bearing interest at 6.00%, due in annual installments through September 2012, of which \$1,045,726, \$947,009, \$799,543 and \$397,778 is due in fiscal years 2009, 2010, 2011 and 2012, respectively. Unsecured loans at September 30, 2007 consist of 18 unsecured notes totaling \$2,664,582.

#### (6) 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 seven 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, 2008, the ESOP will receive an allocation of 309,370 shares of common stock valued at \$19.70 per share. As of September 30, 2008, the number of shares of Davidson stock held by the ESOP is 3,496,747 with an established fair market value of \$68,885,916. At September 30, 2007, the ESOP held 3,376,906 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, 2008 and 2007, the Company purchased 207,050 and 90,001 shares of Davidson stock from the ESOP for \$4,330,889 and \$1,641,896, respectively.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

#### (7) 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:

	2008	2007
Deferred tax assets:		
Employee compensation and benefits	\$ 5,211,832	6,539,198
Equipment and leasehold improvements, principally differences in depreciation	694,139	809,739
Allowance for doubtful receivables	18,006	138,687
Accrued expenses	285,492	289,350
Other	622,007	264,063
Total deferred tax assets	6,831,476	8,041,037
 Deferred tax liabilities:		
Prepaid expenses	440,592	647,380
State taxes	99,713	32,640
Total deferred tax liabilities	540,305	680,020
Net deferred tax asset	\$ 6,291,171	7,361,017

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, 2008, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

#### (8) 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 payroll and profit sharing at September 30, 2008 and 2007 was \$2,623,214 and \$2,315,354, respectively, due to the retirement savings and profit sharing plan and \$6,087,892 and \$5,340,309, respectively, due to the ESOP.

Notes receivable consist of loans to the Company's financial consultants. 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 consultants' bonus compensation.

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

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

#### (9) 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:

	<b>Options Outstanding</b>		
	<b>Weighted Average Remaining Contractual Life</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding at September 30, 2008	28 months	692,918	\$ 16.07
Exercisable at September 30, 2008	19 months	302,960	\$ 14.41

Proceeds received on exercises of stock options were \$2,093,123 and \$1,820,283 for the years ended September 30, 2008 and 2007, 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, 2008 and 2007 there was \$614,599 and \$506,617 of total unrecognized compensation cost related to options granted during fiscal 2008 and 2007. Those costs are expected to be recognized over the remaining weighted average vesting period of 3.1 (2008 options) and 2.3 (2007 options) years as of September 30, 2008.

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 offers restricted stock grants in which its shares are issued subject to forfeiture if vesting conditions are not satisfied. There was \$2,497,527 and \$2,438,169 of total unrecognized compensation related to these share-based awards as of September 30, 2008 and September 30, 2007, respectively. Those costs are expected to be recognized over the remaining weighted average vesting period of 3.4 (2008 grants) and 3.3 (2007 grants) years as of September 30, 2008.

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

#### (10) 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, 2008, and subsequently settled, had no material effect on the financial statements.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

The Company's normal business activities also 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. These risks are not recorded in the statement of financial condition.

As part of its normal brokerage activities, the Company sells securities not yet purchased (short sales) for its own account and will therefore be obligated to purchase such securities at a later date. The Company has recorded these obligations in the financial statements at market values of the related securities and will incur a loss in the event prices increase subsequent to year end.

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.

A portion of the Company's customer activity involves the sale of securities not yet purchased and the writing of option contracts. Such transactions may require the Company to purchase or sell financial instruments at prevailing market prices in order to fulfill the customer's obligation.

The Company arranges secured financing by pledging firm and unpaid customer securities for bank loans, securities loaned, and to satisfy deposits required by various clearing organizations. In the event the counterparty is unable to return such securities pledged, the Company may be exposed to the risks of acquiring the securities at prevailing market prices or holding collateral possessing a market value less than that of the related pledged securities. The Company seeks to control these risks by monitoring the market value of securities pledged and requiring adjustments of collateral levels where necessary.

The Company is engaged in various trading and brokerage activities whose counterparties primarily include broker-dealers, banks, and other financial institutions. In the event the counterparties do not fulfill their obligations, the Company may be exposed to risk. The risk of default depends on the creditworthiness of the counterparty or issuer of the instrument. It is the Company's policy to review, as necessary, the credit standing of each counterparty with which it conducts business.

Davidson Funding Company 1 (Davidson Funding) was formed as a special purpose entity for the purpose of financing multi-family housing bonds. At September 30, 2007, investments in multi-family housing bonds totaling \$12,080,000 were deposited with an independent custodian in exchange for a depositor certificate. During the year ended September 30, 2008, all \$12,080,000 of these multi-family housing bonds were redeemed or refinanced, eliminating any remaining balances.

#### **(11) Fair Value Considerations**

Substantially all the Company's financial instruments are carried at fair value or amounts that approximate fair value. Receivables from customers, primarily consisting of floating rate loans collateralized by margin securities, earn interest at rates similar to other such loans made throughout the industry. The Company's remaining financial instruments are generally short-term in nature and liquidate at their carrying values. The estimated fair value amounts have been determined by the Company using available market information and appropriate methodologies. Considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value and, accordingly, the estimates are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

#### (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, 2008:

		<b>Related Party</b>	<b>Third Party</b>
2009	\$	942,097	5,283,463
2010		956,228	4,731,061
2011		970,571	3,917,446
2012		985,130	3,101,392
2013		999,908	1,873,922
Thereafter		187,922	1,113,949
	\$	5,041,856	20,021,233

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 approximately \$7,357,458 at September 30, 2008. 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.

The Company has agreements with each of 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. SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (SFAS 150), 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.

The provisions of SFAS 150 originally were set to be effective on July 1, 2003; however, adoption of this provision 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.

## DAVIDSON COMPANIES AND SUBSIDIARIES

### Notes to Consolidated Statements of Financial Condition

September 30, 2008 and 2007

In accordance with share purchase agreements, the Company is committed to repurchase 22,431 and 12,645 outstanding shares, as of September 30, 2008 and 2007 respectively, at amounts to be determined annually on the anniversary of the redemptions over the next four years. In accordance with SFAS 150, such amounts will be reclassified from shareholders' equity to liabilities as the amount to be paid is determined.

#### **(13) Acquisition**

On December 31, 2004, the Company completed an asset acquisition of Kirkpatrick Pettis Smith, Polian, Inc. and Kirkpatrick Pettis Investment Management, Inc., and a stock purchase of Kirkpatrick Pettis Capital Management, Inc., now operating as Davidson Fixed Income Management, Inc. The purchase price paid of \$939,551 was based on the fair value of the assets acquired of \$2,204,037, less liabilities assumed at closing of \$1,514,486, plus a premium of \$250,000.

The \$250,000 premium paid was recorded as an intangible asset and was amortized on a straight-line basis over its estimated useful life of 3 years, which ended on December 31, 2007.

In conjunction with the acquisition, the Company entered into employment agreements with certain key employees of the acquired entities obligating the Company to pay compensation (the Retention Compensation) over three years up to a maximum amount of \$4,750,000. The Retention Compensation was expensed over the three year term of the employment agreements, which ended on December 31, 2007.