

SUMMIT FINANCIAL GROUP INC  
Form 10-Q  
August 10, 2012

---

---

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, 2012.

or

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 0-16587

Summit Financial Group, Inc.  
(Exact name of registrant as specified in its charter)

West Virginia  
(State or other jurisdiction of  
incorporation or organization)

55-0672148  
(IRS Employer  
Identification No.)

300 North Main Street  
Moorefield, West Virginia 26836  
(Address of principal executive offices) (Zip Code)

(304) 530-1000  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities and 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

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 definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  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.

Common Stock, \$2.50 par value  
7,425,472 shares outstanding as of August 6, 2012

---

Summit Financial Group, Inc. and Subsidiaries  
Table of Contents

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1.</b>	<b>Financial Statements</b>
	Consolidated balance sheets June 30, 2012 (unaudited), December 31, 2011, and June 30, 2011 (unaudited) 4
	Consolidated statements of income for the three and six months ended June 30, 2012 and 2011 (unaudited) 5
	Consolidated statements of comprehensive income for the three and six months ended June 30, 2012 and 2011 (unaudited) 6
	Consolidated statements of shareholders' equity for the six months ended June 30, 2012 and 2011 (unaudited) 7
	Consolidated statements of cash flows for the six months ended June 30, 2012 and 2011 (unaudited) 8-9
	Notes to consolidated financial statements (unaudited) 10-41
<b>Item 2.</b>	<b>Management's Discussion and Analysis of Financial Condition and Results of Operations 42-58</b>
<b>Item 3.</b>	<b>Quantitative and Qualitative Disclosures about Market Risk 57</b>
<b>Item 4.</b>	<b>Controls and Procedures 58</b>

Summit Financial Group, Inc. and Subsidiaries  
 Table of Contents

PARTOTHER INFORMATION		
II.		
Item 1.	Legal Proceedings	59
Item 1A.	Risk Factors	59
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	None
Item 3.	Defaults upon Senior Securities	None
Item 4.	Mine Safety Disclosures	None
Item 5.	Other Information	None
Item 6.	Exhibits	59
SIGNATURES		60
EXHIBIT INDEX		61

Summit Financial Group, Inc. and Subsidiaries  
Consolidated Balance Sheets (unaudited)

	June 30, 2012	December 31, 2011	June 30, 2011
Dollars in thousands	(unaudited)	(*)	(unaudited)
<b>ASSETS</b>			
Cash and due from banks	\$ 4,266	\$ 4,398	\$ 4,515
Interest bearing deposits with other banks	14,288	28,294	24,658
Securities available for sale	289,151	286,599	295,806
Other investments	17,506	19,146	20,951
Loans held for sale, net	622	-	405
Loans, net	948,294	965,516	971,127
Property held for sale	60,068	63,938	66,188
Premises and equipment, net	21,470	22,084	22,587
Accrued interest receivable	5,515	5,784	5,743
Intangible assets	8,475	8,651	8,826
Cash surrender value of life insurance policies	29,808	29,284	28,762
Other assets	16,978	16,427	18,418
<b>Total assets</b>	<b>\$ 1,416,441</b>	<b>\$ 1,450,121</b>	<b>\$ 1,467,986</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Liabilities</b>			
<b>Deposits</b>			
Non interest bearing	\$ 96,172	\$ 88,655	\$ 85,964
Interest bearing	905,498	927,845	960,130
<b>Total deposits</b>	<b>1,001,670</b>	<b>1,016,500</b>	<b>1,046,094</b>
Short-term borrowings	10,957	15,956	2,047
Long-term borrowings	253,635	270,254	282,631
Subordinated debentures	16,800	16,800	16,800
	19,589	19,589	19,589

Subordinated debentures owed to unconsolidated subsidiary trusts				
Other liabilities	8,083	8,456	8,966	
Total liabilities	1,310,734	1,347,555	1,376,127	
Commitments and Contingencies				
Shareholders' Equity				
Preferred stock and related surplus - authorized 250,000 shares;				
Series 2009, 8% Non-cumulative convertible preferred stock, par value \$1.00; issued 3,710 shares	3,519	3,519	3,519	
Series 2011, 8% Non-cumulative convertible preferred stock, par value \$1.00; issued June 2012 and December 2011 - 12,000 shares	5,807	5,807	-	
Common stock and related surplus - authorized 20,000,000 shares; \$2.50 par value; issued and outstanding 2012 and 2011 - 7,425,472 shares	24,519	24,518	24,516	
Retained earnings	67,126	64,904	61,711	
Accumulated other comprehensive income	4,736	3,818	2,113	
Total shareholders' equity	105,707	102,566	91,859	
Total liabilities and shareholders' equity	\$ 1,416,441	\$ 1,450,121	\$ 1,467,986	

(\*) - December 31, 2011 financial information has been extracted  
from audited consolidated financial statements  
See Notes to  
Consolidated  
Financial Statements



Summit Financial Group, Inc. and Subsidiaries  
Consolidated Statements of Income (unaudited)

Dollars in thousands, except per share amounts	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Interest income				
Interest and fees on loans				
Taxable	\$ 13,960	\$ 14,892	\$ 28,239	\$ 29,967
Tax-exempt	81	64	167	129
Interest and dividends on securities				
Taxable	1,553	2,574	3,252	5,183
Tax-exempt	671	551	1,393	985
Interest on interest bearing deposits with other banks	12	28	24	45
Total interest income	16,277	18,109	33,075	36,309
Interest expense				
Interest on deposits	3,359	4,667	7,073	9,410
Interest on short-term borrowings	10	1	16	2
Interest on long-term borrowings and subordinated debentures	2,937	3,281	5,997	6,635
Total interest expense	6,306	7,949	13,086	16,047
Net interest income	9,971	10,160	19,989	20,262
Provision for loan losses	2,001	3,000	4,002	6,000
Net interest income after provision for loan losses	7,970	7,160	15,987	14,262
Other income				
Insurance commissions	1,141	1,142	2,299	2,384
Service fees related to deposit accounts	1,075	1,057	2,089	1,945
Realized securities gains	320	318	1,485	1,946
Gain (loss) on sale of assets	(523 )	76	(599 )	147
Write-down of foreclosed properties	(1,631 )	(689 )	(3,543 )	(4,132 )
Other	552	484	1,135	845
Total other-than-temporary impairment loss on securities	(370 )	(1,304 )	(882 )	(3,131 )
Portion of loss recognized in other comprehensive income	264	771	547	1,370
Net impairment loss recognized in earnings	(106 )	(533 )	(335 )	(1,761 )
Total other income	828	1,855	2,531	1,374
Other expense				
	3,892	4,055	7,793	8,028

Salaries, commissions, and  
employee benefits

Net occupancy expense	490	481	969	990
Equipment expense	603	581	1,196	1,161
Professional fees	227	193	531	389
Amortization of intangibles	88	88	176	176
FDIC premiums	500	586	1,022	1,279
Foreclosed properties expense	248	412	623	846
Other	1,247	1,376	2,525	2,010
Total other expense	7,295	7,772	14,835	14,879
Income before income taxes	1,503	1,243	3,683	757
Income tax expense	590	338	1,073	100
Net Income	913	905	2,610	657
Dividends on preferred shares	194	74	388	148
Net Income applicable to common shares	\$ 719	\$ 831	\$ 2,222	\$ 509

Basic earnings per common share	\$ 0.10	\$ 0.11	\$ 0.30	\$ 0.07
Diluted earnings per common share	\$ 0.09	\$ 0.11	\$ 0.27	\$ 0.07

See Notes to Consolidated  
Financial Statements

Summit Financial Group, Inc. and Subsidiaries  
 Consolidated Statements of Comprehensive Income (unaudited)

Dollars in thousands	For the Three Months Ended	
	June 30,	
	2012	2011
Net income	\$913	\$905
Other comprehensive income (loss):		
Non-credit related other-than-temporary impairment on available for sale debt securities - 2012 - \$264, net of deferred taxes of \$100; 2011 - \$771, net of deferred taxes of \$293	(164)	(478)
Net unrealized gain on available for sale debt securities of: 2012 - \$1,213 net of deferred taxes of \$461 and reclassification adjustment for net realized gains included in net income of \$320; 2011 - \$3,823, net of deferred taxes of \$1,453 and reclassification adjustment for net realized gains included in net income of \$318	752	2,370
Total comprehensive income	\$1,501	\$2,797

Dollars in thousands	For the Six Months Ended	
	June 30,	
	2012	2011
Net income	\$2,610	\$657
Other comprehensive income (loss):		
Non-credit related other-than-temporary impairment on available for sale debt securities - 2012 - \$547, net of deferred taxes of \$208; 2011 - \$1,370, net of deferred taxes of \$521	(339)	(849)

Net unrealized gain on available		
for sale debt securities of:		
2012 - \$2,027 net of deferred taxes of \$770 and		
reclassification adjustment		
for net realized gains included in net income of		
\$1,487; 2011 - \$3,823, net of		
deferred taxes of \$1,453 and reclassification		
adjustment for net realized		
gains included in net income of		
\$1,946	1,257	2,370
Total comprehensive income	\$3,528	\$2,178

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries  
Consolidated Statements of Shareholders' Equity (unaudited)

Dollars in thousands, except per share amounts	Series 2009 Preferred Stock and Related Surplus	Series 2011 Preferred Stock and Related Surplus	Common Stock and Related Surplus	Retained Earnings	Accumulated Other Compre- hensive Income	Total Share- holders' Equity
Balance, December 31, 2011	\$ 3,519	\$ 5,807	\$ 24,518	\$ 64,904	\$ 3,818	\$ 102,566
Six Months Ended June 30, 2012						
Comprehensive income:						
Net income	-	-	-	2,610	-	2,610
Other comprehensive income					918	918
Total comprehensive income						3,528
Stock compensation expense	-	-	1	-	-	1
Series 2009 Preferred Stock cash dividends declared (\$40.00 per share)	-	-	-	(148)	-	(148)
Series 2011 Preferred Stock cash dividends declared (\$40.00 per share)	-	-	-	(240)	-	(240)
Balance, June 30, 2012	\$ 3,519	\$ 5,807	\$ 24,519	\$ 67,126	\$ 4,736	\$ 105,707
Balance, December 31, 2010	\$ 3,519	\$ -	\$ 24,508	\$ 61,201	\$ 593	\$ 89,821
Six Months Ended June 30, 2011						
Comprehensive income:						
Net income	-	-	-	657	-	657
					1,521	1,521

Other comprehensive income						
Total comprehensive income						2,178
Stock compensation expense	-	-	8	-	-	8
Series 2011 Preferred Stock cash dividends declared (\$40.00 per share)	-	-	-	(148	)	(148)
Balance, June 30, 2011	\$ 3,519	\$ -	\$ 24,516	\$ 61,710	\$ 2,114	\$ 91,859

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows (unaudited)

Dollars in thousands	Six Months Ended	
	June 30, 2012	June 30, 2011
Cash Flows from Operating Activities		
Net income	\$ 2,610	\$ 657
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	676	709
Provision for loan losses	4,002	6,000
Stock compensation expense	1	8
Deferred income tax (benefit)	(586 )	(1,840 )
Loans originated for sale	(4,875 )	(4,918 )
Proceeds from loans sold	4,253	4,856
Securities (gains)	(1,485 )	(1,946 )
Other-than-temporary impairment of securities	335	1,761
(Gain) loss on disposal of assets	599	(147 )
Write down of foreclosed properties	3,543	4,132
Amortization of securities premiums (accretion of discounts), net	1,882	816
Amortization of goodwill and purchase accounting adjustments, net	182	181
Decrease in accrued interest receivable	269	136
(Increase) in cash surrender value of bank owned life insurance	(524 )	(303 )
(Increase) in other assets	(1,244 )	(2,027 )
Increase (decrease) in other liabilities	(493 )	(664 )
Net cash provided by operating activities	9,145	7,411
Cash Flows from Investing Activities		
Proceeds from (purchase of) interest bearing deposits		
with other banks	14,005	21,039
Proceeds from maturities and calls of securities available for sale	2,736	6,941

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Proceeds from sales of securities available for sale	51,798	57,190
Principal payments received on securities available for sale	29,943	29,207
Purchases of securities available for sale	(86,284 )	(121,591 )
Proceeds from maturities and calls of other investments	-	6,000
Redemption of Federal Home Loan Bank Stock	1,641	1,991
Net principal payments received on loans	8,616	13,959
Purchases of premises and equipment	(62 )	(204 )
Proceeds from sales of other repossessed assets & property held for sale	5,121	4,927
Purchase of life insurance contracts	-	(15,000 )
Net cash provided by (used in) investing activities	27,514	4,459
Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and savings accounts	9,601	46,764
Net (decrease) in time deposits	(24,431 )	(37,609 )
Net increase in short-term borrowings	(4,999 )	464
Proceeds from long-term borrowings	-	842
Repayment of long-term borrowings	(16,619 )	(22,320 )
Dividends paid on preferred stock	(343 )	(148 )
Net cash provided by (used in) financing activities	(36,791 )	(12,007 )
(Decrease) in cash and due from banks	(132 )	(137 )
Cash and due from banks:		
Beginning	4,398	4,652
Ending	\$ 4,266	\$ 4,515

(Continued)

See Notes to Consolidated Financial Statements





Summit Financial Group, Inc. and Subsidiaries  
 Consolidated Statements of Cash Flows (unaudited)

Six Months Ended  
 June 30,                  June 30,  
 Dollars in thousands                  2012                  2011

Supplemental Disclosures  
 of Cash Flow Information

Cash payments for:

Interest	\$ 13,344	\$ 16,303
Income taxes	\$ 1,834	\$ 1,929

Supplemental Schedule of Noncash Investing and  
 Financing Activities

Other assets acquired in settlement of loans	\$ 5,025	\$ 4,232
---	----------	----------

See Notes to Consolidated  
 Financial Statements

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

NOTE 1. BASIS OF PRESENTATION

We, Summit Financial Group, Inc. and subsidiaries, prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for annual year end financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature.

The presentation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates.

The results of operations for the quarter ended June 30, 2012 are not necessarily indicative of the results to be expected for the full year. The consolidated financial statements and notes included herein should be read in conjunction with our 2011 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2011 and June 30, 2011, as previously presented, have been reclassified to conform to current year classifications.

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU No. 2011-03, Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 was effective for us on January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2011-04, Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 was effective January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income amends Topic 220, Comprehensive Income, to require that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 was effective January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment, amends Topic 350, Intangibles – Goodwill and Other, permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-than-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of impairment loss, if any. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on our financial statements.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

ASU 2011-11, Disclosures about Offsetting Assets and Liabilities (Topic 210), requires an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning January 1, 2013, and is not expected to have a significant impact on our financial statements.

ASU 2011-12, Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05, defers changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 became effective for us on January 1, 2012 and did not have a significant impact on our financial statements.

### NOTE 3. FAIR VALUE MEASUREMENTS

ASC Topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Accordingly, securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, and impaired loans held for investment. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-Sale Securities: Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are

measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

**Loans Held for Sale:** Loans held for sale are carried at the lower of cost or market value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, we classify loans subject to nonrecurring fair value adjustments as Level 2.

**Loans:** We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, Accounting by Creditors for Impairment of a Loan. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2012, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with ASC Topic 310, impaired loans where an allowance is established based on the fair value of collateral requires classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When a current appraised value is not available and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

When a collateral-dependent loan is identified as impaired, management immediately begins the process of evaluating the estimated fair value of the underlying collateral to determine if a related specific allowance for loan losses or charge-off is necessary. Current appraisals are ordered once a loan is deemed impaired if the existing appraisal is more than twelve months old, or more frequently if there is known deterioration in value. For recently identified impaired loans, a current appraisal may not be available at the financial statement date. Until the current appraisal is obtained, the original appraised value is discounted, as appropriate, to compensate for the estimated depreciation in the value of the loan's underlying collateral since the date of the original appraisal. Such discounts are generally estimated based upon management's knowledge of sales of similar collateral within the applicable market area and its knowledge of other real estate market-related data as well as general economic trends. When a new appraisal is received (which generally are received within 3 months of a loan being identified as impaired), management then re-evaluates the fair value of the collateral and adjusts any specific allocated allowance for loan losses, as appropriate. In addition, management also assigns a discount of 7–10% for the estimated costs to sell the collateral. As of June 30, 2012, the appraised values of the underlying collateral for our collateral-dependent impaired loans which had a related specific allowance or prior charge-off was in excess of the total fair value by \$9,074,000.

**Other Real Estate Owned ("OREO"):** OREO consists of real estate acquired in foreclosure or other settlement of loans. Such assets are carried on the balance sheet at the lower of the investment in the real estate or its fair value less estimated selling costs. The fair value of OREO is determined on a nonrecurring basis generally utilizing current appraisals performed by an independent, licensed appraiser applying an income or market value approach using observable market data (Level 2). Updated appraisals of OREO are generally obtained if the existing appraisal is more than 18 months old or more frequently if there is a known deterioration in value. However, if a current appraisal is not available, the original appraised value is discounted, as appropriate, to compensate for the estimated depreciation in the value of the real estate since the date of its original appraisal. Such discounts are generally estimated based upon management's knowledge of sales of similar property within the applicable market area and its knowledge of other real estate market-related data as well as general economic trends (Level 3). Upon foreclosure, any fair value adjustment is charged against the allowance for loan losses. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest income in the consolidated statements of income.





Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets measured at fair value on a recurring basis.

Dollars in thousands	Balance at June 30, 2012	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 18,663	\$ -	\$ 18,663	\$ -
Mortgage backed securities:				
Government sponsored agencies	161,167	-	161,167	-
Nongovernment sponsored entities	23,261	-	23,261	-
State and political subdivisions	8,656	-	8,656	-
Corporate debt securities	1,840	-	1,840	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	72,518	-	72,518	-
Tax-exempt mortgage-backed securities	2,969	-	2,969	-
Total available for sale securities	\$ 289,151	\$ -	\$ 289,151	\$ -

Dollars in thousands	Balance at December 31, 2011	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 8,747	\$ -	\$ 8,747	\$ -
Mortgage backed securities:				
Government sponsored agencies	155,505	-	155,505	-
Nongovernment sponsored entities	34,428	-	34,428	-
State and political subdivisions	4,571	-	4,571	-
Corporate debt securities	817	-	817	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	79,326	-	79,326	-
Tax-exempt mortgage backed securities	3,128	-	3,128	-
Total available for sale securities	\$ 286,599	\$ -	\$ 286,599	\$ -

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended June 30, 2012.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis are included in the table below.

Dollars in thousands	Total at June 30, 2012	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Residential mortgage loans held for sale	\$ 622	\$ -	\$ 622	\$ -
<b>Impaired loans</b>				
Commercial	\$ 6,641	\$ -	\$ -	\$ 6,641
Commercial real estate	25,636	-	13,900	11,736
Construction and development	30,786	-	28,809	1,977
Residential real estate	28,378	-	23,867	4,511
Consumer	41	-	-	41
Total impaired loans	\$ 91,482	\$ -	\$ 66,576	\$ 24,906
<b>OREO</b>				
Commercial	\$ -	\$ -	\$ -	\$ -
Commercial real estate	12,029	-	12,029	-
Construction and development	44,646	-	43,971	675
Residential real estate	3,393	-	3,393	-
Consumer	-	-	-	-
Total OREO	\$ 60,068	\$ -	\$ 59,393	\$ 675

Dollars in thousands	Total at December 31, 2011	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Residential mortgage loans held for sale	\$ -	\$ -	\$ -	\$ -
<b>Impaired loans</b>				
Commercial	\$ 2,722	\$ -	\$ -	\$ 2,722
Commercial real estate	21,148	-	13,777	7,371
Construction and development	27,667	-	25,297	2,370
Residential real estate	22,768	-	18,253	4,515

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Consumer	6	-	-	6
Total impaired loans	\$ 74,311	\$ -	\$ 57,327	\$ 16,984
<b>OREO</b>				
Commercial	\$ -	\$ -	\$ -	\$ -
Commercial real estate	15,721	-	15,721	-
Construction and development	44,978	-	44,303	675
Residential real estate	3,239	-	3,239	-
Consumer	-	-	-	-
Total OREO	\$ 63,938	\$ -	\$ 63,263	\$ 675

Impaired loans, which are measured for impairment primarily using the fair value of the collateral for collateral-dependent loans, had a carrying amount at June 30, 2012 of \$98,004,000, with a valuation allowance of \$6,522,000, resulting in additional provision for loan losses of \$541,000 for the six months ended June 30, 2012.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

ASC Topic 825, Financial Instruments, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The following summarizes the methods and significant assumptions we used in estimating our fair value disclosures for financial instruments.

Cash and due from banks: The carrying values of cash and due from banks approximate their estimated fair value.

Interest bearing deposits with other banks: The carrying values of interest bearing deposits with other banks approximate their estimated fair values.

Federal funds sold: The carrying values of Federal funds sold approximate their estimated fair values.

Securities: Estimated fair values of securities are based on quoted market prices, where available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable securities.

Loans held for sale: The carrying values of loans held for sale approximate their estimated fair values.

Loans: The estimated fair values for loans are computed based on scheduled future cash flows of principal and interest, discounted at interest rates currently offered for loans with similar terms to borrowers of similar credit quality. No prepayments of principal are assumed.

Accrued interest receivable and payable: The carrying values of accrued interest receivable and payable approximate their estimated fair values.

Deposits: The estimated fair values of demand deposits (i.e. non-interest bearing checking, NOW, money market and savings accounts) and other variable rate deposits approximate their carrying values. Fair values of fixed maturity deposits are estimated using a discounted cash flow methodology at rates currently offered for deposits with similar remaining maturities. Any intangible value of long-term relationships with depositors is not considered in estimating the fair values disclosed.

Short-term borrowings: The carrying values of short-term borrowings approximate their estimated fair values.

Long-term borrowings: The fair values of long-term borrowings are estimated by discounting scheduled future payments of principal and interest at current rates available on borrowings with similar terms.

Subordinated debentures: The carrying values of subordinated debentures approximate their estimated fair values.

Subordinated debentures owed to unconsolidated subsidiary trusts: The carrying values of subordinated debentures owed to unconsolidated subsidiary trusts approximate their estimated fair values.

Off-balance sheet instruments: The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit standing of the counter parties. The amounts of fees currently charged on commitments and standby letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values are not shown below.



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The carrying values and estimated fair values of our financial instruments are summarized below:

Dollars in thousands	June 30, 2012		December 31, 2011	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial assets</b>				
Cash and due from banks	\$ 4,266	\$ 4,266	\$ 4,398	\$ 4,398
Interest bearing deposits with				
other banks	14,288	14,288	28,294	28,294
Securities available for sale	289,151	289,151	286,599	286,599
Other investments	17,506	17,506	19,146	19,146
Loans held for sale, net	622	622	-	-
Loans, net	948,294	970,774	965,516	977,782
Accrued interest receivable	5,515	5,515	5,784	5,784
	\$ 1,279,642	\$ 1,302,122	\$ 1,309,737	\$ 1,322,003
<b>Financial liabilities</b>				
Deposits	\$ 1,001,670	\$ 1,041,268	\$ 1,016,500	\$ 1,054,093
Short-term borrowings	10,957	10,957	15,956	15,956
Long-term borrowings	253,635	272,685	270,254	291,099
Subordinated debentures	16,800	16,800	16,800	16,800
Subordinated debentures owed to				
unconsolidated subsidiary trusts	19,589	19,589	19,589	19,589
Accrued interest payable	2,299	2,299	2,558	2,558
	\$ 1,304,950	\$ 1,363,598	\$ 1,341,657	\$ 1,400,095

NOTE 4. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

Dollars in thousands, except per share amounts	2012	For the Three Months Ended June 30,		2011		
		Common	Common		Common	Common
	Income	Shares	Per	Income	Shares	Per
	(Numerator)	(Denominator)	Share	(Numerator)	(Denominator)	Share

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Net income	\$ 913			\$ 905		
Less preferred stock dividends	(194 )			(74 )		
Basic EPS	\$ 719	7,425,472	\$0.10	\$ 831	7,425,472	\$0.11
Effect of dilutive securities:						
Stock options	-	2,330		-	-	
Series 2011 convertible preferred stock	120	1,500,000		-	-	
Diluted EPS	\$ 839	8,927,802	\$0.09	\$ 831	7,425,472	\$0.11



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands, except per share amounts	For the Six Months Ended June 30,						
	2012	Common			2011	Common	
	Income	Shares	Per Share	Income	Shares	Per Share	
	(Numerator)	(Denominator)	Share	(Numerator)	(Denominator)	Share	
Net income	\$ 2,610			\$ 657			
Less preferred stock dividends	(388 )			(148 )			
Basic EPS	\$ 2,222	7,425,472	\$0.30	\$ 509	7,425,472	\$0.07	
Effect of dilutive securities:							
Stock options	-	1,023		-	-		
Series 2009 convertible preferred stock	148	674,545		-	-		
Series 2011 convertible preferred stock	240	1,500,000		-	-		
Diluted EPS	\$ 2,610	9,601,040	\$0.27	\$ 509	7,425,472	\$0.07	

Stock option grants and the convertible preferred shares are disregarded in this computation if they are determined to be anti-dilutive. Our anti-dilutive stock options at June 30, 2012 and 2011 totaled 282,980 shares and 312,180 shares, respectively. Our anti-dilutive convertible preferred shares totaled 674,545 for the quarter ended June 30, 2012, and for the quarter ended and six months ended June 30, 2011.

NOTE 5. SECURITIES

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at June 30, 2012, December 31, 2011, and June 30, 2011 are summarized as follows:

Dollars in thousands Available for Sale	Amortized Cost	June 30, 2012		Estimated Fair Value
		Gains	Losses	
Taxable debt securities:				

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

U. S. Government agencies and corporations	\$ 18,000	\$ 665	\$ 2	\$ 18,663
Residential mortgage-backed securities:				
Government-sponsored agencies	157,618	3,846	297	161,167
Nongovernment-sponsored agencies	23,188	550	477	23,261
State and political subdivisions	8,672	27	43	8,656
Corporate debt securities	1,951	16	127	1,840
Total taxable debt securities	209,429	5,104	946	213,587
Tax-exempt debt securities:				
State and political subdivisions	69,036	3,733	251	72,518
Residential mortgage-backed securities:				
Government-sponsored agencies	2,969	-	-	2,969
Total tax-exempt debt securities	72,005	3,733	251	75,487
Equity securities	77	-	-	77
Total available for sale securities	\$ 281,511	\$ 8,837	\$ 1,197	\$ 289,151

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	Amortized	December 31, 2011		Estimated
Available for Sale	Cost	Unrealized	Losses	Fair Value
Taxable debt securities				
U. S. Government agencies				
and corporations	\$ 8,262	\$ 495	\$ 10	\$ 8,747
Residential mortgage-backed securities:				
Government-sponsored agencies	152,815	3,460	770	155,505
Nongovernment-sponsored entities	35,246	742	1,560	34,428
State and political subdivisions	4,559	16	4	4,571
Corporate debt securities	999	-	182	817
Total taxable debt securities	201,881	4,713	2,526	204,068
Tax-exempt debt securities				
State and political subdivisions	75,371	3,986	31	79,326
Residential mortgage-backed securities	3,109	19	-	3,128
Total tax-exempt debt securities	78,480	4,005	31	82,454
Equity securities	77	-	-	77
Total available for sale securities	\$ 280,438	\$ 8,718	\$ 2,557	\$ 286,599

Dollars in thousands	Amortized	June 30, 2011		Estimated
Available for Sale	Cost	Unrealized	Losses	Fair Value
Taxable debt securities:				
U. S. Government agencies				
and corporations	\$ 14,749	\$ 303	\$ 102	\$ 14,950
Residential mortgage-backed securities:				
Government-sponsored agencies	147,619	3,288	296	150,611
Nongovernment-sponsored agencies	44,101	1,459	1,523	44,037
State and political subdivisions	12,411	30	284	12,157
Corporate debt securities	999	-	53	946
Total taxable debt securities	219,879	5,080	2,258	222,701
Tax-exempt debt securities:				
State and political subdivisions	72,439	1,151	562	73,028

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Total tax-exempt debt securities	72,439	1,151	562	73,028
Equity securities	77	-	-	77
Total available for sale securities	\$ 292,395	\$ 6,231	\$ 2,820	\$ 295,806

The maturities, amortized cost and estimated fair values of securities at June 30, 2012, are summarized as follows:

Dollars in thousands	Available for Sale	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 75,249	\$ 76,316
Due from one to five years	99,177	101,506
Due from five to ten years	17,252	17,836
Due after ten years	89,756	93,416
Equity securities	77	77
	\$ 281,511	\$ 289,151

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The proceeds from sales, calls and maturities of available for sale securities, including principal payments received on mortgage-backed obligations, and the related gross gains and losses realized, for the six months ended June 30, 2012 are as follows:

Dollars in thousands	Sales	Calls and Maturities	Principal Payments	Gains	Losses
Securities available for sale	\$ 51,798	\$ 2,736	\$ 29,943	\$ 2,325	\$ 840

During the three and six months ended June 30, 2012 and 2011, we recorded other-than-temporary impairment losses on residential mortgage-backed nongovernment sponsored entity securities as follows:

In thousands	Three Months Ended June		Six Months Ended	
	2012	30, 2011	2012	2011
Total other-than-temporary impairment losses	\$ (370 )	\$ (1,304 )	\$ (882 )	\$ (3,131 )
Portion of loss recognized in other comprehensive income	264	771	547	1,370
Net impairment losses recognized in earnings	\$ (106 )	\$ (533 )	\$ (335 )	\$ (1,761 )

Activity related to the credit component recognized on debt securities available for sale for which a portion of other-than-temporary impairment was recognized in other comprehensive income for the three and six months ended June 30, 2012 is as follows:

In thousands	Three Months	Six Months
	Ended June 30, 2012	Ended June 30, 2012
Beginning Balance	\$ (6,584 )	\$ (6,355 )
Additions for the credit component on debt securities in which other-than-temporary impairment was not previously recognized	(106 )	(335 )
Securities sold during the period	790	790
Ending Balance	\$ (5,900 )	\$ (5,900 )

At June 30, 2012, our debt securities with other-than-temporary impairment in which only the amount of loss related to credit was recognized in earnings consisted solely of residential mortgage-backed securities issued by nongovernment-sponsored entities. We utilize third party vendors to estimate the portion of loss attributable to credit using a discounted cash flow models. The vendors estimate cash flows of the underlying collateral of each mortgage-backed security using models that incorporate their best estimates of current key assumptions, such as default rates, loss severity and prepayment rates. Assumptions utilized vary widely from security to security, and are influenced by such factors as underlying loan interest rates, geographical location of underlying borrowers, collateral type and other borrower characteristics. Specific such assumptions utilized by our vendors in their valuation of our other-than-temporarily impaired residential mortgage-backed securities issued by nongovernment-sponsored entities were as follows at June 30, 2012:

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

	Weighted Average		Range Minimum Maximum			
Constant voluntary prepayment rates	8.4	%	1.6	%	11.1	%
Constant default rates	5.3	%	4.2	%	7.9	%
Loss severities	47.4	%	40.0	%	52.0	%

Our vendors performing these valuations also analyze the structure of each mortgage-backed instrument in order to determine how the estimated cash flows of the underlying collateral will be distributed to each security issued from the structure. Expected principal and interest cash flows on the impaired debt securities are discounted predominantly using unobservable discount rates which the vendors assume that market participants would utilize in pricing the specific security. Based on the discounted expected cash flows derived from our vendor's models, we expect to recover the remaining unrealized losses on residential mortgage-backed securities issued by nongovernment sponsored entities.

Provided below is a summary of securities available for sale which were in an unrealized loss position at June 30, 2012 and December 31, 2011, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income.

Dollars in thousands	June 30, 2012								
	Less than 12 months		12 months or more		Total				
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss			
Temporarily impaired securities									
Taxable debt securities									
U. S. Government agencies									
and corporations	\$1,012	\$(2	)\$115	\$-	\$1,127	\$(2			
Residential mortgage-backed securities:									
Government-sponsored agencies	43,087	(233	)	3,081	(64	)	46,168	(297	)
Nongovernment-sponsored entities	3,377	(87	)	1,447	(70	)	4,824	(157	)
State and political subdivisions	2,424	(39	)	386	(4	)	2,810	(43	)
Corporate debt securities	-	-		872	(127	)	872	(127	)
Tax-exempt debt securities									
State and political subdivisions	17,029	(251	)	-	-		17,029	(251	)
Total temporarily impaired securities	66,929	(612	)	5,901	(265	)	72,830	(877	)
Other-than-temporarily impaired securities									
Taxable debt securities									

Residential mortgage-backed securities:

Nongovernment-sponsored entities	111	(75 )	1,743	(245 )	1,854	(320 )
Total other-than-temporarily impaired securities	111	(75 )	1,743	(245 )	1,854	(320 )
Total	\$67,040	\$(687 )	\$7,644	\$(510 )	\$74,684	\$(1,197 )



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	Less than 12 months		December 31, 2011 12 months or more		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Temporarily impaired securities						
Taxable debt securities						
U. S. Government agencies and corporations	\$1,074	\$(10)	\$120	\$-	\$1,194	\$(10)
Residential mortgage-backed securities:						
Government-sponsored agencies	55,678	(770)	-	-	55,678	(770)
Nongovernment-sponsored entities	5,558	(158)	4,245	(239)	9,803	(397)
State and political subdivisions	-	-	-	-	-	-
Corporate debt securities	-	-	817	(182)	817	(182)
Tax-exempt debt securities						
State and political subdivisions	1,418	(29)	1,132	(6)	2,550	(35)
Total temporarily impaired securities	63,728	(967)	6,314	(427)	70,042	(1,394)
Other-than-temporarily impaired securities						
Taxable debt securities						
Residential mortgage-backed securities:						
Nongovernment-sponsored entities	466	(261)	5,638	(902)	6,104	(1,163)
Total other-than-temporarily impaired securities	466	(261)	5,638	(902)	6,104	(1,163)
Total	\$64,194	\$(1,228)	\$11,952	\$(1,329)	\$76,146	\$(2,557)

We held 70 available for sale securities, including debt securities with other-than-temporary impairment in which a portion of the impairment remains in other comprehensive income, having an unrealized loss at June 30, 2012. We do not intend to sell these securities, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost bases. We believe that this decline in value is primarily attributable to the lack of market liquidity and to changes in market interest rates and not due to credit quality. Accordingly, no additional other-than-temporary impairment charge to earnings is warranted at this time.

At June 30, 2012, we had \$477,000 in total unrealized losses related to residential mortgage-backed securities issued by nongovernment sponsored entities. We monitor the performance of the mortgages underlying these bonds. Although there has been some deterioration in their collateral performance, we primarily hold the senior tranches of each issue which provides protection against defaults. We attribute the unrealized loss on these mortgage-backed securities held largely to the current absence of liquidity in the markets for such securities. The

mortgages in these asset pools have been made to borrowers with strong credit history and significant equity invested in their homes. Nonetheless, further weakening of economic fundamentals coupled with significant increases in unemployment and substantial deterioration in the value of high end residential properties could extend distress to this borrower population. This could increase default rates and put additional pressure on property values. Should these conditions occur, the value of these securities could decline further and result in the recognition of additional other-than-temporary impairment charges recognized in earnings.

#### NOTE 6. LOANS

Loans are generally stated at the amount of unpaid principal, reduced by unearned discount and allowance for loan losses. Interest on loans is accrued daily on the outstanding balances. Loan origination fees and certain direct loan origination costs are deferred and amortized as adjustments of the related loan yield over its contractual life.

Generally, loans are placed on nonaccrual status when principal or interest is greater than 90 days past due based upon the loan's contractual terms. Interest is accrued daily on impaired loans unless the loan is placed on nonaccrual status. Impaired loans are placed on nonaccrual status when the payments of principal and interest are in default for a period of 90 days, unless the loan is both well-secured and in the process of collection. Interest on nonaccrual loans is recognized primarily using the cost-recovery method. Loans may be returned to accrual status when repayment is reasonably assured and there has been demonstrated performance under the terms of the loan or, if applicable, the terms of the restructured loans.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Commercial-related loans or portions thereof (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination is made on a case by case basis considering many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity. We deem a loss confirmed when a loan or a portion of a loan is classified "loss" in accordance with bank regulatory classification guidelines, which state, "Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted".

Consumer-related loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), which ever is earlier. Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Loans are summarized as follows:

	June 30,	December	June 30,
Dollars in thousands	2012	31, 2011	2011
Commercial	\$ 92,060	\$ 99,024	\$ 92,287
Commercial real estate			
Owner-occupied	152,347	158,754	180,943
Non-owner occupied	280,891	270,226	242,431
Construction and development			
Land and land development	84,383	93,035	94,464
Construction	1,793	2,936	12,223
Residential real estate			
Non-jumbo	217,321	221,733	228,205
Jumbo	61,961	61,535	60,817
Home equity	51,693	50,898	50,884
Consumer	21,212	22,325	23,773
Other	2,523	2,762	3,116
Total loans, net of unearned fees	966,184	983,228	989,143
Less allowance for loan losses	17,890	17,712	18,016
Loans, net	\$ 948,294	\$ 965,516	\$ 971,127



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The following table presents the contractual aging of the recorded investment in past due loans by class as of June 30, 2012 and 2011 and December 31, 2011.

At June 30, 2012						Recorded Investment > 90 days and Accruing
Dollars in thousands	Past Due			Total	Current	
	30-59 days	60-89 days	> 90 days			
Commercial	\$367	\$20	\$2,334	\$2,721	\$89,339	\$-
Commercial real estate						
Owner-occupied	1,074	888	590	2,552	149,795	-
Non-owner occupied	480	101	1,287	1,868	279,023	-
Construction and development						
Land and land development	1,756	79	12,634	14,469	69,914	-
Construction	-	-	153	153	1,640	-
Residential mortgage						
Non-jumbo	3,819	950	3,139	7,908	209,413	-
Jumbo	2,160	1,050	12,592	15,802	46,159	-
Home equity	450	7	69	526	51,167	-
Consumer	329	88	37	454	20,758	-
Other	-	-	-	-	2,523	-
Total	\$10,435	\$3,183	\$32,835	\$46,453	\$919,731	\$-

At December 31, 2011						Recorded Investment > 90 days and Accruing
Dollars in thousands	Past Due			Total	Current	
	30-59 days	60-89 days	> 90 days			
Commercial	\$ 904	\$ 324	\$ 2,544	\$ 3,772	\$ 95,252	\$ -
Commercial real estate						
Owner-occupied	4,241	197	664	5,102	153,652	-
Non-owner occupied	1,566	1,752	1,705	5,023	265,203	-
Construction and development						

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Land and land development	1,539	116	16,392	18,047	74,988	344
Construction	106	-	979	1,085	1,851	-
Residential mortgage						
Non-jumbo	4,730	1,624	2,336	8,690	213,043	-
Jumbo	699	-	13,965	14,664	46,871	-
Home equity	-	223	91	314	50,584	-
Consumer	381	144	85	610	21,715	-
Other	-	-	-	-	2,762	-
Total	\$ 14,166	\$ 4,380	\$ 38,761	\$ 57,307	\$ 925,921	\$ 344

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	Past Due			Total	Current	Recorded Investment > 90 days and Accruing
	30-59 days	60-89 days	> 90 days			
Commercial	\$315	\$1,476	\$1,964	\$3,755	\$88,532	\$-
Commercial real estate						
Owner-occupied	1,284	379	1,648	3,311	177,632	-
Non-owner occupied	1,167	137	976	2,280	240,151	-
Construction and development						
Land and land development	12	152	8,423	8,587	85,877	-
Construction	-	-	152	152	12,071	-
Residential mortgage						
Non-jumbo	5,427	1,265	4,459	11,151	217,054	-
Jumbo	-	2,302	-	2,302	58,515	-
Home equity	-	209	378	587	50,297	-
Consumer	335	99	112	546	23,227	2
Other	-	-	-	-	3,116	-
Total	\$8,540	\$6,019	\$18,112	\$32,671	\$956,472	\$2

Nonaccrual loans: The following table presents the nonaccrual loans included in the net balance of loans at June 30, 2012, December 31, 2011 and June 30, 2011.

Dollars in thousands	6/30/2012	12/31/2011	6/30/2011
Commercial	\$ 6,476	\$ 3,260	\$ 2,212
Commercial real estate			
Owner-occupied	2,248	2,815	3,848
Non-owner occupied	1,288	4,348	4,245
Construction and development			
Land & land development	17,244	22,362	19,069
Construction	153	979	152
Residential mortgage			
Non-jumbo	3,449	3,683	4,419
Jumbo	14,752	13,966	3,876
Home equity	349	538	941
Consumer	78	145	128
Other	-	-	2
Total	\$ 46,037	\$ 52,096	\$ 38,892

Impaired loans: Impaired loans include the following:

§ Loans which we risk-rate (consisting of loan relationships having aggregate balances in excess of \$2,000,000, or loans exceeding \$500,000 and exhibiting credit weakness) through our normal loan review procedures and which, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement. Risk-rated loans with insignificant delays or insignificant short falls in the amount of payments expected to be collected are not considered to be impaired.

§ Loans that have been modified in a troubled debt restructuring.

Both commercial and consumer loans are deemed impaired upon being contractually modified in a troubled debt restructuring. Troubled debt restructurings typically result from our loss mitigation activities and occur when we grant a concession to a borrower who is experiencing financial difficulty in order to minimize our economic loss and to avoid foreclosure or repossession of collateral. Once restructured in a troubled debt restructuring, a loan is generally considered impaired until its maturity, regardless of whether the borrower performs under the modified terms. Although such a loan may be returned to accrual status if the criteria set forth in our accounting policy are met, the loan would continue to be evaluated for an asset-specific allowance for loan losses and we would continue to report the loan in the impaired loan table below.



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The table below sets forth information about our impaired loans.

Method Used to Measure Impairment of Impaired Loans  
Dollars in thousands

Loan Category	6/30/2012	12/31/2011	6/30/2011	Method used to measure impairment
Commerical	\$ 3,031	\$ 2,969	\$ 1,638	Fair value of collateral
	3,864	-	-	Discounted cash flow
Commerical real estate				
Owner-occupied	13,299	9,698	11,103	Fair value of collateral
	2,709	2,580	2,598	Discounted cash flow
Non-owner occupied	9,987	9,790	11,458	Fair value of collateral
	-	-	1,794	Discounted cash flow
Construction and development				
Land & land development	33,160	29,862	25,456	Fair value of collateral
	656	-	1,525	Discounted cash flow
Construction	-	735	-	Fair value of collateral
Residential mortgage				
Non-jumbo	5,997	4,488	6,516	Fair value of collateral
	1,243	372	1,188	Discounted cash flow
Jumbo	23,653	18,147	15,974	Fair value of collateral
Home equity	360	407	541	Fair value of collateral
Consumer	45	8	38	Fair value of collateral
Total	\$ 98,004	\$ 79,056	\$ 79,829	



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The following tables present loans individually evaluated for impairment at June 30, 2012, December 31, 2011 and June 30, 2011.

Dollars in thousands	June 30, 2012				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
<b>Without a related allowance</b>					
Commercial	\$ 5,938	\$ 5,947	\$ -	\$ 1,818	\$ 47
Commercial real estate					
Owner-occupied	12,893	12,872	-	9,778	359
Non-owner occupied	6,642	6,645	-	6,260	304
Construction and development					
Land & land development	17,981	17,982	-	15,696	579
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,810	3,819	-	3,164	140
Jumbo	17,665	17,669	-	15,504	250
Home equity	191	191	-	191	11
Consumer	41	41	-	26	1
Total without a related allowance	\$ 65,161	\$ 65,166	\$ -	\$ 52,437	\$ 1,691
<b>With a related allowance</b>					
Commercial	\$ 948	\$ 948	\$ 254	\$ 879	\$ 4
Commercial real estate					
Owner-occupied	3,136	3,136	53	2,854	156
Non-owner occupied	3,341	3,342	306	3,350	115

Construction and development					
Land & land development	15,834	15,834	3,029	13,589	114
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,418	3,421	1,095	2,019	57
Jumbo	5,979	5,984	1,634	2,583	25
Home equity	169	169	147	165	7
Consumer	4	4	4	-	-
Total with a related allowance	\$ 32,829	\$ 32,838	\$ 6,522	\$ 25,439	\$ 478
Total					
Commercial	\$ 66,713	\$ 66,706	\$ 3,642	\$ 54,224	\$ 1,678
Residential real estate	31,232	31,253	2,876	23,626	490
Consumer	45	45	4	26	1
Total	\$ 97,990	\$ 98,004	\$ 6,522	\$ 77,876	\$ 2,169

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	December 31, 2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
Without a related allowance					
Commercial	\$ 2,074	\$ 2,076	\$ -	\$ 874	\$ 10
Commercial real estate					
Owner-occupied	9,013	9,034	-	8,132	253
Non-owner occupied	5,599	5,600	-	2,891	116
Construction and development					
Land & land development	12,128	12,128	-	9,509	346
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,697	3,708	-	2,843	68
Jumbo	15,203	15,204	-	12,626	-
Home equity	194	194	-	99	6
Total without a related allowance	\$ 47,908	\$ 47,944	\$ -	\$ 36,974	\$ 799
With a related allowance					
Commercial	\$ 893	\$ 893	\$ 247	\$ 661	\$ 1
Commercial real estate					
Owner-occupied	3,244	3,244	465	3,588	143
Non-owner occupied	4,190	4,190	456	3,357	87
Construction and development					
Land & land development	17,719	17,734	2,901	8,726	40
Construction	735	735	29	2	-
Residential real estate					
Non-jumbo	1,150	1,152	209	706	31
Jumbo	2,943	2,943	275	1,349	-

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Home equity	213	213	162	125	2
Consumer	8	8	1	-	-
Total with a related allowance	\$ 31,095	\$ 31,112	\$ 4,745	\$ 18,514	\$ 304
<b>Total</b>					
Commercial	\$ 55,595	\$ 55,634	\$ 4,098	\$ 37,740	\$ 996
Residential real estate	23,400	23,414	646	17,748	107
Consumer	8	8	1	-	-
Total	\$ 79,003	\$ 79,056	\$ 4,745	\$ 55,488	\$ 1,103

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

	June 30, 2011				
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
Without a related allowance					
Commercial	\$ 614	\$ 615	\$ -	\$ 603	\$ 4
Commercial real estate					
Owner-occupied	6,991	7,007	-	6,141	84
Non-owner occupied	7,298	7,301	-	691	7
Construction and development					
Land & land development	22,302	22,302	-	15,191	94
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	5,095	5,108	-	4,178	62
Jumbo	13,670	13,672	-	12,622	456
Home equity	194	194	-	1	-
Total without a related allowance	\$ 56,164	\$ 56,199	\$ -	\$ 39,427	\$ 707
With a related allowance					
Commercial	\$ 1,023	\$ 1,023	\$ 423	\$ 411	\$ -
Commercial real estate					
Owner-occupied	6,691	6,694	844	3,941	71
Non-owner occupied	5,952	5,951	684	2,491	44
Construction and development					
Land & land development	4,679	4,679	1,103	2,650	43
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	2,595	2,596	691	2,085	23
Jumbo	2,298	2,302	541	1,350	-

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Home equity	347	347	326	210	1
Consumer	38	38	12	-	-
Total with a related allowance	\$ 23,623	\$ 23,630	\$ 4,624	\$ 13,138	\$ 182
<b>Total</b>					
Commercial	\$ 55,550	\$ 55,572	\$ 3,054	\$ 32,119	\$ 347
Consumer	38	38	12	-	-
Residential real estate	24,199	24,219	1,558	20,446	542
Total	\$ 79,787	\$ 79,829	\$ 4,624	\$ 52,565	\$ 889

A modification of a loan is considered a troubled debt restructuring (“TDR”) when a borrower is experiencing financial difficulty and the modification constitutes a concession that we would not otherwise consider. This may include a transfer of real estate or other assets from the borrower, a modification of loan terms, or a combination of both. A loan continues to qualify as a TDR until a consistent payment history or change in the borrower’s financial condition has been evidenced, generally no less than twelve months. Included in impaired loans are TDRs of \$51,459,000 and \$47,770,000 at June 30, 2012 and December 31, 2011, respectively, with no commitments to lend additional funds under these restructurings at either balance sheet date.



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The following table presents by class the TDRs that were restructured during the three and six months ended June 30, 2012. Generally, the modifications were extensions of term, modifying the payment terms from principal and interest to interest only for an extended period, or reduction in interest rate. All TDRs are evaluated individually for allowance for loan loss purposes.

dollars in thousands	For the Three Months Ended June 30, 2012			For the Six Months Ended June 30, 2012		
	Number of Modifications	Pre-modification	Post-modification	Number of Modifications	Pre-modification	Post-modification
		Recorded Investment	Recorded Investment		Recorded Investment	Recorded Investment
Commercial	1	\$ 77	\$ 78	3	\$ 1,109	\$ 1,117
Commercial real estate						
Owner-occupied	-	-	-	-	-	-
Non-owner occupied	-	-	-	2	2,134	1,757
Construction and development						
Land & land development	1	1,789	1,000	1	1,789	1,000
Construction	-	-	-	-	-	-
Residential real estate						
Non-jumbo	3	497	506	5	557	567
Jumbo	3	2,301	2,701	3	2,301	2,701
Home equity	-	-	-	-	-	-
Consumer	1	4	4	2	42	42
Total	9	\$ 4,668	\$ 4,289	16	\$ 7,932	\$ 7,184

The following table presents defaults during the stated period of TDRs that were restructured during the past twelve months. For purposes of these tables, a default is considered as either the loan was past due 30 days or more at any time during the period, or the loan was fully or partially charged off during the period.

dollars in thousands	For the Three Months Ended June 30, 2012		For the Six Months Ended June 30, 2012	
	Number of Defaults	Recorded Investment at Default Date	Number of Defaults	Recorded Investment at Default Date
	Commercial	-	\$ -	-
Commercial real estate				

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Owner-occupied	1	580	2	1,103
Non-owner occupied	-	-	-	-
Construction and development				
Land & land development	-	-	-	-
Construction	-	-	-	-
Residential real estate				
Non-jumbo	2	384	2	386
Jumbo	2	4,225	3	4,727
Home equity	-	-	-	-
Consumer	1	36	1	36
Total	6	\$ 5,225	8	\$ 6,252

We categorize loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. We analyze loans individually by classifying the loans as to credit risk. We internally grade all commercial loans at the time of loan origination. In addition, we perform an annual loan review on all non-homogenous commercial loan relationships with an aggregate exposure of \$2 million, at which time these loans are re-graded. We use the following definitions for our risk grades:

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Pass: Loans graded as Pass are loans to borrowers of acceptable credit quality and risk. They are higher quality loans that do not fit any of the other categories described below.

OLEM (Special Mention): Commercial loans categorized as OLEM are potentially weak. The credit risk may be relatively minor yet represent a risk given certain specific circumstances. If the potential weaknesses are not monitored or mitigated, the asset may weaken or inadequately protect our position in the future.

Substandard: Commercial loans categorized as Substandard are inadequately protected by the borrower's ability to repay, equity, and/or the collateral pledged to secure the loan. These loans have identified weaknesses that could hinder normal repayment or collection of the debt. These loans are characterized by the distinct possibility that we will sustain some loss if the identified weaknesses are not mitigated.

Doubtful: Commercial loans categorized as Doubtful have all the weaknesses inherent in those loans classified as Substandard, with the added elements that the full collection of the loan is improbable and the possibility of loss is high.

Loss: Loans classified as loss are considered to be non-collectible and of such little value that their continuance as a bankable asset is not warranted. This does not mean that the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future.

Loan Risk Profile by Internal  
Risk Rating

	Construction and Development				Commercial Real Estate					
	Land and land development		Construction		Commercial		Owner Occupied		Non-Owner Occupied	
Dollars in thousands	6/30/2012	12/31/2011	6/30/2012	12/31/2011	6/30/2012	12/31/2011	6/30/2012	12/31/2011	6/30/2012	12/31/2011
Pass	\$44,538	\$47,521	\$1,640	\$1,886	\$77,402	\$84,225	\$137,289	\$143,845	\$263,385	\$253,319
OLEM (Special Mention)	7,816	18,615	-	-	7,385	6,889	1,737	5,474	13,154	10,421
Substandard	32,029	26,899	153	1,049	7,273	7,910	13,321	9,435	4,352	6,486
Doubtful	-	-	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-	-	-
Total	\$84,383	\$93,035	\$1,793	\$2,935	\$92,060	\$99,024	\$152,347	\$158,754	\$280,891	\$270,226

The following table presents the recorded investment in consumer, residential real estate, and home equity loans, which are generally evaluated based on the aging status of the loans, which was previously presented, and payment activity.

	Performing		Nonperforming	
	6/30/2012	12/31/2011	6/30/2011	6/30/2012

Dollars in  
thousands  
Residential real  
estate

Non-jumbo	\$ 213,872	\$ 218,050	\$ 223,786	\$ 3,449	\$ 3,683	\$ 4,419
Jumbo	47,209	47,570	56,940	14,752	13,965	3,877
Home Equity	51,344	50,360	50,756	349	538	128
Consumer	21,134	22,180	22,832	78	145	941
Other	2,523	2,762	3,116	-	-	-
Total	\$ 336,082	\$ 340,922	\$ 357,430	\$ 18,628	\$ 18,331	\$ 9,365

Loan commitments: ASC Topic 815, Derivatives and Hedging, requires that commitments to make mortgage loans should be accounted for as derivatives if the loans are to be held for sale, because the commitment represents a written option and accordingly is recorded at the fair value of the option liability.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

## NOTE 7. ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses for the six month periods ended June 30, 2012 and 2011, and for the year ended December 31, 2011 is as follows:

Dollars in thousands	Six Months Ended		Year
	2012	June 30, 2011	Ended December 31, 2011
Balance, beginning of year	\$ 17,712	\$ 17,224	\$ 17,224
Losses:			
Commercial	126	93	506
Commercial real estate			
Owner occupied	636	152	508
Non-owner occupied	457	61	78
Construction and development			
Land and land development	1,715	1,875	3,568
Construction	368	-	-
Residential real estate			
Non-jumbo	480	2,000	3,178
Jumbo	237	1,098	1,511
Home equity	4	-	346
Consumer	65	82	162
Other	41	57	86
Total	4,129	5,418	9,943
Recoveries:			
Commercial	4	32	35
Commercial real estate			
Owner occupied	24	36	37
Non-owner occupied	13	21	55
Construction and development			
Land and land development	14	4	43
Construction	-	-	-
Real estate - mortgage			
Non-jumbo	32	27	83
Jumbo	84	1	14

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Home equity	60	1	1
Consumer	34	41	112
Other	40	47	51
Total	305	210	431
Net losses	3,824	5,208	9,512
Provision for loan losses	4,002	6,000	10,000
Balance, end of year	\$ 17,890	\$ 18,016	\$ 17,712

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Activity in the allowance for loan losses by loan class during the first six months of 2012 is as follows:

Dollars in thousands	Construction & Land Development		Commercial Real Estate		Residential Real Estate		Non-jumbo	Home Equity	Consumer	Other	Total
	Land & Land Development	Construction	Commercial Owner Occupied	Real Estate Non-Owner Occupied	Non-jumbo	Jumbo					
Allowance for loan losses											
Beginning balance	\$7,262	\$120	\$771	\$1,336	\$3,283	\$2,586	\$1,331	\$831	\$160	\$32	\$17,712
Charge-offs	1,715	368	126	636	457	480	237	4	65	41	4,129
Recoveries	14	-	4	24	13	32	84	60	34	40	305
Provision	321	339	123	347	275	1,227	1,403	(33)	5	(5)	4,002
Ending balance	\$5,882	\$91	\$772	\$1,071	\$3,114	\$3,365	\$2,581	\$854	\$134	\$26	\$17,890

Allowance related to:

Loans individually evaluated for impairment	\$3,029	\$-	\$255	\$53	\$306	\$1,094	\$1,634	\$147	\$4	\$-	\$6,522
Loans collectively evaluated for impairment	2,853	91	517	1,018	2,808	2,271	947	707	130	26	11,368
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	\$5,882	\$91	\$772	\$1,071	\$3,114	\$3,365	\$2,581	\$854	\$134	\$26	\$17,890

Loans individually evaluated for	\$33,816	\$-	\$6,895	\$16,008	\$9,987	\$7,240	\$23,653	\$360	\$45	\$-	\$98,004
----------------------------------	----------	-----	---------	----------	---------	---------	----------	-------	------	-----	----------

impairment												
Loans												
collectively												
evaluated												
for												
impairment	50,567	1,793	85,165	136,339	270,904	210,081	38,308	51,333	21,167	2,523	\$868,180	
Loans												
acquired with												
deteriorated												
credit quality	-	-	-	-	-	-	-	-	-	-	-	-
Total	\$84,383	\$1,793	\$92,060	\$152,347	\$280,891	\$217,321	\$61,961	\$51,693	\$21,212	\$2,523	\$966,184	



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

## NOTE 8. GOODWILL AND OTHER INTANGIBLE ASSETS

The following tables present our goodwill by reporting unit at June 30, 2012 and other intangible assets by reporting unit at June 30, 2012 and December 31, 2011.

Dollars in thousands	Goodwill Activity		
	Community Banking	Insurance Services	Total
Balance, January 1, 2012	\$ 1,488	\$ 4,710	\$ 6,198
Acquired goodwill, net	-	-	-
Balance, June 30, 2012	\$ 1,488	\$ 4,710	\$ 6,198

Dollars in thousands	Other Intangible Assets					
	June 30, 2012			December 31, 2011		
	Community Banking	Insurance Services	Total	Community Banking	Insurance Services	Total
Unidentifiable intangible assets						
Gross carrying amount	\$ 2,267	\$ -	\$ 2,267	\$ 2,267	\$ -	\$ 2,267
Less: accumulated amortization	1,990	-	1,990	1,914	-	1,914
Net carrying amount	\$ 277	\$ -	\$ 277	\$ 353	\$ -	\$ 353
Identifiable intangible assets						
Gross carrying amount	\$ -	\$ 3,000	\$ 3,000	\$ -	\$ 3,000	\$ 3,000
Less: accumulated amortization	-	1,000	1,000	-	900	900
Net carrying amount	\$ -	\$ 2,000	\$ 2,000	\$ -	\$ 2,100	\$ 2,100

We recorded amortization expense of approximately \$176,000 for the six months ended June 30, 2012 relative to our other intangible assets. Annual amortization is expected to be approximately \$351,000 for each of the years ending 2012 through 2014.

## NOTE 9. DEPOSITS

The following is a summary of interest bearing deposits by type as of June 30, 2012 and 2011 and December 31, 2011:

Dollars in thousands	December		
	June 30, 2012	31, 2011	June 30, 2011
Demand deposits, interest bearing	\$ 164,868	\$ 158,483	\$ 150,004
Savings deposits	204,509	208,809	212,745
Retail time deposits	301,865	328,082	401,599
Wholesale deposits	234,256	232,471	195,782
Total	\$ 905,498	\$ 927,845	\$ 960,130

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Wholesale deposits represent certificates of deposit acquired through a third party or bulletin board listing services on the internet.

A summary of the scheduled maturities for all time deposits as of June 30, 2012 is as follows:

Dollars in thousands	
Six month period ending December 31, 2012	\$ 121,663
Year ending December 31, 2013	161,769
Year ending December 31, 2014	56,747
Year ending December 31, 2015	54,873
Year ending December 31, 2016	72,163
Thereafter	68,906
	\$ 536,121

The following is a summary of the maturity distribution of all certificates of deposit in denominations of \$100,000 or more as of June 30, 2012:

Dollars in thousands	Amount	Percent
Three months or less	\$ 30,193	8.2 %
Three through six months	46,319	12.6 %
Six through twelve months	46,751	12.7 %
Over twelve months	244,596	66.5 %
Total	\$ 367,859	100.0 %

NOTE 10. BORROWED FUNDS

Short-term borrowings: A summary of short-term borrowings is presented below:

Six Months Ended June 30, 2012		
Short-term	Federal Funds Purchased and	
FHLB	Repurchase	Lines

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Dollars in thousands	Advances	Agreements	of Credit
Balance at June 30	\$ 10,000	\$ -	\$ 957
Average balance outstanding for the period	14,162	-	956
Maximum balance outstanding at any month end during period	20,000	-	957
Weighted average interest rate for the period	0.22 %	0.00 %	0.25 %
Weighted average interest rate for balances outstanding at June 30	0.23 %	0.00 %	0.25 %

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	Year Ended December 31, 2011		
	Short-term	Short-Term	Federal
	FHLB	Repurchase	Funds
	Advances	Agreements	Purchased and Lines of Credit
Balance at December 31	\$ 15,000	\$ -	\$ 956
Average balance outstanding for the period	2,753	531	954
Maximum balance outstanding at any month end during period	15,000	1,233	956
Weighted average interest rate for the period	0.17 %	0.15 %	0.25 %
Weighted average interest rate for balances outstanding at December 31	0.15 %	0.00 %	0.25 %

Dollars in thousands	Six Months Ended June 30, 2011		
	Short-term		Federal
	FHLB	Repurchase	Funds
	Advances	Agreements	Purchased and Lines of Credit
Balance at June 30	\$ -	\$ 1,092	\$ 955
Average balance outstanding for the period	-	932	954
Maximum balance outstanding at any month end during period	-	1,233	955
Weighted average interest rate for the period	0.00 %	0.15 %	0.25 %

Weighted average interest rate  
for balances

outstanding at June 30	0.00 %	0.15 %	0.25 %
------------------------	--------	--------	--------

Long-term borrowings: Our long-term borrowings of \$253,635,000, \$270,254,000 and \$282,631,000 at June 30, 2012, December 31, 2011, and June 30, 2011 respectively, consisted primarily of advances from the Federal Home Loan Bank (“FHLB”) and structured reverse repurchase agreements with two unaffiliated institutions. All FHLB advances are collateralized primarily by similar amounts of residential mortgage loans, certain commercial loans, mortgage backed securities and securities of U. S. Government agencies and corporations.

Dollars in thousands	Balance at June 30,		Balance at December 31,
	2012	2011	2011
Long-term FHLB advances	\$ 157,609	\$ 161,799	\$ 160,325
Long-term reverse repurchase agreements	87,000	110,000	100,000
Term loan	9,026	10,832	9,929
Total	\$ 253,635	\$ 282,631	\$ 270,254

The term loan represents a long-term borrowing with an unaffiliated banking institution which is secured by the common stock of our subsidiary bank, bears a variable interest rate of prime minus 50 basis points, and matures in 2017.

Our long term borrowings bear both fixed and variable rates and mature in varying amounts through the year 2026.

The average interest rate paid on long-term borrowings for the six month period ended June 30, 2012 was 3.95% compared to 4.13% for the first six months of 2011.

Subordinated debentures: We have subordinated debt totaling \$16.8 million at June 30, 2012, December 31, 2011, and June 30, 2011. The subordinated debt qualifies as Tier 2 capital under Federal Reserve Board guidelines until the debt is within 5 years of its maturity; thereafter the amount qualifying as Tier 2 capital is reduced by 20 percent each year until maturity. During 2009, we issued \$6.8 million in subordinated debt, of which \$5 million was issued to an affiliate of a director of Summit. We also issued \$1.0 million and \$0.8 million to two unrelated parties. These three issuances bear an interest rate of 10 percent per annum, a term of 10 years, and are not prepayable by us within the first five years. During 2008, we issued \$10 million of subordinated debt to an unrelated institution, which bears a variable interest rate of 1 month LIBOR plus 275 basis points and a term of 7.5 years.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Subordinated debentures owed to unconsolidated subsidiary trusts: We have three statutory business trusts that were formed for the purpose of issuing mandatorily redeemable securities (the “capital securities”) for which we are obligated to third party investors and investing the proceeds from the sale of the capital securities in our junior subordinated debentures (the “debentures”). The debentures held by the trusts are their sole assets. Our subordinated debentures totaled \$19,589,000 at June 30, 2012, December 31, 2011, and June 30, 2011.

In October 2002, we sponsored SFG Capital Trust I, in March 2004, we sponsored SFG Capital Trust II, and in December 2005, we sponsored SFG Capital Trust III, of which 100% of the common equity of each trust is owned by us. SFG Capital Trust I issued \$3,500,000 in capital securities and \$109,000 in common securities and invested the proceeds in \$3,609,000 of debentures. SFG Capital Trust II issued \$7,500,000 in capital securities and \$232,000 in common securities and invested the proceeds in \$7,732,000 of debentures. SFG Capital Trust III issued \$8,000,000 in capital securities and \$248,000 in common securities and invested the proceeds in \$8,248,000 of debentures. Distributions on the capital securities issued by the trusts are payable quarterly at a variable interest rate equal to 3 month LIBOR plus 345 basis points for SFG Capital Trust I, 3 month LIBOR plus 280 basis points for SFG Capital Trust II, and 3 month LIBOR plus 145 basis points for SFG Capital Trust III, and equals the interest rate earned on the debentures held by the trusts, and is recorded as interest expense by us. The capital securities are subject to mandatory redemption in whole or in part, upon repayment of the debentures. We have entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of the guarantee. The debentures of each Capital Trust are redeemable by us quarterly.

The capital securities held by SFG Capital Trust I, SFG Capital Trust II, and SFG Capital Trust III qualify as Tier 1 capital under Federal Reserve Board guidelines. In accordance with these Guidelines, trust preferred securities generally are limited to 25% of Tier 1 capital elements, net of goodwill. The amount of trust preferred securities and certain other elements in excess of the limit can be included in Tier 2 capital.

A summary of the maturities of all long-term borrowings and subordinated debentures for the next five years and thereafter is as follows:

Dollars in thousands Year Ending		Subordinated debentures owed to unconsolidated subsidiary trusts		
		Long-term borrowings	Subordinated debentures	
December 31,	2012	\$ 50,818	\$ -	\$ -
	2013	41,898	-	-
	2014	83,429	-	-
	2015	1,909	10,000	-
	2016	28,911	-	-
	Thereafter	46,670	6,800	19,589
		\$ 253,635	\$ 16,800	\$ 19,589

NOTE 11. STOCK OPTION PLAN

The 2009 Officer Stock Option Plan was adopted by our shareholders in May 2009 and provides for the granting of stock options for up to 350,000 shares of common stock to our key officers. Each option granted under the Plan vests according to a schedule designated at the grant date and has a term of no more than 10 years following the vesting date. Also, the option price per share was not to be less than the fair market value of our common stock on the date of grant. The 2009 Officer Stock Option Plan, which expires in May 2019, replaces the 1998 Officer Stock Option Plan (collectively the “Plans”) that expired in May 2008.



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The fair value of our employee stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options at the time of grant. There were no options granted during the first six months of 2012 or 2011.

We recognize compensation expense based on the estimated number of stock awards expected to actually vest, exclusive of the awards expected to be forfeited. During the first six months of 2012 and 2011, our stock compensation expense and related deferred taxes were insignificant.

A summary of activity in our Plans during the first six months of 2012 and 2011 is as follows:

	For the Six Months Ended June 30,			
	2012	Weighted-Average Exercise Price	2011	Weighted-Average Exercise Price
	Options		Options	
Outstanding, January 1	317,180	\$ 18.17	317,180	\$ 18.17
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Expired	(22,800 )	5.12	-	-
Outstanding, June 30	294,380	\$ 19.18	317,180	\$ 18.17

Other information regarding options outstanding and exercisable at June 30, 2012 is as follows:

Range of exercise price	# of shares	Options Outstanding			Options Exercisable		
		Wt. Avg. Remaining Contractual WAEP	Wted. Avg. Remaining Contractual Life (yrs)	Aggregate Intrinsic Value (in thousands)	# of shares	Wt. Avg. Remaining Contractual WAEP	Aggregate Intrinsic Value (in thousands)
\$2.54 - \$6.00	41,350	\$5.16	2.89	\$17	37,350	\$5.44	\$6
6.01 - 10.00	33,680	9.20	4.09	-	31,880	9.37	-
10.01 - 17.50	2,300	17.43	1.67	-	2,300	17.43	-
	51,300	17.79	4.50	-	51,200	17.79	-

17.51 -  
20.00  
20.01 -

25.93	165,750	25.15	3.37	-	165,750	25.15	-
	294,380	19.18		17	288,480	19.49	6

NOTE 12. COMMITMENTS AND CONTINGENCIES

Off-Balance Sheet Arrangements

We are a party to certain financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial position. The contract amounts of these instruments reflect the extent of involvement that we have in this class of financial instruments.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

Many of our lending relationships contain both funded and unfunded elements. The funded portion is reflected on our balance sheet. The unfunded portion of these commitments is not recorded on our balance sheet until a draw is made under the loan facility. Since many of the commitments to extend credit may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash flow requirements.

A summary of the total unfunded, or off-balance sheet, credit extension commitments follows:

	June 30,
Dollars in thousands	2012
Commitments to extend credit:	
Revolving home equity and credit card lines	\$ 46,513
Construction loans	13,407
Other loans	35,719
Standby letters of credit	2,036
Total	\$ 97,675

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if we deem necessary upon extension of credit, is based on our credit evaluation. Collateral held varies but may include accounts receivable, inventory, equipment or real estate.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of the underlying contract with the third party.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments.

#### NOTE 13. REGULATORY MATTERS

We and our subsidiaries are subject to various regulatory capital requirements administered by the banking regulatory agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we and each of our subsidiaries must meet specific capital guidelines that involve quantitative measures of our and our subsidiaries' assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. We and each

of our subsidiaries' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us and each of our subsidiaries to maintain minimum amounts and ratios of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). We believe, as of June 30, 2012, that we and each of our subsidiaries met all capital adequacy requirements to which they were subject.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

The most recent notifications from the banking regulatory agencies categorized us and each of our subsidiaries as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, we and each of our subsidiaries must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below.

Our actual capital amounts and ratios as well as our subsidiary, Summit Community Bank's ("Summit Community") are presented in the following table.

Dollars in thousands As of June 30, 2012	Actual		Minimum Required Regulatory Capital		To be Well Capitalized under Prompt Corrective Action Provisions			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
Total Capital (to risk weighted assets)								
Summit	\$138,013	13.6	% \$81,056	8.0	% \$101,320	10.0	%	
Summit Community	145,218	14.3	% 81,127	8.0	% 101,409	10.0	%	
Tier I Capital (to risk weighted assets)								
Summit	112,359	11.1	% 40,528	4.0	% 60,792	6.0	%	
Summit Community	132,364	13.1	% 40,564	4.0	% 60,845	6.0	%	
Tier I Capital (to average assets)								
Summit	112,359	7.9	% 57,017	4.0	% 71,272	5.0	%	
Summit Community	132,364	9.3	% 56,809	4.0	% 71,011	5.0	%	
As of December 31, 2011								
Total Capital (to risk weighted assets)								
Summit	136,060	13.0	% 83,617	8.0	% 104,522	10.0	%	
Summit Community	142,329	13.6	% 83,604	8.0	% 104,505	10.0	%	
Tier I Capital (to risk weighted assets)								
Summit	109,989	10.5	% 41,809	4.0	% 62,713	6.0	%	
Summit Community	129,058	12.3	% 41,802	4.0	% 62,703	6.0	%	
Tier I Capital (to average assets)								
Summit	109,989	7.6	% 58,031	4.0	% 72,538	5.0	%	
Summit Community	129,058	8.9	% 57,995	4.0	% 72,493	5.0	%	

Summit Financial Group, Inc. ("Summit") and its bank subsidiary, Summit Community Bank, Inc. (the "Bank"), have entered into informal Memoranda of Understanding ("MOU's") with their respective regulatory authorities. A memorandum of understanding is characterized by the regulatory authorities as an informal action that is not

published or publicly available and that is used when circumstances warrant a milder form of action than a formal supervisory action, such as a formal written agreement or order. Among other things, under the MOU's, Summit's management team has agreed to:

- § The Bank achieving and maintaining a minimum Tier 1 leverage capital ratio of at least 8% and a total risk-based capital ratio of at least 11%;
- § The Bank providing 30 days prior notice of any declaration of intent to pay cash dividends to provide the Bank's regulatory authorities an opportunity to object;
- § Summit suspending all cash dividends on its common stock until further notice. Dividends on all preferred stock, as well as interest payments on subordinated notes underlying Summit's trust preferred securities, continue to be permissible; and,
- § Summit not incurring any additional debt, other than trade payables, without the prior written consent of the principal banking regulators.

Additional information regarding the MOU's is included in Part I. Item 1A – Risk Factors on our Form 10-K for the year ended December 31, 2011.

Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

## NOTE 14. SEGMENT INFORMATION

We operate two business segments: community banking and insurance services. These segments are primarily identified by the products or services offered. The community banking segment consists of our full service banks which offer customers traditional banking products and services through various delivery channels. The insurance services segment consists of three insurance agency offices that sell insurance products. The accounting policies discussed throughout the notes to the consolidated financial statements apply to each of our business segments.

Intersegment revenue and expense consists of management fees allocated to the bank and Summit Insurance Services, LLC for all centralized functions that are performed by the parent, including overall direction in the areas of strategic planning, investment portfolio management, asset/liability management, financial reporting and other financial and administrative services. Information for each of our segments is included below:

In thousands	Six Months Ended June 30, 2012				
	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	\$ 20,882	\$ -	\$ (893 )	\$ -	\$ 19,989
Provision for loan losses	4,002	-	-	-	4,002
Net interest income after provision for loan losses	16,880	-	(893 )	-	15,987
Other income	228	2,322	503	(522 )	2,531
Other expenses	12,537	1,958	862	(522 )	14,835
Income (loss) before income taxes	4,571	364	(1,252 )	-	3,683
Income tax expense (benefit)	1,342	146	(415 )	-	1,073
Net income (loss)	3,229	218	(837 )	-	2,610
Dividends on preferred shares	-	-	388	-	388
Net income (loss) applicable to common shares	\$ 3,229	\$ 218	\$ (1,225 )	\$ -	\$ 2,222
Intersegment revenue (expense)	\$ (471 )	\$ (51 )	\$ 522	\$ -	\$ -
Average assets	\$ 1,496,527	\$ 6,453	\$ 153,426	\$ (217,297)	\$ 1,439,109

In thousands	Six Months Ended June 30, 2011				
	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	\$ 21,167	\$ -	\$ (905 )	\$ -	\$ 20,262
Provision for loan losses	6,000	-	-	-	6,000
Net interest income after provision for loan losses	15,167	-	(905 )	-	14,262
Other income	(2,193 )	2,456	1,606	(495 )	1,374
Other expenses	12,341	2,142	891	(495 )	14,879

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Income (loss) before income taxes	633	314	(190 )	-	757
Income tax expense (benefit)	(33 )	126	7	-	100
Net income (loss)	666	188	(197 )	-	657
Dividends on preferred shares	-	-	148	-	148
Net income (loss) applicable to common shares	\$ 666	\$ 188	\$ (345 )	\$ -	\$ 509
Intersegment revenue (expense)	\$ (438 )	\$ (57 )	\$ 495	\$ -	\$ -
Average assets	\$ 1,539,586	\$ 6,751	\$ 140,502	\$ (210,103)	\$ 1,476,736



Summit Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (unaudited)

In thousands	Three Months Ended June 30, 2012				
	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	\$ 10,416	\$ -	\$ (445 )	\$ -	\$ 9,971
Provision for loan losses	2,001	-	-	-	2,001
Net interest income after provision for loan losses	8,415	-	(445 )	-	7,970
Other income	(300 )	1,146	243	(261 )	828
Other expenses	6,176	953	427	(261 )	7,295
Income (loss) before income taxes	1,939	193	(629 )	-	1,503
Income tax expense (benefit)	716	77	(203 )	-	590
Net income (loss)	1,223	116	(426 )	-	913
Dividends on preferred shares	-	-	194	-	194
Net income (loss) applicable to common shares	\$ 1,223	\$ 116	\$ (620 )	\$ -	\$ 719
Intersegment revenue (expense)	\$ (236 )	\$ (25 )	\$ 261	\$ -	\$ -
Average assets	\$ 1,490,039	\$ 6,538	\$ 153,986	\$ (217,516)	\$ 1,433,047

In thousands	Three Months Ended June 30, 2011				
	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	\$ 10,614	\$ -	\$ (454 )	\$ -	\$ 10,160
Provision for loan losses	3,000	-	-	-	3,000
Net interest income after provision for loan losses	7,614	-	(454 )	-	7,160
Other income	636	1,219	247	(247 )	1,855
Other expenses	6,472	1,115	432	(247 )	7,772
Income (loss) before income taxes	1,778	104	(639 )	-	1,243
Income tax expense (benefit)	514	36	(212 )	-	338
Net income (loss)	1,264	68	(427 )	-	905
Dividends on preferred shares	-	-	74	-	74
Net income (loss) applicable to common shares	\$ 1,264	\$ 68	\$ (501 )	\$ -	\$ 831
Intersegment revenue (expense)	\$ (219 )	\$ (28 )	\$ 247	\$ -	\$ -
Average assets	\$ 1,543,308	\$ 6,822	\$ 140,714	\$ (209,657)	\$ 1,481,187

Summit Financial Group, Inc. and Subsidiaries  
 Management's Discussion and Analysis of Financial Condition and  
 Results of Operations

## INTRODUCTION

The following discussion and analysis focuses on significant changes in our financial condition and results of operations of Summit Financial Group, Inc. ("Company" or "Summit") and our operating segments, Summit Community Bank ("Summit Community"), and Summit Insurance Services, LLC for the periods indicated. See Note 14 of the accompanying consolidated financial statements for our segment information. This discussion and analysis should be read in conjunction with our 2011 audited financial statements and Annual Report on Form 10-K.

The Private Securities Litigation Act of 1995 indicates that the disclosure of forward-looking information is desirable for investors and encourages such disclosure by providing a safe harbor for forward-looking statements by us. Our following discussion and analysis of financial condition and results of operations contains certain forward-looking statements that involve risk and uncertainty. In order to comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed in those forward-looking statements.

## OVERVIEW

Our primary source of income is net interest income from loans and deposits. Business volumes tend to be influenced by the overall economic factors including market interest rates, business spending, and consumer confidence, as well as competitive conditions within the marketplace.

Interest earning assets declined by 3.43% for the first six months in 2012 compared to the same period of 2011 while our net interest earnings on a tax equivalent basis decreased 0.20%. Our tax equivalent net interest margin increased 10 basis points. Historically high levels of nonaccrual loans continue to negatively impact our net interest earnings while our reduced cost of interest bearing funds continues to positively impact our net interest earnings.

## BUSINESS SEGMENT RESULTS

We are organized and managed along two major business segments, as described in Note 14 of the accompanying consolidated financial statements. The results of each business segment are intended to reflect each segment as if it were a stand alone business. Net income by segment follows:

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
In thousands	2012	2011	2012	2011
Community banking	\$1,223	\$1,264	\$3,229	\$666
Insurance	116	68	218	188
Parent	(620)	(501)	(1,225)	(345)
Consolidated net income	\$719	\$831	\$2,222	\$509

## CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the financial services industry. Application of these principles requires us to make estimates, assumptions, and judgments that affect the amounts reported in our financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported.

Summit Financial Group, Inc. and Subsidiaries  
 Management's Discussion and Analysis of Financial Condition and  
 Results of Operations

Our most significant accounting policies are presented in the notes to the consolidated financial statements of our 2011 Annual Report on Form 10-K. These policies, along with the other disclosures presented in the financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, we have identified the determination of the allowance for loan losses, the valuation of goodwill, fair value measurements and deferred tax assets to be the accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

**Allowance for Loan Losses:** The allowance for loan losses represents our estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on our consolidated balance sheet. To the extent actual outcomes differ from our estimates, additional provisions for loan losses may be required that would negatively impact earnings in future periods. Note 8 to the consolidated financial statements of our 2011 Annual Report on Form 10-K describes the methodology used to determine the allowance for loan losses and a discussion of the factors driving changes in the amount of the allowance for loan losses is included in the Asset Quality section of the financial review of the 2011 Annual Report on Form 10-K.

**Goodwill:** Goodwill is subject to a two-step impairment test by reporting unit at least annually to determine whether write-downs of the recorded balances are necessary. During the third quarter, we completed the required annual impairment test for 2011 for each of our reporting units, community banking and insurance services. The first step (Step 1) of impairment testing requires a comparison of each reporting unit's fair value to its carrying value to identify potential impairment. If the fair value equals or exceeds the related unit's carrying value, no write-down of recorded goodwill is necessary. If the fair value is less than the carrying value, an expense may be required on our books to write down the goodwill to the proper carrying value. The second step (Step 2) of impairment testing is necessary only if the reporting unit does not pass Step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination.

The fair value, carrying amount and allocated goodwill with regard to each of our reporting units as of September 30, 2011 (date of our most recent goodwill impairment test) were as follows:

(in thousands)	Community Banking	Insurance Services
Fair value	\$164,235	\$6,929
Carrying amount	132,845	6,414
Allocated goodwill	1,488	4,710

Neither of our reporting units failed Step 1 of the goodwill impairment tests conducted as of September 30, 2011. For purposes of these goodwill impairment tests, the following methodologies were utilized and key assumptions were made in determining the fair value of each reporting unit:

Community Banking – We performed an internal valuation utilizing the income approach to determine the fair value of our Community Banking reporting unit. The income approach was based on discounted cash flows derived from assumptions of balances sheet and income statement activity based upon an internally developed forecast considering several long-term key business drivers such as anticipated loan and deposit growth. The long term growth rate used in determining the terminal value was estimated at 3.5%, and a discount rate of 11% based upon the Capital Asset Pricing Model was applied to the Bank's estimated future cash flow streams.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Insurance Services – We performed an internal valuation, which was verified by a third party firm, utilizing the income approach to determine the fair value of our Insurance Services reporting unit. This methodology consisted of discounting the expected future cash flows of this unit based upon a forecast of its operations considering long-term key business drivers such as anticipated commission revenue growth. The long term growth rate used in determining the terminal value was estimated at 2.5%, and a discount rate of 11% was applied to the Insurance Services unit's estimated future cash flows.

We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Note 11 of the consolidated financial statements of our Annual Report on Form 10-K for further discussion of our intangible assets, which include goodwill.

Fair Value Measurements: ASC Topic 820 Fair Value Measurements and Disclosures provides a definition of fair value, establishes a framework for measuring fair value, and requires expanded disclosures about fair value measurements. Fair value is the price that could be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Based on the observability of the inputs used in the valuation techniques, we classify our financial assets and liabilities measured and disclosed at fair value in accordance with the three-level hierarchy (e.g., Level 1, Level 2 and Level 3) established under ASC Topic 820. Fair value determination in accordance with this guidance requires that we make a number of significant judgments. In determining the fair value of financial instruments, we use market prices of the same or similar instruments whenever such prices are available. We do not use prices involving distressed sellers in determining fair value. If observable market prices are unavailable or impracticable to obtain, then fair value is estimated using modeling techniques such as discounted cash flow analyses. These modeling techniques incorporate our assessments regarding assumptions that market participants would use in pricing the asset or the liability, including assumptions about the risks inherent in a particular valuation technique and the risk of nonperformance.

Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Additionally, fair value is used on a non-recurring basis to evaluate assets or liabilities for impairment or for disclosure purposes in accordance with ASC Topic 825 Financial Instruments.

Deferred Income Tax Assets: At June 30, 2012, we had net deferred tax assets of \$11.6 million. Based on our ability to offset the net deferred tax asset against taxable income in carryback years and expected future taxable income in carryforward years, there was no impairment of the deferred tax asset at June 30, 2012. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. However, our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryback/carryforward periods available under applicable law is not sufficient to cover the amount of net deferred tax assets, such assets may become impaired.

## RESULTS OF OPERATIONS

### Earnings Summary

Net income applicable to common shares for the six months ended June 30, 2012 increased to \$2,222,000, or \$0.27 per diluted share as compared to \$509,000 or \$0.07 per diluted share for the same period of 2011. Net income



Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

applicable to common shares for the quarter ended June 30, 2012 totaled \$719,000, or \$0.09 per diluted share as compared to \$831,000, or \$0.11 per diluted share for the quarter ended June 30, 2011. Earnings for both the quarter and six months ended June 30, 2012 were positively impacted by lower provisions for loan losses and negatively impacted by our continued write-downs of foreclosed properties to their estimated fair values, losses on sales of assets, primarily foreclosed properties, and other-than-temporary impairment of securities. The provision for loan losses was \$4.0 million and \$6.0 million for the six months ended June 30, 2012 and 2011, respectively. Included in earnings for the six months ended June 30, 2012 was \$1.5 million of realized securities gains, \$599,000 in losses on the sales of assets, primarily foreclosed properties, \$3.5 million of charges resulting from the write down of a portion of our foreclosed properties to fair value and \$335,000 in other than temporary impairment charges on securities. Returns on average equity and assets for the first six months of 2012 were 4.96% and 0.36%, respectively, compared with 1.50% and 0.09% for the same period of 2011.

#### Net Interest Income

Net interest income is the principal component of our earnings and represents the difference between interest and fee income generated from earning assets and the interest expense paid on deposits and borrowed funds. Fluctuations in interest rates as well as changes in the volume and mix of earning assets and interest bearing liabilities can materially impact net interest income.

Our net interest income on a fully tax-equivalent basis totaled \$20,794,000 for the six months ended June 30, 2012 compared to \$20,835,000 for the same period of 2011, representing a decrease of \$41,000 or 0.20%. While our earnings on interest earning assets decreased \$3,003,000, this decrease was nearly offset by a reduction in the volume of interest bearing liabilities and a reduction in the cost of interest bearing liabilities (see Table II). Average interest earning assets decreased 3.43% from \$1,353,613,000 during the first six months of 2011 to \$1,307,178,000 for the first six months of 2012. Average interest bearing liabilities declined 4.81% from \$1,294,312,000 at June 30, 2011 to \$1,232,005,000 at June 30, 2012, at an average yield for the first six months of 2012 of 2.14% compared to 2.50% for the same period of 2011.

Our consolidated net interest margin increased to 3.20% for the six months ended June 30, 2012, compared to 3.10% for the same period in 2011. The margin continues to be affected by elevated levels of nonaccruing loans. The present continued low interest rate environment has served to positively impact our net interest margin due to our liability sensitive balance sheet. For the six months ended June 30, 2012 compared to June 30, 2011, the yields on earning assets decreased 28 basis points, while the cost of our interest bearing funds decreased by 36 basis points.

Assuming no significant change in market interest rates, we anticipate a relatively stable net interest margin in the near term as we do not expect interest rates to rise in the near future, we do not expect significant growth in our interest earning assets, nor do we expect our nonperforming asset balances to decline significantly in the near future. We continue to monitor the net interest margin through net interest income simulation to minimize the potential for any significant negative impact. See the "Market Risk Management" section for further discussion of the impact changes in market interest rates could have on us. Further analysis of our yields on interest earning assets and interest bearing liabilities are presented in Tables I and II below.





Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Table I - Average Balance Sheet and Net Interest Income Analysis

Dollars in thousands

	For the Six Months Ended					
	June 30, 2012			June 30, 2011		
	Average Balance	Earnings/Expense	Yield/Rate	Average Balance	Earnings/Expense	Yield/Rate
Interest earning assets						
Loans, net of unearned income (1)						
Taxable	\$969,965	\$28,239	5.85%	\$993,905	\$29,967	6.08%
Tax-exempt (2)	7,034	253	7.23%	4,861	195	8.09%
Securities						
Taxable	234,584	3,252	2.79%	270,338	5,183	3.87%
Tax-exempt (2)	71,318	2,111	5.95%	44,434	1,492	6.77%
Federal funds sold and interest bearing deposits with other banks						
Total interest earning assets	1,307,178	33,879	5.21%	1,353,613	36,882	5.49%
Noninterest earning assets						
Cash & due from banks	4,169			3,894		
Premises and equipment	21,818			22,857		
Other assets	124,321			114,467		
Allowance for loan losses	(18,377)			(18,095)		
Total assets	\$1,439,109			\$1,476,736		
Interest bearing liabilities						
Interest bearing demand deposits						
Savings deposits	\$163,228	\$164	0.20%	\$150,437	\$201	0.27%
Time deposits	210,030	733	0.70%	204,666	1,005	0.99%
Short-term borrowings	543,169	6,176	2.29%	615,953	8,204	2.69%
Long-term borrowings and capital trust securities	15,145	16	0.21%	1,886	2	0.21%
and capital trust securities	300,433	5,996	4.01%	321,370	6,635	4.16%

Edgar Filing: SUMMIT FINANCIAL GROUP INC - Form 10-Q

Total interest bearing liabilities	1,232,005	13,085	2.14%	1,294,312	16,047	2.50%
Noninterest bearing liabilities and shareholders' equity						
Demand deposits	90,498			82,142		
Other liabilities	11,323			9,378		
Total liabilities	1,333,826			1,385,832		
Shareholders' equity						
- preferred	9,326			3,519		
- common	95,957			87,385		
Total liabilities and shareholders' equity	\$1,439,109			\$1,476,736		
Net interest earnings		\$20,794			20,835	
Net yield on interest earning assets			3.20%			3.10%

(1) For purposes of this table, nonaccrual loans are included in average loan balances.

(2) - Interest income on tax-exempt securities and loans has been adjusted assuming an effective tax rate of 34% for all periods presented.

The tax equivalent adjustment resulted in an increase in interest income of \$805,000 and \$573,000 for the periods ended

June 30, 2012 and June 30, 2011, respectively.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Table II - Changes in Interest Margin Attributable to Rate and  
Volume

In thousands	For the Six Months Ended		
	June 30, 2012 versus June 30, 2011		
	Increase (Decrease) Due to Change		
	in:		
	Volume	Rate	Net
Interest earned on:			
Loans			
Taxable	\$(681)	\$(1,047)	\$(1,728)
Tax-exempt	80	(22)	58
Securities			
Taxable	(621)	(1,310)	(1,931)
Tax-exempt	817	(198)	619
Federal funds sold and interest bearing deposits with other banks			
	(16)	(5)	(21)
Total interest earned on interest earning assets			
	(421)	(2,582)	(3,003)
Interest paid on:			
Interest bearing demand deposits			
	16	(53)	(37)
Savings deposits	26	(298)	(272)
Time deposits	(898)	(1,130)	(2,028)
Short-term borrowings			
	14	-	14
Long-term borrowings and capital trust securities			
	(411)	(228)	(639)
Total interest paid on interest bearing liabilities			
	(1,253)	(1,709)	(2,962)
Net interest income	\$832	\$(873)	\$(41)

Noninterest Income

Total noninterest income increased to \$2,531,000 for the first six months of 2012, compared to \$1,374,000 for the same period of 2011, with losses on the sales of assets, primarily foreclosed properties, other-than-temporary impairment charges on securities and writedowns of foreclosed properties to their estimated fair value being the primary negative components. Further detail regarding noninterest income is reflected in the following table.

Table III - Noninterest Income

Dollars in thousands	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Insurance commissions	\$1,141	\$1,142	\$2,299	\$2,384
Service fees related to deposit accounts	1,075	1,057	2,089	1,945
Realized securities gains (losses)	320	318	1,485	1,946
Other-than-temporary impairment of securities	(106)	(533)	(335)	(1,761)
Gain (loss) on sale of assets	(523)	76	(599)	147
Bank owned life insurance income	250	172	525	303
Writedown of foreclosed properties	(1,631)	(689)	(3,543)	(4,132)
Other	302	312	610	542
Total	\$828	\$1,855	\$2,531	\$1,374

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Other-than-temporary impairment of securities: During the first six months of 2012, we recorded non-cash other-than-temporary impairment charges of \$335,000 related to certain residential mortgage-backed securities which we continue to own.

Gain/(loss) on sale of assets: During second quarter 2012, we recognized \$523,000 in losses on sales of assets, principally foreclosed properties.

Writedown of foreclosed properties: During the first six months of 2012, we recorded \$3,543,000 in charges to writedown certain OREO properties to fair value less estimated costs to sell as part of our normal, ongoing re-appraisal process. Continued volatility in the real estate markets could result in further writedowns of these properties in the foreseeable future.

#### Noninterest Expense

Total noninterest expense decreased slightly for the six months ended June 30, 2012, as compared to the same period in 2011. While professional fees, primarily related to complex collection issues relative to our problem assets, continue to increase, FDIC premiums are lower in 2012 due to our lower deposit base and a change in the assessment base used in calculating FDIC premiums that became effective during second quarter 2011. Other expenses are higher for the six months ended June 30, 2012 due to the refund during first quarter 2011 of Virginia business franchise taxes. Table IV below shows the breakdown of the changes.

Table IV -  
Noninterest Expense

Dollars in thousands	For the Quarter Ended June 30,			For the Six Months Ended June 30,				
	2012	\$	Change %	2011	2012	\$	Change %	2011
Salaries, commissions, and employee benefits	\$3,892	\$(163)	-4.0%	\$4,055	\$7,793	\$(235)	-2.9%	\$8,028
Net occupancy expense	490	9	1.9%	481	969	(21)	-2.1%	990
Equipment expense	603	22	3.8%	581	1,196	35	3.0%	1,161
Professional fees	227	34	17.6%	193	531	142	36.5%	389
Amortization of intangibles	88	-	0.0%	88	176	-	0.0%	176
FDIC premiums	500	(86)	-14.7%	586	1,022	(257)	-20.1%	1,279
Foreclosed properties expense	248	(164)	-39.8%	412	623	(223)	-26.4%	846
Other	1,247	(129)	-9.4%	1,376	2,525	515	25.6%	2,010
Total	\$7,295	\$(477)	-6.1%	\$7,772	\$14,835	\$(44)	-0.3%	\$14,879

## Credit Experience

Due to continued recessionary economic conditions, borrowers have in many cases been unable to refinance their loans to a range of factors including declining property values and elevated unemployment levels. As a result, we have experienced higher delinquencies and nonperforming assets, particularly with regard to our construction & development, residential real estate, and commercial real estate loan portfolios. It is not known when the housing market will stabilize. Management anticipates loan delinquencies will remain higher than historical levels in the near term, and we anticipate that nonperforming assets will remain elevated for the foreseeable future.

The provision for loan losses represents charges to earnings necessary to maintain an adequate allowance for probable credit losses inherent in the loan portfolio. Our determination of the appropriate level of the allowance is based on an ongoing analysis of credit quality and loss potential in the loan portfolio, change in the composition and risk characteristics of the loan portfolio, and the anticipated influence of national and local economic conditions. The adequacy of the allowance for loan losses is reviewed quarterly and adjustments are made as considered necessary.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

We recorded \$4,002,000 and \$6,000,000 provisions for loan losses for the first six months of 2012 and 2011, respectively. Although the level of impaired loans has increased over the past year as well as specific reserves on impaired loans, the level of historic charge-offs has continued to decline, requiring lower levels of FAS 5 reserves. As illustrated in Table V below, our non-performing assets have decreased since year end 2011.

Table V - Summary of  
Non-Performing Assets

Dollars in thousands	2012	June 30, 2011	December 31, 2011
Accruing loans past due 90 days or more	\$ -	\$ 2	\$ 344
Nonaccrual loans			
Commercial	6,476	2,212	3,260
Commercial real estate	3,536	8,093	7,163
Commercial construction and development	662	-	1,052
Residential construction and development	16,735	19,222	22,289
Residential real estate	18,550	9,237	18,187
Consumer	78	128	145
Total nonaccrual loans	46,037	38,892	52,096
Foreclosed properties			
Commercial	-	597	-
Commercial real estate	12,029	14,179	15,721
Commercial construction and development	18,632	16,886	17,101
Residential construction and development	26,014	30,512	27,877
Residential real estate	3,393	4,014	3,239
Consumer	-	-	-
Total foreclosed properties	60,068	66,188	63,938
Repossessed assets	-	264	263
Total nonperforming assets	\$ 106,105	\$ 105,346	\$ 116,641
Total nonperforming loans as a percentage of total loans	4.76 %	3.93 %	5.33 %
Total nonperforming assets as a percentage of total assets	7.49 %	7.18 %	8.04 %

The following table details the activity regarding our foreclosed properties for the three months and six months ended June 30, 2012 and 2011.



Table VI - Foreclosed Property Activity	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
Dollars in thousands	2012	2011	2012	2011
Beginning balance	\$ 61,584	\$ 66,961	\$ 63,938	\$ 70,235
Acquisitions	3,937	2,525	5,021	4,232
Improvements	309	484	521	610
Disposals	(4,130 )	(3,093 )	(5,449 )	(4,757 )
Writedowns to fair value	(1,631 )	(689 )	(3,543 )	(4,132 )
Reclassification of covered loans	(1 )	-	(420 )	-
Balance June 30	\$ 60,068	\$ 66,188	\$ 60,068	\$ 66,188

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

The following table details our most significant nonperforming loan relationships at June 30, 2012.

Table VII - Significant Nonperforming Loan Relationships

June 30,

2012

Dollars in thousands

Location	Underlying Collateral	Loan Origination Date	Loan Nonaccrual Date	Loan Balance	Method Used to Measure Impairment	Most Recent Appraised Value	Amount Allocated to Allowance for Loan Losses	Amount Previously Charged-off
Southwestern WV	Accounts Receivable, Inventory, Equipment, & Commercial Real Estate	Oct. 2007	Jun. 2012	\$ 3,860	PV Cash Flow	\$ 3,311	(2 ) \$ -	\$ -
Northern VA	Five residential lots, one commercial lot, and one single family residence	Jun. 2005, July 2005, Sept. 2005, Jan. 2006, & Aug. 2006	Jun. 2012	\$ 3,622	Collateral Value	\$ 2,810	(1 ) \$ 1,097	\$ -
Shenandoah Valley, VA	Residential subdivision & building lot	Sept. 2005 & Feb. 2009	Dec. 2011	\$ 1,056	Collateral value	\$ 1,316	(1 ) \$ -	\$ 789
Shenandoah Valley, VA	Residential Building Lots	Aug. 2004, July 2005, & July 2007	Jun. 2011	\$ 2,091	Collateral value	\$ 1,860	(1 ) \$ 431	\$ -
Northern VA	Single family residence & Business Investment	Aug. 2007, Oct. 2007 & Sept. 2008	Dec. 2011	\$ 12,592	Collateral value	\$ 16,714	(1 ) \$ 935	\$ -
Maryland	7 Single family residences	Aug., Sept., Oct. & Dec. 2008 & Feb.	Feb. 2012	\$ 1,086	Collateral value	\$ 602	(3 ) \$ 555	\$ -

2009

Eastern Panhandle, WV	Residential development & undeveloped acreage	Mar. 2008 & June 2008	Jun. 2011	\$ 8,380	Collateral value	\$ 8,158	(1 )	\$ 1,100	\$ -
Shenandoah Valley, VA	Residential Subdivision & 2 single family residential building lots	Jun. 2008	Sept. 2011	\$ 2,137	Collateral value	\$ 1,792	(1 )	\$ 504	\$ -
Southcentral WV	UCC Business Assets & Residential Subdivision	Feb. 2003, Mar. 2008 & Apr. 2008	May 2011 & Jul. 2011	\$ 1,246	Collateral value	\$ 1,653	(2 )	\$ 31	\$ -

(1) - Values are based upon recent external appraisal.

(2) - Value is based upon current appraisal on the real estate and most recent estimate on business assets.

(3) - Value is based upon 2012 tax assessments or the contract price if the property is under contract.

Refer to Note 6 of the accompanying consolidated financial statements for information regarding our past due loans, impaired loans, nonaccrual loans, and troubled debt restructurings.

We maintain the allowance for loan losses at a level considered adequate to provide for estimated probable credit losses inherent in the loan portfolio. The allowance is comprised of three distinct reserve components: (1) specific reserves related to loans individually evaluated, (2) quantitative reserves related to loans collectively evaluated, and (3) qualitative reserves related to loans collectively evaluated. A summary of the methodology we employ on a quarterly basis with respect to each of these components in order to evaluate the overall adequacy of our allowance for loan losses is as follows:

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Specific Reserve for Loans Individually Evaluated

First, we identify loan relationships having aggregate balances in excess of \$500,000 and that may also have credit weaknesses. Such loan relationships are identified primarily through our analysis of internal loan evaluations, past due loan reports, and loans adversely classified by regulatory authorities. Each loan so identified is then individually evaluated to determine whether it is impaired – that is, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the contractual terms of the underlying loan agreement.

Substantially all of our impaired loans are and historically have been collateral dependent, meaning repayment of the loan is expected to be provided solely from the sale of the loan's underlying collateral. For such loans, we measure impairment based on the fair value of the loan's collateral, which is generally determined utilizing current appraisals. A specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over the fair value of its underlying collateral, less estimated costs to sell. Our policy is to re-evaluate the fair value of collateral dependent loans at least every twelve months unless there is a known deterioration in the collateral's value, in which case a new appraisal is obtained.

Quantitative Reserve for Loans Collectively Evaluated

Second, we stratify the loan portfolio into the following ten loan pools: land and land development, construction, commercial, commercial real estate -- owner-occupied, commercial real estate -- non-owner occupied, conventional residential mortgage, jumbo residential mortgage, home equity, consumer, and other. Loans within each pool are then further segmented between (1) loans which were individually evaluated for impairment and not deemed to be impaired, (2) larger-balance loan relationships exceeding \$2 million which are assigned an internal risk rating in conjunction with our normal ongoing loan review procedures and (3) smaller-balance homogenous loans.

Quantitative reserves relative to each loan pool are established as follows: for all loan segments detailed above an allocation equaling 100% of the respective pool's average 12 month historical net loan charge-off rate (determined based upon the most recent twelve quarters) is applied to the aggregate recorded investment in the pool of loans.

Qualitative Reserve for Loans Collectively Evaluated

Third, we consider the necessity to adjust our average historical net loan charge-off rates relative to each of the above ten loan pools for potential risks factors that could result in actual losses deviating from prior loss experience. For example, if we observe a significant increase in delinquencies within the conventional mortgage loan pool above historical trends, an additional allocation to the average historical loan charge-off rate is applied. Such qualitative risk factors considered are: (1) levels of and trends in delinquencies and impaired loans, (2) levels of and trends in charge-offs and recoveries, (3) trends in volume and term of loans, (4) effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practice, (5) experience, ability, and depth of lending management and other relevant staff, (6) national and local economic trends and conditions, (7) industry conditions, and (8) effects of changes in credit concentrations.

Relationship between Allowance for Loan Losses, Net Charge-offs and Nonperforming Loans

In analyzing the relationship between the allowance for loan losses, net loan charge-offs and nonperforming loans, it is helpful to understand the process of how loans are treated as they deteriorate over time. Reserves for loans are

established at origination through the quantitative and qualitative reserve process discussed above.

Charge-offs, if necessary, are typically recognized in a period after the reserves were established. If the previously established reserves exceed that needed to satisfactorily resolve the problem credit, a reduction in the overall level of the reserve could be recognized. In summary, if loan quality deteriorates, the typical credit sequence is periods of reserve building, followed by periods of higher net charge-offs.

Consumer loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), whichever is earlier.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Commercial-related loans (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination includes many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity.

Substantially all of our nonperforming loans are secured by real estate. The substantial majority of these loans were underwritten in accordance with our loan-to-value policy guidelines which range from 70-85% at the time of origination. Although property values have deteriorated across our market areas, the fair values of the underlying collateral value remains in excess of the recorded investment in many of our nonperforming loans, and therefore, no specific reserve allocation is required; as of June 30, 2012, approximately 66% of our impaired loans required no reserves or have been charged down to their fair value. Our allowance may or may not fluctuate proportionately as our nonperforming loans fluctuate. The allowance for loan loss will, however, increase as a result of an increase in net loan charge-offs due to the incremental higher historical net charge-off rate applied to the loans which are collectively evaluated for impairment.

At June 30, 2012, our allowance for loan losses totaled \$17,890,000, or 1.85% of total loans, and is considered adequate to cover our estimate of probable credit losses inherent in our loan portfolio. At December 30, 2011 and June 30, 2011, our allowance for loan losses totaled \$17,712,000, or 1.80% of total loans and \$18,016,000, or 1.82% of total loans, respectively.

At June 30, 2012, December 31, 2011, and June 30, 2011, we had approximately \$60,068,000, \$63,938,000 and \$66,188,000, respectively, in other real estate owned which was obtained as the result of foreclosure proceedings. Although foreclosed property is recorded at fair value less estimated costs to sell, the prices ultimately realized upon their sale may or may not result in us recognizing loss.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

## FINANCIAL CONDITION

Our total assets were \$1,416,441,000 at June 30, 2012, compared to \$1,450,121,000 at December 31, 2011, representing a 2.32% decrease. Table VIII below serves to illustrate significant changes in our financial position between December 31, 2011 and June 30, 2012.

Table VIII - Summary of Significant Changes in Financial Position

Dollars in thousands	Balance	Increase (Decrease)		Balance
	December 31, 2011	Amount	Percentage	June 30, 2012
<b>Assets</b>				
Securities available for sale	\$ 286,599	\$ 2,552	0.9 %	\$ 289,151
Loans, net of unearned interest	983,228	(17,044)	-1.7 %	966,184
<b>Liabilities</b>				
Deposits	\$ 1,016,500	\$ (14,830)	-1.5 %	\$ 1,001,670
Short-term borrowings	15,956	(4,999 )	-31.3 %	10,957
Long-term borrowings	270,254	(16,619)	-6.1 %	253,635
Subordinated debentures	16,800	-	0.0 %	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	-	0.0 %	19,589

Loans decreased 1.7% and securities increased slightly during the first six months of 2012. We have slowed our loan growth due to the current weakened economic conditions in our market areas and limited availability of new capital resources.

Deposits decreased approximately \$14.8 million during the first six months of 2012; wholesale deposits increased approximately \$1.8 million while retail deposits decreased approximately \$16.6 million.

The decrease in long term borrowings is primarily attributable to maturities and repayments of long-term FHLB advances during the first six months of 2012.

Refer to Notes 5, 6, 9, and 10 of the notes to the accompanying consolidated financial statements for additional information with regard to changes in the composition of our securities, loans, deposits and borrowings between June

30, 2012 and December 31, 2011.

## LIQUIDITY AND CAPITAL RESOURCES

Liquidity reflects our ability to ensure the availability of adequate funds to meet loan commitments and deposit withdrawals, as well as provide for other transactional requirements. Liquidity is provided primarily by funds invested in cash and due from banks (net of float and reserves), Federal funds sold, non-pledged securities, and available lines of credit with the Federal Home Loan Bank of Pittsburgh (“FHLB”) and Federal Reserve Bank of Richmond, which totaled approximately \$390 million or 27.5% of total consolidated assets at June 30, 2012.

Our liquidity strategy is to fund loan growth with deposits and other borrowed funds while maintaining an adequate level of short- and medium-term investments to meet normal daily loan and deposit activity. As a member of the FHLB, we have access to approximately \$332 million. As of June 30, 2012 and December 31, 2011, these advances totaled approximately \$168 million and \$175 million, respectively. At June 30, 2012, we had additional borrowing capacity of \$164 million through FHLB programs. We have established a line with the Federal Reserve Bank to be used as a contingency liquidity vehicle. The amount available on this line at June 30, 2012 was approximately \$91 million, which is secured by a pledge of our consumer and commercial and industrial loan portfolios. Also, we classify all of our securities as available for sale to enable us to liquidate them if the need arises.

Liquidity risk represents the risk of loss due to the possibility that funds may not be available to satisfy current or future commitments based on external market issues, customer or creditor perception of financial strength, and events unrelated to Summit such as war, terrorism, or financial institution market specific issues. The Asset/Liability Management Committee (“ALCO”), comprised of members of senior management and certain members of the Board of Directors, oversees our liquidity risk management process. The ALCO develops and recommends policies and limits governing our liquidity to the Board of Directors for approval with the objective of ensuring that we can obtain cost-effective funding to meet current and future obligations, as well as maintain sufficient levels of on-hand liquidity, under both normal and “stressed” circumstances.



Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

One aspect of our liquidity management process is establishing contingency liquidity funding plans under various scenarios in order to prepare for unexpected liquidity shortages or events. The following represents three "stressed" liquidity circumstances and our related contingency plans with respect to each.

Scenario 1 – Summit Community's capital status becomes less than "well capitalized". Banks which are less than "well capitalized" in accordance with regulatory capital guidelines are prohibited from issuing new brokered deposits without first obtaining a waiver from the FDIC to do so. In the event Summit Community's capital status were to fall below well capitalized and was not successful in obtaining the FDIC's waiver to issue new brokered deposits, Summit Community:

- Would have limited amounts of maturing brokered deposits to replace in the short-term, as we have limited our brokered deposits maturing in any one quarter to no more than \$50 million.
- Presently has \$390 million in available sources of liquid funds which could be drawn upon to fund maturing brokered deposits until Summit Community had restored its capital to well capitalized status.
- Would first seek to restore its capital to well capitalized status through capital contributions from Summit, its parent holding company. Summit has present reserves in excess of \$6.5 million available for capital infusion into Summit Community.
- Would generally have no more than \$100 million in brokered deposits maturing in any one year time frame, which is well within its presently available sources of liquid funds, if in the event Summit does not have the capital resources to restore Summit Community's capital to well capitalized status. One year would give Summit Community ample time to raise alternative funds either through retail deposits or the sale of assets, and obtain capital resources to restore it to well capitalized status.

Scenario 2 – Summit Community's credit quality deteriorates such that the FHLB restricts further advances. If in the event that the Bank's credit quality deteriorated to the point that further advances under its line with the FHLB were restricted, Summit Community:

- Would severely curtail lending and other growth activities until such time as access to this line could be restored, thus eliminating the need for net new advances, and
- Would still have available current liquid funding sources secured by unencumbered loans and securities totaling \$284 million aside from its FHLB line, which would result in a funding source of approximately \$228 million.

Scenario 3 – A competitive financial institution offers a retail deposit program at interest rates significantly above current market rates in the Summit Community's market areas. If a competitive financial institution offered a retail deposit program at rates well in excess of current market rates in the Summit Community's market area, the Bank:

- Presently has \$390 million in available sources of liquid funds which could be drawn upon immediately to fund any "net run off" of deposits from this activity.
- Would severely curtail lending and other growth activities so as to preserve the availability of as much contingency funds as possible.
- Would begin offering its own competitive deposit program when deemed prudent so as to restore the retail deposits lost to the competition.

We continuously monitor our liquidity position to ensure that day-to-day as well as anticipated funding needs are met. We are not aware of any trends, commitments, events or uncertainties that have resulted in or are reasonably likely to result in a material change to our liquidity.

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

One of our continuous goals is maintenance of a strong capital position. Through management of our capital resources, we seek to provide an attractive financial return to our shareholders while retaining sufficient capital to support future growth. Shareholders' equity at June 30, 2012 totaled \$105,707,000 compared to \$102,566,000 at December 31, 2011.

Summit and Summit Community have each entered into informal Memoranda of Understanding ("MOU's") with their respective regulatory authorities. A memorandum of understanding is characterized by the regulatory authorities as an informal action that is not published or publicly available and that is used when circumstances warrant a milder form of action than a formal supervisory action, such as a formal written agreement or order. Among other things, under the MOU's, Summit's management team has agreed to:

- Summit Community achieving and maintaining a minimum Tier 1 leverage capital ratio of at least 8% and a total risk-based capital ratio of at least 11%;
- Summit Community providing 30 days prior notice of any declaration of intent to pay cash dividends to provide the Bank's regulatory authorities an opportunity to object;
- Summit suspending all cash dividends on its common stock until further notice. Dividends on all preferred stock, as well as interest payments on subordinated notes underlying Summit's trust preferred securities, continue to be permissible; and,
- Summit not incurring any additional debt, other than trade payables, without the prior written consent of the banking regulators.

Management presently believes Summit and the Bank are in compliance with all provisions of the MOUs.

Dividends on Summit's preferred stock, as well as interest payments on our subordinated debt and junior subordinated debentures underlying our trust preferred securities, continue to be permissible. However, such dividends and interest payments on our preferred stock and trust preferred debt are subject to future review by the regulatory authorities should we continue to experience deterioration in our financial condition.

Although dividends from Summit Community are the principal source of funds to pay dividends, interest, and principal payments on Summit's preferred stock, subordinated debentures (including those owed to unconsolidated subsidiary trusts), and term bank borrowing, we currently have sufficient cash on hand to continue to service our subordinated debentures and term bank borrowing obligations as well as the dividend payments on our preferred stock through at least 2013. Nevertheless, we can make no assurances that we will continue to have sufficient funds available for Summit's debt service and for distributions to the holders of our preferred stock.

Refer to Note 13 of the notes to the accompanying consolidated financial statements for additional information regarding regulatory restrictions on our capital as well as our subsidiaries' capital.



Summit Financial Group, Inc. and Subsidiaries  
 Management's Discussion and Analysis of Financial Condition and  
 Results of Operations

### CONTRACTUAL CASH OBLIGATIONS

During our normal course of business, we incur contractual cash obligations. The following table summarizes our contractual cash obligations at June 30, 2012.

Table IX -  
 Contractual Cash  
 Obligations

Dollars in thousands	Long Term Debt	Capital Trust Securities	Operating Leases
2012	\$ 50,818	\$ -	\$ 123
2013	41,898	-	235
2014	83,429	-	175
2015	11,909	-	21
2016	1,911	-	-
Thereafter	80,470	19,589	-
Total	\$ 270,435	\$ 19,589	\$ 554

### OFF-BALANCE SHEET ARRANGEMENTS

We are involved with some off-balance sheet arrangements that have or are reasonably likely to have an effect on our financial condition, liquidity, or capital. These arrangements at June 30, 2012 are presented in the following table.

Table X - Off-Balance Sheet  
 Arrangements

Dollars in thousands	June 30, 2012
Commitments to extend credit:	
Revolving home equity and credit card lines	\$ 46,513
Construction loans	13,407
Other loans	35,719
Standby letters of credit	2,036
Total	\$ 97,675

Summit Financial Group, Inc. and Subsidiaries  
 Management's Discussion and Analysis of Financial Condition and  
 Results of Operations

MARKET RISK MANAGEMENT

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. Interest rate risk is our primary market risk and results from timing differences in the repricing of assets, liabilities and off-balance sheet instruments, changes in relationships between rate indices and the potential exercise of imbedded options. The principal objective of asset/liability management is to minimize interest rate risk and our actions in this regard are taken under the guidance of our Asset/Liability Management Committee ("ALCO"), which is comprised of members of senior management and members of the Board of Directors. The ALCO actively formulates the economic assumptions that we use in our financial planning and budgeting process and establishes policies which control and monitor our sources, uses and prices of funds.

Some amount of interest rate risk is inherent and appropriate to the banking business. Our net income is affected by changes in the absolute level of interest rates. Our interest rate risk position is liability sensitive. The nature of our lending and funding activities tends to drive our interest rate risk position to being liability sensitive. That is, absent any changes in the volumes of our interest earning assets or interest bearing liabilities, liabilities are likely to reprice faster than assets, resulting in a decrease in net income in a rising rate environment. Net income would increase in a falling interest rate environment. Net income is also subject to changes in the shape of the yield curve. In general, a flattening yield curve would result in a decline in our earnings due to the compression of earning asset yields and funding rates, while a steepening would result in increased earnings as margins widen.

Several techniques are available to monitor and control the level of interest rate risk. We primarily use earnings simulations modeling to monitor interest rate risk. The earnings simulation model forecasts the effects on net interest income under a variety of interest rate scenarios that incorporate changes in the absolute level of interest rates and changes in the shape of the yield curve. Each increase or decrease in interest rates is assumed to gradually take place over the next 12 months, and then remain stable, except for the up 400 scenario, which assumes a gradual increase in rates over 24 months. Assumptions used to project yields and rates for new loans and deposits are derived from historical analysis. Securities portfolio maturities and prepayments are reinvested in like instruments. Mortgage loan prepayment assumptions are developed from industry estimates of prepayment speeds. Noncontractual deposit repricings are modeled on historical patterns.

The following table presents the estimated sensitivity of our net interest income to changes in interest rates, as measured by our earnings simulation model as of June 30, 2012. The sensitivity is measured as a percentage change in net interest income given the stated changes in interest rates (gradual change over 12 months, stable thereafter for the up and down 100 and the up 200 scenarios, and gradual change over 24 months for the up 400 scenario) compared to net interest income with rates unchanged in the same period. The estimated changes set forth below are dependent on the assumptions discussed above and are well within our ALCO policy limit, which is a 10% reduction in net interest income over the ensuing twelve month period.

Change in Interest Rates (basis points)	Estimated % Change in Net Interest Income Over:
---	---

	0-12 Months		13-24 Months	
Down 100 (1)	0.69	%	3.55	%
Up 100 (1)	-2.38	%	-3.92	%
Up 200 (1)	-4.38	%	-5.74	%
Up 400 (2)	-4.38	%	-7.80	%

(1) assumes a parallel shift in the yield curve

(2) assumes 400 bp increase over 24 months

Summit Financial Group, Inc. and Subsidiaries  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations

CONTROLS AND PROCEDURES

Our management, including the Chief Executive Officer and Chief Financial Officer, has conducted as of June 30, 2012, an evaluation of the effectiveness of disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures as of June 30, 2012 were effective. There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



Summit Financial Group, Inc. and Subsidiaries  
 Part II. Other Information

Item 1. Legal Proceedings

We are involved in various legal actions arising in the ordinary course of business. In the opinion of management, the outcome of these matters will not have a significant adverse effect on the consolidated financial statements.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2011.

Item 6. Exhibits

Exhibit 3.i	Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.
Exhibit 3.ii	Articles of Amendment 2009
Exhibit 3.iii	Articles of Amendment 2011
Exhibit 3.iv	Amended and Restated By-Laws of Summit Financial Group, Inc.
Exhibit 11	Statement re: Computation of Earnings per Share – Information contained in Note 4 to the Consolidated Financial Statements on page 15 of this Quarterly Report is incorporated herein by reference.
Exhibit 31.1	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer
Exhibit 31.2	Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer
Exhibit 32.1	Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer
Exhibit 32.2	Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer
Exhibit 101	Interactive Data File (XBRL)

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SUMMIT FINANCIAL GROUP, INC.  
(registrant)

By: /s/ H. Charles Maddy, III  
H. Charles Maddy, III,  
President and Chief Executive Officer

By: /s/ Robert S. Tissue  
Robert S. Tissue,  
Senior Vice President and Chief Financial Officer

By: /s/ Julie R. Cook  
Julie R. Cook,  
Vice President and Chief Accounting Officer

Date: August 9, 2012

## EXHIBIT INDEX

Exhibit No.	Description	Page Number
(3)	Articles of Incorporation and By-laws:	
	(i) Amended and Restated Articles of Incorporation of (a) Summit Financial Group, Inc.	
	(ii) Articles of Amendment 2009	(b)
	(iii) Articles of Amendment 2011	(c)
	(iv) Amended and Restated By-laws of Summit Financial Group, Inc.	(d)
11	Statement re: Computation of Earnings per Share	15
31.1	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer	
31.2	Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer	
32.1*	Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer	
32.2*	Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer	
101**	Interactive data file (XBRL)	

\* Furnished, not filed.

\*\*As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

- (a) Incorporated by reference to Exhibit 3.i of Summit Financial Group, Inc.'s filing on Form 10-Q dated March 31, 2006.
- (b) Incorporated by reference to Exhibit 3.1 of Summit Financial Group, Inc.'s filing on Form 8-K dated September 30, 2009.
- (c) Incorporated by reference to Exhibit 3.1 of Summit Financial Group, Inc.'s filing on Form 8-K dated November 3, 2011.
- (d) Incorporated by reference to Exhibit 3.2 of Summit Financial Group, Inc.'s filing on Form 10-Q dated June 30, 2006.

