

SUMMIT FINANCIAL GROUP INC  
Form 10-Q  
May 12, 2014

---

---

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 March 31, 2014

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                      55-0672148  
(State or other                      (IRS Employer  
jurisdiction of  
incorporation or                      Identification No.)  
organization)

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

(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   
b

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

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

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  
7,457,222 shares outstanding as of May 5, 2014

---

Summit Financial Group, Inc. and Subsidiaries  
Table of Contents

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated balance sheets March 31, 2014 (unaudited), December 31, 2013, and March 31, 2013 (unaudited)	<u>4</u>
Consolidated statements of income for the three months ended March 31, 2014 and 2013 (unaudited)	<u>5</u>
Consolidated statements of comprehensive income for the three months ended March 31, 2014 and 2013 (unaudited)	<u>6</u>
Consolidated statements of shareholders' equity for the three months ended March 31, 2014 and 2013 (unaudited)	<u>7</u>
Consolidated statements of cash flows for the three months ended March 31, 2014 and 2013 (unaudited)	<u>8-9</u>
Notes to consolidated financial statements (unaudited)	<u>10-42</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>43-58</u>
Item 3. Quantitative and Qualitative Disclosures about Market Risk	<u>56</u>
Item 4. Controls and Procedures	<u>57</u>

Summit Financial Group, Inc. and Subsidiaries  
Table of Contents

PART OTHER INFORMATION

II.

Item 1.	Legal Proceedings	<u>58</u>
Item 1A.	Risk Factors	<u>58</u>
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	<u>58</u>
SIGNATURES		<u>59</u>
EXHIBIT INDEX		<u>60</u>

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

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

Dollars in thousands	March 31, 2014 (unaudited)	December 31, 2013 (*)	March 31, 2013 (unaudited)
<b>ASSETS</b>			
Cash and due from banks	\$ 3,827	\$ 3,442	\$ 3,906
Interest bearing deposits with other banks	13,424	8,340	7,915
Cash and cash equivalents	17,251	11,782	11,821
Securities available for sale	281,865	288,780	283,054
Other investments	6,610	7,815	12,977
Loans held for sale, net	-	321	148
Loans, net	962,714	937,070	945,741
Property held for sale	52,241	53,392	54,625
Premises and equipment, net	20,457	20,623	21,024
Accrued interest receivable	5,410	5,669	5,543
Intangible assets	7,861	7,949	8,211
Cash surrender value of life insurance policies	35,881	35,611	29,791
Other assets	15,827	17,215	17,263
Total assets	\$ 1,406,117	\$ 1,386,227	\$ 1,390,198
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Liabilities</b>			
<b>Deposits</b>			
Non interest bearing	\$ 99,445	\$ 92,837	\$ 93,125
Interest bearing	953,185	910,975	973,192
Total deposits	1,052,630	1,003,812	1,066,317
Short-term borrowings	68,974	62,769	5,960
Long-term borrowings	123,492	163,516	163,588
Subordinated debentures	16,800	16,800	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589

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

Other liabilities	10,105	8,669	7,928
<b>Total liabilities</b>	<b>1,291,590</b>	<b>1,275,155</b>	<b>1,280,182</b>

**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

Series 2011, 8% Non-cumulative convertible preferred stock,

par value \$1.00; issued 2014- 11,914,

December 2013- 11,938 and March 2013- 12,000 shares

Common stock and related surplus - authorized 20,000,000 shares;

\$2.50 par value; issued and outstanding 2014 - 7,457,222,

December 2013 - 7,451,022, and March 2013- 7,437,472 shares

Retained earnings	79,330	77,134	71,440
-------------------	--------	--------	--------

Accumulated other comprehensive income	1,223	(21 )	4,668
--	-------	-------	-------

<b>Total shareholders' equity</b>	<b>114,527</b>	<b>111,072</b>	<b>110,016</b>
-----------------------------------	----------------	----------------	----------------

<b>Total liabilities and shareholders' equity</b>	<b>\$ 1,406,117</b>	<b>\$ 1,386,227</b>	<b>\$ 1,390,198</b>
---	---------------------	---------------------	---------------------

(\*) - December 31, 2013 financial information has been extracted from audited consolidated financial statements

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

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

	Three Months Ended	
	March 31,	March 31,
Dollars in thousands, except per share amounts	2014	2013
Interest income		
Interest and fees on loans		
Taxable	\$ 12,145	\$ 12,834
Tax-exempt	71	70
Interest and dividends on securities		
Taxable	1,282	1,030
Tax-exempt	570	634
Interest on interest bearing deposits with other banks	2	1
Total interest income	14,070	14,569
Interest expense		
Interest on deposits	2,241	2,768
Interest on short-term borrowings	53	17
Interest on long-term borrowings and subordinated debentures	1,738	2,026
Total interest expense	4,032	4,811
Net interest income	10,038	9,758
Provision for loan losses	1,000	1,500
Net interest income after provision for loan losses	9,038	8,258
Other income		
Insurance commissions	1,181	1,184
Service fees related to deposit accounts	1,043	1,012
Realized securities gains (losses)	(22 )	42
Bank owned life insurance income	270	238
Other	311	326
Total other-than-temporary impairment loss on securities	-	(91)
Portion of loss recognized in other comprehensive income	-	37
Net impairment loss recognized in earnings	-	(54)
Total other income	2,783	2,748



Other expense		
Salaries, commissions, and employee benefits	3,980	4,117
Net occupancy expense	541	456
Equipment expense	566	598
Professional fees	316	251
Amortization of intangibles	88	88
FDIC premiums	502	540
Foreclosed properties expense	254	279
Loss (gain) on sale of foreclosed properties	75	40
Writedown of foreclosed properties	928	929
Other	1,248	1,264
Total other expense	8,498	8,562
Income before income taxes	3,323	2,444
Income tax expense	934	651
Net Income	2,389	1,793
Dividends on preferred shares	193	194
Net Income applicable to common shares	\$ 2,196	\$ 1,599
Basic earnings per common share	\$ 0.29	\$ 0.22
Diluted earnings per common share	\$ 0.25	\$ 0.19

See Notes to  
Consolidated Financial  
Statements

Table of Contents

5

---

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

	For the Three Months Ended March 31,	
Dollars in thousands	2014	2013
Net income	\$ 2,389	\$ 1,793
Other comprehensive income (loss):		
Net unrealized (loss) on cashflow hedge of (\$1,211), net of deferred taxes of (\$448)	(763 )	-
Non-credit related other-than-temporary impairment on available for sale debt securities - 2014 - \$0, net of deferred taxes of \$0; 2013 - \$37, net of deferred taxes of \$14	-	(23)
Net unrealized gain (loss) on available for sale debt securities of:		
2014 - 3,186 net of deferred taxes of \$1,179 and reclassification adjustment for net realized (losses) included in net income of (\$22); 2013 - \$(285), net of deferred taxes of (\$108) and reclassification adjustment for net realized gains included in net income of \$42	2,007	(177)
Total comprehensive income	\$ 3,633	\$ 1,593

See Notes to Consolidated Financial Statements

Table of Contents

6

---

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

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 Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2013	\$3,519	\$5,776	\$24,664	\$77,134	\$ (21 )	\$111,072
Three Months Ended March 31, 2014						
Comprehensive income:						
Net income	-	-	-	2,389	-	2,389
Other comprehensive income					1,244	1,244
Total comprehensive income						3,633
Exercise of stock options	-	-	15	-	-	15
Stock compensation expense	-	-	-	-	-	-
Series 2009 Preferred Stock cash dividends declared (\$20.00 per share)	-	-	-	(74 )	-	(74)
Series 2011 Preferred Stock cash dividends declared (\$10.00 per share)	-	-	-	(119 )	-	(119)
Conversion of Series 2011 Preferred Stock to Common Stock	-	(12 )	12	-	-	-
Balance, March 31, 2014	\$3,519	\$5,764	\$24,691	\$79,330	\$ 1,223	\$114,527
Balance, December 31, 2012	\$3,519	\$5,807	\$24,520	\$69,841	\$ 4,868	\$108,555
Three Months Ended March 31, 2013						
Comprehensive income:						
Net income	-	-	-	1,793	-	1,793
Other comprehensive income					(200 )	(200)
Total comprehensive income						1,593
Exercise of stock options	-	-	61	-	-	61
Stock compensation expense	-	-	1	-	-	1
Series 2009 Preferred Stock cash dividends declared (\$20.00 per share)	-	-	-	(74 )	-	(74)
Series 2011 Preferred Stock cash dividends declared (\$10.00 per share)	-	-	-	(120 )	-	(120)

Balance, March 31, 2013	\$3,519	\$5,807	\$24,582	\$71,440	\$ 4,668	\$110,016
-------------------------	---------	---------	----------	----------	----------	-----------

Table of Contents

7

---

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

Dollars in thousands	Three Months Ended	
	March 31, 2014	March 31, 2013
Cash Flows from Operating Activities		
Net income	\$ 2,389	\$ 1,793
Adjustments to reconcile net earnings to net cash		
provided by operating activities:		
Depreciation	277	298
Provision for loan losses	1,000	1,500
Stock compensation expense	-	1
Deferred income tax (benefit)	(144 )	(160)
Loans originated for sale	(124 )	(1,224)
Proceeds from loans sold	445	1,302
Securities (gains) losses	22	(42)
Other-than-temporary impairment of securities	-	54
Loss on disposal of assets	75	40
Write down of foreclosed properties	928	929
Amortization of securities premiums (accretion of discounts), net	1,214	1,368
Amortization of goodwill and purchase accounting adjustments, net	91	91
Decrease in accrued interest receivable	259	78
(Increase) in cash surrender value of bank owned life insurance	(270 )	(237)
(Increase) decrease in other assets	(76 )	937
	1,028	119

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

Increase in other liabilities		
Net cash provided by operating activities	7,114	6,847
Cash Flows from Investing Activities		
Proceeds from maturities and calls of securities available for sale	2,051	808
Proceeds from sales of securities available for sale	18,157	11,893
Principal payments received on securities available for sale	8,782	15,712
Purchases of securities available for sale	(20,122)	(31,623)
Purchases of other investments	(692 )	-
Redemption of Federal Home Loan Bank Stock	1,897	1,674
Net principal payments received on loans	(27,942)	(11,417)
Purchases of premises and equipment	(110 )	(192)
Proceeds from sales of other repossessed assets & property held for sale	1,514	1,981
Net cash provided by (used in) investing activities	(16,465)	(11,164)
Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and savings accounts	51,336	2,702
Net increase (decrease) in time deposits	(2,518 )	36,490
Net increase in short-term borrowings	6,205	2,002
Proceeds from long-term borrowings	-	3,454
Repayment of long-term borrowings	(40,024)	(43,179)
Exercise of stock options	15	61
Dividends paid on preferred stock	(194 )	(194)
Net cash provided by (used in) financing activities	14,820	1,336
	5,469	(2,981)

(Decrease) increase in  
cash and cash equivalents

Cash and cash  
equivalents:

Beginning	11,782	14,802
Ending	\$ 17,251	\$ 11,821

(Continued)

See Notes to Consolidated  
Financial Statements

Table of Contents

8

---

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



Dollars in thousands	Three Months Ended	
	March 31, 2014	March 31, 2013

Supplemental  
Disclosures of Cash  
Flow Information

Cash payments

for:

Interest	\$ 4,272	\$ 5,047
Income taxes	\$ -	\$ -

Supplemental Schedule of Noncash  
Investing and Financing Activities

Other assets acquired in settlement of loans	\$ 1,297	\$ 1,343
--	----------	----------

See Notes to  
Consolidated  
Financial Statements

Table of Contents

9

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 March 31, 2014 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 2013 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2013 and March 31, 2013, as previously presented, have been reclassified to conform to current year classifications.

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU 2013-11, Income Taxes (Topic 740) - Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists requires that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. However, if a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments were effective for years, and interim periods within those years, beginning after December 15, 2013. The amendments are not expected to have a material impact on our consolidated financial statements.

ASU 2014-01, Investments (Topic 323) - Accounting for Investments in Affordable Housing Projects revises the necessary criteria that need to be met in order for an entity to account for investments in affordable housing projects net of the provision for income taxes. It also changes the method of recognition from an effective amortization approach to a proportional amortization approach. Additional disclosures were also set forth in this update. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. The amendments are required to be applied retrospectively to all periods presented. Early adoption is permitted. Management is currently evaluating the impact of the guidance on our consolidated financial statements.

ASU 2014-04, Receivables (Topic 310) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure clarifies that an in substance repossession or foreclosure occurs upon either the creditor obtaining legal title to the residential real estate property or the borrower conveying all interest in the

residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. The amendments may be adopted using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted. Management does not believe the amendments will have a material impact on our consolidated financial statements.

Table of Contents

10

---

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

### 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.

**Derivative Financial Instruments:** Derivative financial instruments are recorded at fair value on a recurring basis. Fair value measurement is based on pricing models run by a third-party, utilizing observable market-based inputs. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. As a result, we classify interest rate swaps as Level 2.

**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.

#### Table of Contents

11

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 original 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. Prior to January 1, 2014, substantially all impaired loans were valued based upon the fair value of their collateral. Beginning January 1, 2014, only impaired loans internally graded as substandard, doubtful, or loss are evaluated using the fair value of collateral method. 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. This change in accounting estimate did not have a material impact on our financial condition or results of operations.

When impaired loans are deemed required to be included in the fair value hierarchy, 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.

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 noninterest expense in the consolidated statements of income.

Table of Contents

12

## Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

Dollars in thousands	Balance at March 31, 2014	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 28,316	\$ -	\$ 28,316	\$ -
Mortgage backed securities:				
Government sponsored agencies	143,814	-	143,814	-
Nongovernment sponsored entities	10,787	-	10,787	-
State and political subdivisions	10,731	-	10,731	-
Corporate debt securities	3,998	-	3,998	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	84,142	-	84,142	-
Total available for sale securities	\$ 281,865	\$ -	\$ 281,865	\$ -
Derivative financial instrument				
Interest rate swaps	\$ -	\$ -	\$ -	

Dollars in thousands	Balance at December 31, 2013	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	\$ 29,657	\$ -	\$ 29,657	\$ -
Mortgage backed securities:				
Government sponsored agencies	155,716	-	155,716	-

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

Nongovernment sponsored entities	11,819	-	11,819	-
State and political subdivisions	15,870	-	15,870	-
Corporate debt securities	3,966	-	3,966	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	71,675	-	71,675	-
Total available for sale securities	\$ 288,780	\$ -	\$ 288,780	\$ -
Derivative financial instrument				
Interest rate swaps	\$ 803	\$ -	\$ 803	

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended March 31, 2014.

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.

Table of Contents

13

---

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

Dollars in thousands	Fair Value Measurements Using:			
	Total at March 31, 2014	Level 1	Level 2	Level 3
<b>Residential mortgage loans held for sale</b>				
	\$ -	\$ -	\$ -	\$ -
<b>Collateral-dependent impaired loans</b>				
Commercial	\$ 447		\$ 57	\$ 390
Commercial real estate	4,821	-	4,821	-
Construction and development	13,507	-	13,346	161
Residential real estate	9,063	-	8,837	226
Consumer	4	-	-	4
<b>Total collateral-dependent impaired loans</b>	<b>\$ 27,842</b>	<b>\$ -</b>	<b>\$ 27,061</b>	<b>\$ 781</b>
<b>OREO</b>				
Commercial	\$ -	\$ -	\$ -	\$ -
Commercial real estate	8,523	-	8,208	315
Construction and development	31,737	-	30,145	1,592
Residential real estate	11,981	-	11,949	32
<b>Total OREO</b>	<b>\$ 52,241</b>	<b>\$ -</b>	<b>\$ 50,302</b>	<b>\$ 1,939</b>

Dollars in thousands	Fair Value Measurements Using:			
	Total at December 31, 2013	Level 1	Level 2	Level 3
<b>Residential mortgage loans held for sale</b>				
	\$ 321	\$ -	\$ 321	\$ -
<b>Collateral-dependent impaired loans</b>				
Commercial	\$ 1,616		\$ 920	\$ 696
Commercial real estate	17,902	-	4,879	13,023
Construction and development	22,083	-	17,590	4,493



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

Residential real estate	14,747	-	8,336	6,411
Consumer	34	-	3	31
Total collateral-dependent impaired loans	\$ 56,382	\$ -	\$ 31,728	\$ 24,654
<b>OREO</b>				
Commercial	\$ -	\$ -	\$ -	\$ -
Commercial real estate	9,903	-	9,903	-
Construction and development	31,610	-	29,993	1,617
Residential real estate	11,879	-	11,847	32
Total OREO	\$ 53,392	\$ -	\$ 51,743	\$ 1,649

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 cash equivalents: The carrying values of cash and cash equivalents 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.

Table of Contents

14

---

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

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.

Derivative financial instruments: The fair value of the interest rate swaps is valued using independent pricing models.

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.

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

Table of Contents

15

---

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

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

Dollars in thousands	March 31, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial assets</b>				
Cash and due from banks	\$ 17,251	\$ 17,251	\$ 11,782	\$ 11,782
Securities available for sale	281,865	281,865	288,780	288,780
Other investments	6,610	6,610	7,815	7,815
Loans held for sale, net	-	-	321	321
Loans, net	962,714	981,849	937,070	952,592
Accrued interest receivable	5,410	5,410	5,669	5,669
Derivative financial instruments	-	-	803	803
	\$ 1,273,850	\$ 1,292,985	\$ 1,252,240	\$ 1,267,762
<b>Financial liabilities</b>				
Deposits	\$ 1,052,630	\$ 1,077,704	\$ 1,003,812	\$ 1,029,606
Short-term borrowings	68,974	68,974	62,769	62,769
Long-term borrowings	123,492	132,741	163,516	173,863
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	1,193	1,193	1,433	1,433
Derivative financial liabilities	408	408	-	-
	\$ 1,283,086	\$ 1,317,409	\$ 1,267,919	\$ 1,304,060

NOTE 4. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

2014	For the Three Months Ended March 31,	
	2013	2013
	Common	Common

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

Dollars in thousands, except per share amounts	Income (Numerator)	Shares (Denominator)	Per Share	Income (Numerator)	Shares (Denominator)	Per Share
Net income	\$ 2,389			\$ 1,793		
Less preferred stock dividends	(193 )			(194 )		
Basic EPS	\$ 2,196	7,453,370	\$ 0.29	\$ 1,599	7,432,254	\$ 0.22
Effect of dilutive securities:						
Stock options		9,762			7,087	
Series 2011 convertible preferred stock	119	1,491,250		120	1,500,000	
Series 2009 convertible preferred stock	74	674,545		74	674,545	
Diluted EPS	\$ 2,389	\$ 9,628,927	\$ 0.25	\$ 1,793	\$ 9,613,886	\$ 0.19

Stock option grants and the conversion of preferred stock are disregarded in this computation if they are determined to be anti-dilutive. Our anti-dilutive stock options at March 31, 2014 and 2013 totaled 143,000 shares and 170,500 shares, respectively.

Table of Contents

16

---

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

## NOTE 5. SECURITIES

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at March 31, 2014, December 31, 2013, and March 31, 2013 are summarized as follows:

Dollars in thousands	Amortized Cost	March 31, 2014 Unrealized		Estimated Fair Value
		Gains	Losses	
Available for Sale				
Taxable debt securities				
U. S. Government agencies				
and corporations	\$ 27,658	\$ 736	\$ 78	\$ 28,316
Residential mortgage-backed securities:				
Government-sponsored agencies	142,644	2,230	1,060	143,814
Nongovernment-sponsored entities				
State and political subdivisions	10,429	377	19	10,787
General obligations				
Water and sewer revenues	5,681	7	209	5,479
Other revenues	2,389	8	60	2,337
Corporate debt securities	3,021	-	106	2,915
Total taxable debt securities	3,977	25	4	3,998
Total tax-exempt debt securities				
State and political subdivisions				
General obligations	45,761	1,109	504	46,366
Water and sewer revenues				
Lease revenues	14,033	64	110	13,987
Lottery/casino revenues	9,079	47	168	8,958
Other revenues	4,428	102	79	4,451
Total tax-exempt debt securities	10,334	115	69	10,380
Equity securities	83,635	1,437	930	84,142
Total available for sale securities	77	-	-	77
	\$ 279,511	\$ 4,820	\$ 2,466	\$ 281,865

Dollars in thousands	Amortized Cost	December 31, 2013 Unrealized		Estimated Fair Value
		Gains	Losses	

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

Available for Sale

Taxable debt securities

U. S. Government agencies

and corporations	\$ 29,100	\$ 675	\$ 118	\$ 29,657
------------------	-----------	--------	--------	-----------

Residential mortgage-backed

securities:

Government-sponsored

agencies	155,270	2,019	1,573	155,716
----------	---------	-------	-------	---------

Nongovernment-sponsored

entities	11,519	321	21	11,819
----------	--------	-----	----	--------

State and political  
subdivisions

General obligations	9,317	-	475	8,842
---------------------	-------	---	-----	-------

Water and sewer  
revenues

	3,229	-	114	3,115
--	-------	---	-----	-------

Other revenues	4,051	4	142	3,913
----------------	-------	---	-----	-------

Corporate debt securities	3,973	24	31	3,966
---------------------------	-------	----	----	-------

Total taxable debt securities	216,459	3,043	2,474	217,028
-------------------------------	---------	-------	-------	---------

Tax-exempt debt securities

State and political  
subdivisions

General obligations	41,156	675	1,154	40,677
---------------------	--------	-----	-------	--------

Water and sewer  
revenues

	8,996	15	306	8,705
--	-------	----	-----	-------

Lease revenues	7,956	-	391	7,565
----------------	-------	---	-----	-------

Lottery/casino revenues	4,443	63	169	4,337
-------------------------	-------	----	-----	-------

Other revenues	10,527	55	191	10,391
----------------	--------	----	-----	--------

Total tax-exempt debt securities	73,078	808	2,211	71,675
----------------------------------	--------	-----	-------	--------

Equity securities	77	-	-	77
-------------------	----	---	---	----

Total available for sale securities	\$ 289,614	\$ 3,851	\$ 4,685	\$ 288,780
-------------------------------------	------------	----------	----------	------------

Table of Contents

17

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

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

Dollars in thousands	Amortized Cost	March 31, 2013 Unrealized		Estimated Fair Value
		Gains	Losses	
Available for Sale				
Taxable debt securities:				
U. S. Government agencies and corporations	\$ 30,782	\$ 1,035	\$ -	\$ 31,817
Residential mortgage-backed securities:				
Government-sponsored agencies	142,534	3,444	647	145,331
Nongovernment-sponsored agencies	13,691	483	83	14,091
State and political subdivisions	13,889	122	93	13,918
Corporate debt securities	2,962	33	18	2,977
Total taxable debt securities	203,858	5,117	841	208,134
Tax-exempt debt securities:				
State and political subdivisions	68,945	3,527	271	72,201
Residential mortgage-backed securities:				
Government-sponsored agencies	2,642	-	-	2,642
Total tax-exempt debt securities	71,587	3,527	271	74,843
Equity securities	77	-	-	77
Total available for sale securities	\$ 275,522	\$ 8,644	\$ 1,112	\$ 283,054

The below information is relative to the five states where issuers with the highest volume of state and political subdivision securities held in our portfolio are located. We own no such securities of any single issuer which we deem to be a concentration.

Dollars in thousands	Amortized Cost	March 31, 2014 Unrealized		Estimated Fair Value
		Gains	Losses	
California	\$ 16,625	\$ 207	\$ 119	\$ 16,713
West Virginia	13,642	203	109	13,736
Illinois	9,392	75	238	9,229
Texas	6,262	313	78	6,497
Pennsylvania	5,906	25	71	5,860

Management performs pre-purchase and ongoing analysis to confirm that all investment securities meet applicable credit quality standards. Prior to July 1, 2013, we principally used credit ratings from Nationally Recognized Statistical Rating Organizations (“NRSROs”) to support analyses of our portfolio of securities issued by state and political subdivisions, as we generally do not purchase securities that are rated below the six highest NRSRO rating categories. Beginning July 1, 2013, in addition to considering a security’s NRSRO rating, we now also assess or confirm through an internal review of an issuer’s financial information and other applicable information that: 1) the issuer’s risk of default is low; 2) the characteristics of the issuer’s demographics and economic environment are satisfactory; and 3) the issuer’s budgetary position and stability of tax or other revenue sources are sound.

Table of Contents

18

---

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



The maturities, amortized cost and estimated fair values of securities at March 31, 2014, are summarized as follows:

Dollars in thousands	Available for Sale	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 51,630	\$ 52,344
Due from one to five years	95,253	96,145
Due from five to ten years	33,742	34,102
Due after ten years	98,809	99,197
Equity securities	77	77
	\$ 279,511	\$ 281,865

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 three months ended March 31, 2014 are as follows:

Dollars in thousands	Calls and Principal				
	Sales	Maturities	Payments	Gains	Losses
Securities available for sale	\$ 18,157	\$ 2,051	\$ 8,782	\$ 370	\$ 392

During the three months ended March 31, 2014 and 2013, we recorded other-than-temporary impairment losses on residential mortgage-backed nongovernment sponsored entity securities as follows:

Dollars in thousands	Three Months Ended March 31,	
	2014	2013
Total other-than-temporary impairment losses	\$ -	\$ (91)

Portion of loss recognized in other comprehensive income	-	37
Net impairment losses recognized in earnings	\$ -	\$ (54)

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 months ended March 31, 2014 is as follows:

	Three Months Ended March 31, 2014
Dollars in thousands	Total
Beginning Balance	\$ (3,021)
Additions for the credit component on debt securities in which other-than-temporary impairment was not previously recognized	-
Securities sold during the period	-
Ending Balance	\$ (3,021)

We held 110 available for sale securities having an unrealized loss at March 31, 2014. 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 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.

Table of Contents

19

---

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

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

Provided below is a summary of securities available for sale which were in an unrealized loss position at March 31, 2014 and December 31, 2013, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income.

Dollars in thousands	March 31, 2014					
	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	\$ 7,256	\$(78 )	\$-	\$-	\$ 7,256	\$(78)
Residential mortgage-backed securities:						
Government-sponsored agencies	33,536	(763 )	12,566	(297 )	46,102	(1,060)
Nongovernment-sponsored entities	2,162	(10 )	409	(7 )	2,571	(17)
State and political subdivisions:						
General obligations	4,026	(135 )	1,162	(74 )	5,188	(209)
Water and sewer revenues	250	(6 )	1,577	(54 )	1,827	(60)
Other revenues	2,915	(106 )	-	-	2,915	(106)
Corporate debt securities	1,996	(4 )	-	-	1,996	(4)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	17,901	(346 )	3,423	(158 )	21,324	(504)
Water and sewer revenues	6,301	(85 )	432	(25 )	6,733	(110)
Lease revenues	5,121	(65 )	2,083	(103 )	7,204	(168)
Lottery/casino revenues	-	-	1,659	(79 )	1,659	(79)
Other revenues	3,072	(69 )	-	-	3,072	(69)
Total temporarily impaired securities	84,536	(1,667)	23,311	(797)	107,847	(2,464)
Other-than-temporarily impaired securities						
Taxable debt securities						
Residential mortgage-backed securities:						
Nongovernment-sponsored entities	-	(2 )	-	-	-	(2)
Total other-than-temporarily impaired securities	-	(2 )	-	-	-	(2)
Total	\$ 84,536	\$(1,669)	\$23,311	\$(797)	\$107,847	\$(2,466)

Table of Contents

20

---

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

	December 31, 2013					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Dollars in thousands						
Temporarily impaired securities						
Taxable debt securities						
U. S. Government agencies						
and corporations	\$ 10,868	\$(118 )	\$-	\$-	\$ 10,868	\$(118)
Residential mortgage-backed securities:						
Government-sponsored agencies	55,035	(1,385)	13,249	(188)	68,284	(1,573)
Nongovernment-sponsored entities	2,407	(12 )	565	(7 )	2,972	(19)
State and political subdivisions:						
General obligations	4,505	(264 )	2,337	(211)	6,842	(475)
Water and sewer revenues	1,309	(31 )	1,554	(83 )	2,863	(114)
Other revenues	3,142	(142 )	-	-	3,142	(142)
Corporate debt securities	2,968	(31 )	-	-	2,968	(31)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	19,603	(997 )	2,102	(157)	21,705	(1,154)
Water and sewer revenues	5,643	(224 )	983	(82 )	6,626	(306)
Lease revenues	6,112	(349 )	958	(42 )	7,070	(391)
Lottery/casino revenues	2,720	(132 )	554	(37 )	3,274	(169)
Other revenues	8,815	(191 )	-	-	8,815	(191)
Total temporarily impaired securities	123,127	(3,876)	22,302	(807)	145,429	(4,683)
Other-than-temporarily impaired securities						
Taxable debt securities						
Residential mortgage-backed securities:						
Nongovernment-sponsored entities	-	-	1	(2 )	1	(2)
Total other-than-temporarily impaired securities	-	-	1	(2 )	1	(2)
Total	\$ 123,127	\$(3,876)	\$22,303	\$(809)	\$145,430	\$(4,685)

## 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. We categorize residential real estate loans in excess of \$600,000 as jumbo loans.

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.

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".

Table of Contents

21

---

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

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:

	March 31,	December	March 31,
Dollars in thousands	2014	31,	2013
		2013	2013
Commercial	\$ 93,517	\$ 88,352	\$ 86,877
Commercial real estate			
Owner-occupied	150,025	149,618	151,942
Non-owner occupied	297,197	280,790	288,475
Construction and development			
Land and land development	67,342	71,453	76,277
Construction	18,327	15,155	5,782
Residential real estate			
Non-jumbo	215,665	212,946	213,965
Jumbo	51,406	53,406	62,849
Home equity	56,161	54,844	53,765
Consumer	19,106	19,889	19,638
Other	5,037	3,276	3,191
Total loans, net of unearned fees	973,783	949,729	962,761
Less allowance for loan losses	11,069	12,659	17,020
Loans, net	\$ 962,714	\$ 937,070	\$ 945,741

The following table presents the contractual aging of the recorded investment in past due loans by class as of March 31, 2014 and 2013 and December 31, 2013.

At March 31, 2014	
Past Due	> 90 days

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

Dollars in thousands	30-59 days	60-89 days	> 90 days	Total	Current	and Accruing
Commercial	\$ 52	\$ 50	\$ 796	\$ 898	\$ 92,619	\$ -
Commercial real estate						
Owner-occupied	-	236	125	361	149,664	-
Non-owner occupied	1,076	-	768	1,844	295,353	-
Construction and development						
Land and land development	754	-	6,123	6,877	60,465	-
Construction	-	-	-	-	18,327	-
Residential mortgage						
Non-jumbo	2,780	804	1,821	5,405	210,260	-
Jumbo	712	-	-	712	50,694	-
Home equity	75	-	69	144	56,017	-
Consumer	207	32	45	284	18,822	-
Other	-	-	-	-	5,037	-
Total	\$ 5,656	\$ 1,122	\$ 9,747	\$ 16,525	\$ 957,258	\$ -

Table of Contents

22

---

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



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

At December 31, 2013

Dollars in thousands	30-59 days	Past Due		Total	Current	> 90 days and Accruing
		60-89 days	> 90 days			
Commercial	\$ 74	\$ 34	\$ 1,190	\$ 1,298	\$ 87,054	\$ -
Commercial real estate						
Owner-occupied	328	459	487	1,274	148,344	-
Non-owner occupied	912	115	128	1,155	279,635	-
Construction and development						
Land and land development	1,627	-	8,638	10,265	61,188	-
Construction	-	-	-	-	15,155	-
Residential mortgage						
Non-jumbo	2,708	1,673	1,321	5,702	207,244	-
Jumbo	-	-	-	-	53,406	-
Home equity	588	87	-	675	54,169	-
Consumer	224	82	106	412	19,477	-
Other	-	-	-	-	3,276	-
Total	\$ 6,461	\$ 2,450	\$ 11,870	\$ 20,781	\$ 928,948	\$ -

At March 31, 2013

Dollars in thousands	30-59 days	Past Due		Total	Current	> 90 days and Accruing
		60-89 days	> 90 days			
Commercial	\$ 148	\$ 44	\$ 1,921	\$ 2,113	\$ 84,764	\$ -
Commercial real estate						
Owner-occupied	1,075	310	-	1,385	150,557	-
Non-owner occupied	222	708	909	1,839	286,636	-
Construction and development						
Land and land development	65	794	10,538	11,397	64,880	-
Construction	-	-	153	153	5,629	-
Residential mortgage						
Non-jumbo	4,910	1,052	2,362	8,324	205,641	-
Jumbo	-	-	12,565	12,565	50,284	-
Home equity	247	48	-	295	53,470	-
Consumer	244	34	44	322	19,316	-

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

Other	-	-	-	-	3,191	-
Total	\$ 6,911	\$ 2,990	\$ 28,492	\$ 38,393	\$ 924,368	\$ -

Nonaccrual loans: The following table presents the nonaccrual loans included in the net balance of loans at March 31, 2014, December 31, 2013, and March 31, 2013.

Dollars in thousands	3/31/2014	12/31/2013	3/31/2013
Commercial	\$ 866	\$ 1,224	\$ 4,763
Commercial real estate			
Owner-occupied	2,404	1,953	495
Non-owner occupied	430	365	1,030
Construction and development			
Land & land development	10,252	12,830	12,923
Construction	-	-	153
Residential mortgage			
Non-jumbo	2,593	2,446	4,001
Jumbo	-	-	12,565
Home equity	297	-	303
Consumer	73	128	72
Total	\$ 16,915	\$ 18,946	\$ 36,305

Table of Contents

23

---

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

Impaired loans: Impaired loans include the following:

§ Loans which we risk-rate (consisting of loan relationships having aggregate balances in excess of \$2.0 million, 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.

The table below sets forth information about our impaired loans.

Loan Category	03/31/2014	12/31/2013	03/31/2013	Method used to measure impairment
Commerical	\$ 899	\$ 1,864	\$ 10,322	Fair value of collateral
	-	158	164	Discounted cash flow
Commerical real estate				
Owner-occupied	4,856	10,067	13,334	Fair value of collateral
	7,598	2,483	2,673	Discounted cash flow
Non-owner occupied	518	5,832	6,858	Fair value of collateral
	5,259	-	-	Discounted cash flow
Construction and development				
Land & land development	16,107	24,625	27,395	Fair value of collateral
	1,457	644	656	Discounted cash flow
Construction	-	-	-	Fair value of collateral
Residential mortgage				
Non-jumbo	3,450	5,516	5,190	

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

				Fair value of collateral
	2,603	566	829	Discounted cash flow
Jumbo	6,644	8,768	21,450	Fair value of collateral
	2,086	-	-	Discounted cash flow
Home equity	186	212	213	Fair value of collateral
Consumer	40	47	62	Fair value of collateral
Total	\$ 51,703	\$ 60,782	\$ 89,146	

Table of Contents

24

---

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

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

The following tables present loans individually evaluated for impairment at March 31, 2014, December 31, 2013 and March 31, 2013.

Dollars in thousands	March 31, 2014				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
Without a related allowance					
Commercial	\$ 824	\$ 824	\$ -	\$ 824	\$ 27
Commercial real estate					
Owner-occupied	7,836	7,836	-	7,836	231
Non-owner occupied	5,035	5,037	-	5,037	249
Construction and development					
Land & land development	11,793	11,793	-	11,793	323
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,209	3,217	-	3,217	140
Jumbo	7,828	7,833	-	7,833	401
Home equity	186	186	-	186	11
Consumer	40	40	-	40	3
Total without a related allowance	\$ 36,751	\$ 36,766	\$ -	\$ 36,766	\$ 1,385
With a related allowance					
Commercial	\$ 75	\$ 75	\$ 18	\$ 75	\$ 5
Commercial real estate					
Owner-occupied	4,618	4,618	324	4,618	213
Non-owner occupied	740	740	85	740	28
Construction and development					
Land & land development	5,771	5,771	2,553	5,771	40
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	2,835	2,836	337	2,836	134

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

Jumbo	896	897	56	897	45
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
Total with a related allowance	\$ 14,935	\$ 14,937	\$ 3,373	\$ 14,937	\$ 465
Total					
Commercial	\$ 36,692	\$ 36,694	\$ 2,980	\$ 36,694	\$ 1,116
Residential real estate	14,954	14,969	393	14,969	731
Consumer	40	40	-	40	3
Total	\$ 51,686	\$ 51,703	\$ 3,373	\$ 51,703	\$ 1,850

Table of Contents

25

---

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

December 31, 2013					
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
<b>Without a related allowance</b>					
Commercial	\$ 1,161	\$ 1,167	\$ -	\$ 1,518	\$ 98
<b>Commercial real estate</b>					
Owner-occupied	8,434	8,434	-	7,675	226
Non-owner occupied	5,075	5,077	-	5,110	253
<b>Construction and development</b>					
Land & land development	14,732	14,737	-	11,628	325
Construction	-	-	-	-	-
<b>Residential real estate</b>					
Non-jumbo	3,587	3,595	-	2,858	157
Jumbo	7,862	7,867	-	7,910	405
Home equity	186	186	-	186	11
Consumer	26	27	-	28	1
<b>Total without a related allowance</b>	<b>41,063</b>	<b>41,090</b>	<b>-</b>	<b>36,913</b>	<b>1,476</b>
<b>With a related allowance</b>					
Commercial	855	855	406	1,013	-
<b>Commercial real estate</b>					
Owner-occupied	4,116	4,116	305	3,945	184
Non-owner occupied	747	755	175	515	28
<b>Construction and development</b>					
Land & land development	10,532	10,532	3,186	11,310	147
Construction	-	-	-	-	-
<b>Residential real estate</b>					
Non-jumbo	2,485	2,487	256	2,292	107
Jumbo	900	901	37	906	45
Home equity	27	26	22	27	-

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

Consumer	20	20	13	9	-
Total with a related allowance	19,682	19,692	4,400	20,017	511
Total					
Commercial	45,652	45,673	4,072	42,714	1,261
Residential real estate	15,047	15,062	315	14,179	725
Consumer	46	47	13	37	1
Total	\$ 60,745	\$ 60,782	\$ 4,400	\$ 56,930	\$ 1,987

Table of Contents

26

---

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



March 31, 2013					
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
<b>Without a related allowance</b>					
Commercial	\$ 9,442	\$ 9,446	\$ -	\$ 9,446	\$ 439
<b>Commercial real estate</b>					
Owner-occupied	9,882	9,886	-	9,886	455
Non-owner occupied	5,430	5,432	-	5,432	271
<b>Construction and development</b>					
Land & land development	15,623	15,622	-	14,883	575
Construction	-	-	-	-	-
<b>Residential real estate</b>					
Non-jumbo	3,523	3,531	-	3,531	153
Jumbo	7,264	7,265	-	7,265	360
Home equity	185	186	-	186	11
Consumer	35	35	-	35	1
<b>Total without a related allowance</b>	<b>\$ 51,384</b>	<b>\$ 51,403</b>	<b>\$ -</b>	<b>\$ 50,664</b>	<b>\$ 2,265</b>
<b>With a related allowance</b>					
Commercial	\$ 1,031	\$ 1,040	\$ 403	\$ 1,040	\$ 8
<b>Commercial real estate</b>					
Owner-occupied	6,121	6,121	437	6,120	282
Non-owner occupied	1,426	1,426	152	1,427	29
<b>Construction and development</b>					
Land & land development	12,429	12,429	1,421	12,429	157
Construction	-	-	-	-	-
<b>Residential real estate</b>					
Non-jumbo	2,487	2,488	303	2,487	87
Jumbo	14,180	14,185	3,707	14,185	94
Home equity	28	27	28	28	-
Consumer	26	27	14	26	2

Total with a related allowance	\$ 37,728	\$ 37,743	\$ 6,465	\$ 37,742	\$ 659
<b>Total</b>					
Commercial	\$ 61,384	\$ 61,402	\$ 2,413	\$ 60,663	\$ 2,216
Residential real estate	27,667	27,682	4,038	27,682	705
Consumer	61	62	14	61	3
Total	\$ 89,112	\$ 89,146	\$ 6,465	\$ 88,406	\$ 2,924

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 be classified as a TDR for the life of the loan. Included in impaired loans are TDRs of \$33.5 million, of which \$32.2 million were current with respect to restructured contractual payments at March 31, 2014, and \$34.5 million, of which \$33.6 million were current with respect to restructured contractual payments at December 31, 2013. There were no commitments to lend additional funds under these restructurings at either balance sheet date.

The following table presents by class the TDRs that were restructured during the three months ended March 31, 2014 and 2013. 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.

Table of Contents

27

---

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

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

dollars in thousands	For the Three Months Ended March 31, 2014			For the Three Months Ended March 31, 2013		
	Pre-modification		Post-modification	Pre-modification		Post-modification
	Number of Modifications	Recorded Investment	Recorded Investment	Number of Modifications	Recorded Investment	Recorded Investment
Commercial	-	\$ -	\$ -	-	\$ -	\$ -
Commercial real estate						
Owner-occupied	-	-	-	-	-	-
Non-owner occupied	-	-	-	-	-	-
Construction and development						
Land & land development	-	-	-	1	49	50
Construction	-	-	-	-	-	-
Residential real estate						
Non-jumbo	-	-	-	-	-	-
Jumbo	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	-	\$ -	\$ -	1	\$ 49	\$ 50

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 March 31, 2014	
	Number of Defaults	Recorded Investment at Default Date
	Commercial	1
Commercial real estate		
Owner-occupied	-	-
Non-owner occupied	-	-
Construction and development		
Land & land development	1	698
Construction	-	-

Residential real estate			
Non-jumbo	4	576	
Jumbo	-	-	
Home equity	-	-	
Consumer	-	-	
Total	6	\$ 1,330	

Table of Contents

28

---

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

The following table details the activity regarding TDRs by loan type during the first three months of 2014, and the related allowance on TDRs.

Dollars in thousands	March 31, 2014										
	Construction & Land Development		Land & Land Development		Commercial Real Estate		Residential Real Estate				Total
	ment	tion	cial	Owner Occupied	Owner Occupied	Non-jumbo	Jumbo	Home Equity	sumer	Other	
Troubled debt restructurings											
Balance January 1, 2014	\$ 6,164	\$ -	\$ 1,242	\$ 9,698	\$ 5,544	\$ 5,542	\$ 6,278	\$ -	\$ 46	\$ -	\$ 34,514
Additions	-	-	-	-	-	-	-	-	-	-	-
Charge-offs	-	-	-	-	-	-	-	-	(3 )	-	(3)
Net (paydowns) advances	(95 )	-	(733 )	(54 )	(52 )	(29 )	(41 )	-	(3 )	-	(1,007)
Transfer into OREO	-	-	-	-	-	-	-	-	-	-	-
Refinance out of TDR status	-	-	-	-	-	-	-	-	-	-	-
Balance March 31, 2014	\$ 6,069	\$ -	\$ 509	\$ 9,644	\$ 5,492	\$ 5,513	\$ 6,237	\$ -	\$ 40	\$ -	\$ 33,504
Allowance related to troubled debt restructurings	\$ 171	\$ -	\$ 18	\$ 176	\$ 85	\$ 334	\$ 56	\$ -	\$ -	\$ -	\$ 840

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:

**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.

Table of Contents

29

---

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

The following table presents the recorded investment in construction and development, commercial, and commercial real estate loans which are generally evaluated based upon the internal risk ratings defined above.

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	3/31/2014	12/31/2013	3/31/2014	12/31/2013	3/31/2014	12/31/2013	3/31/2014	12/31/2013	3/31/2014	12/31/2013
Pass	\$ 45,857	\$ 41,662	\$ 18,035	\$ 15,022	\$ 91,387	\$ 82,323	\$ 143,443	\$ 143,982	\$ 285,977	\$ 268,967
OLEM (Special Mention)	5,304	5,550	292	133	1,225	4,544	1,927	1,412	9,560	10,222
Substandard	16,071	24,131	-	-	515	1,485	4,655	4,224	1,660	1,601
Doubtful	110	110	-	-	390	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-	-	-
Total	\$ 67,342	\$ 71,453	\$ 18,327	\$ 15,155	\$ 93,517	\$ 88,352	\$ 150,025	\$ 149,618	\$ 297,197	\$ 280,790

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.

Dollars in thousands	Performing			Nonperforming		
	3/31/2014	12/31/2013	3/31/2013	3/31/2014	12/31/2013	3/31/2013
Residential real estate						
Non-jumbo	\$ 213,071	\$ 210,500	\$ 209,964	\$ 2,594	\$ 2,446	\$ 4,001
Jumbo	51,406	53,406	50,284	-	-	12,565
Home Equity	55,865	54,844	53,462	296	-	303
Consumer	19,033	19,761	19,566	73	128	72
Other	5,037	3,276	3,191	-	-	-
Total	\$ 344,412	\$ 341,787	\$ 336,467	\$ 2,963	\$ 2,574	\$ 16,941

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.

NOTE 7. ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses for the three month periods ended March 30, 2014 and 2013, and for the year ended December 31, 2013 is as follows:

Table of Contents

30

---

Summit Financial Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (unaudited)



Dollars in thousands	Three Months Ended		Year
	March 31,		Ended December 31,
	2014	2013	2013
Balance, beginning of year	\$ 12,659	\$ 17,933	\$ 17,933
Losses:			
Commercial	390	17	723
Commercial real estate			
Owner occupied	11	63	1,031
Non-owner occupied	-	3	9
Construction and development			
Land and land development	2,376	2,062	3,596
Construction	-	-	-
Residential real estate			
Non-jumbo	9	228	541
Jumbo	8	60	4,741
Home equity	-	20	77
Consumer	45	22	79
Other	23	22	162
Total	2,862	2,497	10,959
Recoveries:			
Commercial	6	2	12
Commercial real estate			
Owner occupied	7	2	8
Non-owner occupied	3	-	674
Construction and development			
Land and land development	26	5	187
Construction	-	-	-
Real estate - mortgage			
Non-jumbo	20	19	127

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

Jumbo	163	1	6
Home equity	2	-	5
Consumer	20	21	79
Other	25	34	87
Total	272	84	1,185
Net losses	2,590	2,413	9,774
Provision for loan losses	1,000	1,500	4,500
Balance, end of period	\$ 11,069	\$ 17,020	\$ 12,659

Table of Contents

31

---

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 three months of 2014 is as follows:

Dollars in thousands	Construction & Land Development		Commercial Real Estate		Residential Real Estate		Non-jumbo	Jumbo	Home Equity	Consumer	Other	Total
	Land Development	Construction	Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo						
Allowance for loan losses												
Beginning balance	\$5,455	\$269	\$1,323	\$969	\$641	\$1,843	\$1,888	\$173	\$48	\$50		\$12,659
Charge-offs	2,376	-	390	11	-	9	8	-	45	23		2,862
Recoveries	26	-	6	7	3	20	163	2	20	25		272
Provision	1,758	27	181	69	(217)	(332)	(471)	(41)	11	15		1,000
Ending balance	\$4,863	\$296	\$1,120	\$1,034	\$427	\$1,522	\$1,572	\$134	\$34	\$67		\$11,069
Allowance related to:												
Loans individually evaluated for impairment												
	\$2,553	\$-	\$18	\$324	\$85	\$337	\$56	\$-	\$-	\$-		\$3,373
Loans collectively evaluated for impairment												
	2,310	296	1,102	710	342	1,185	1,516	134	34	67		7,696
Loans acquired with deteriorated credit quality												
	-	-	-	-	-	-	-	-	-	-		-
Total	\$4,863	\$296	\$1,120	\$1,034	\$427	\$1,522	\$1,572	\$134	\$34	\$67		\$11,069
Loans individually evaluated for impairment												
	\$17,564	\$-	\$899	\$12,454	\$5,778	\$6,053	\$8,730	\$186	\$39	\$-		\$51,703

Loans collectively evaluated for impairment	49,778	18,327	92,618	137,571	291,419	209,612	42,676	55,975	19,067	5,037	\$922,080
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	\$67,342	\$18,327	\$93,517	\$150,025	\$297,197	\$215,665	\$51,406	\$56,161	\$19,106	\$5,037	\$973,783

Table of Contents

32

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 March 31, 2014 and other intangible assets by reporting unit at March 31, 2014 and December 31, 2013.

Goodwill Activity						
Community Insurance						
Dollars in thousands	Banking	Services	Total			
Balance, January 1, 2014	\$ 1,488	\$ 4,710	\$ 6,198			
Acquired goodwill, net	-	-	-			
Balance, March 31, 2014	\$ 1,488	\$ 4,710	\$ 6,198			
Other Intangible Assets						
March 31, 2014						
December 31, 2013						
Dollars in thousands	Community Insurance			Community Insurance		
Unidentifiable intangible assets	Banking	Services	Total	Banking	Services	Total
Gross carrying amount	\$ 2,267	\$ -	\$ 2,267	\$ 2,267	\$ -	\$ 2,267
Less: accumulated amortization	2,254	-	2,254	2,216	-	2,216
Net carrying amount	\$ 13	\$ -	\$ 13	\$ 51	\$ -	\$ 51
Identifiable intangible assets						
Gross carrying amount	\$ -	\$ 3,000	\$ 3,000	\$ -	\$ 3,000	\$ 3,000
Less: accumulated amortization	-	1,350	1,350	-	1,300	1,300
Net carrying amount	\$ -	\$ 1,650	\$ 1,650	\$ -	\$ 1,700	\$ 1,700

We recorded amortization expense of approximately \$88,000 for the three months ended March 31, 2014 relative to our other intangible assets. Annual amortization is expected to be approximately \$251,000 in 2014, and \$200,000 for each of the years ending 2015 through 2018.

NOTE 9. DEPOSITS

The following is a summary of interest bearing deposits by type as of March 31, 2014 and 2013 and December 31, 2013:

	March 31,	December	March 31,
Dollars in thousands	2014	31,	2013
		2013	
Demand deposits, interest bearing	\$ 195,898	\$ 186,578	\$ 181,326
Savings deposits	228,854	193,446	197,587
Time deposits	528,433	530,951	594,279
Total	\$ 953,185	\$ 910,975	\$ 973,192

[Table of Contents](#)

33

---

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

Included in time deposits are deposits acquired through a third party (“brokered deposits”) totaling \$160.4 million, \$160.8 million and \$213.6 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively.

A summary of the scheduled maturities for all time deposits as of March 31, 2014 is as follows:

Dollars in thousands	
Nine month period ending December 31, 2014	\$ 176,012
Year ending December 31, 2015	100,144
Year ending December 31, 2016	106,520
Year ending December 31, 2017	35,522
Year ending December 31, 2018	43,048
Thereafter	67,187
	\$ 528,433

The following is a summary of the maturity distribution of all certificates of deposit in denominations of \$100,000 or more as of March 31, 2014:

Dollars in thousands	Amount	Percent
Three months or less	\$ 50,642	13.0%
	45,428	11.7%

Three through six months			
Six through twelve months	45,408	11.7%	
Over twelve months	248,245	63.7%	
Total	\$ 389,723	100.0%	

## NOTE 10. BORROWED FUNDS

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

	2014		Three Months Ended March 31, 2013			
	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit		
Dollars in thousands						
Balance at March 31	\$ 60,000	\$ 8,974	\$ -	\$ 5,960		
Average balance outstanding for the period	66,205	8,971	24,321	3,514		
Maximum balance outstanding at any month end during period	80,000	8,974	45,000	5,960		
Weighted average interest rate for the period	0.28 %	0.25 %	0.25 %	0.25%		
Weighted average interest rate for balances outstanding at March 31	0.31 %	0.25 %	0.25 %	0.25%		

[Table of Contents](#)

34



Notes to Consolidated Financial Statements (unaudited)

	Year Ended December 31, 2013	
	Short-term FHLB	Federal Funds Purchased and Lines
Dollars in thousands	Advances	of Credit
Balance at December 31	\$ 53,800	\$ 8,969
Average balance outstanding for the period	29,786	4,313
Maximum balance outstanding at any month end during period	55,300	8,969
Weighted average interest rate for the period	0.28 %	0.25%
Weighted average interest rate for balances outstanding at December 31	0.26 %	0.25%

Long-term borrowings: Our long-term borrowings of \$123.5 million, \$163.5 million and \$163.6 million at March 31, 2014, December 31, 2013, and March 31, 2013 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.

	Balance at March 31,		Balance at December 31,
Dollars in thousands	2014	2013	2013
Long-term FHLB advances	\$ 42,576 72,000	\$ 82,672 72,000	\$ 82,600 72,000

Long-term reverse repurchase agreements				
Term loans	8,916	8,916	8,916	
Total	\$ 123,492	\$ 163,588	\$ 163,516	

The term loans are secured by the common stock of our subsidiary bank. \$5.4 million bears a variable interest rate of prime minus 50 basis points with a final maturity of 2017, and \$3.5 million bears a fixed rate of 8% with a final maturity of 2023.

Our long term FHLB borrowings and reverse repurchase agreements bear fixed rates and mature in varying amounts through the year 2026.

The average interest rate paid on long-term borrowings for the three month period ended March 31, 2014 was 3.95% compared to 3.82% for the first three months of 2013.

Subordinated debentures: We have subordinated debt totaling \$16.8 million at March 31, 2014, December 31, 2013, and March 31, 2013. 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.

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 \$19.6 million at March 31, 2014, December 31, 2013, and March 31, 2013.

#### Table of Contents

35

---

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

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 \$3.5 million in capital securities and \$109,000 in common securities and invested the proceeds in \$3.61 million of debentures. SFG Capital Trust II issued \$7.5 million in capital securities and \$232,000 in common securities and invested the proceeds in \$7.73 million of debentures. SFG Capital Trust III issued \$8.0 million in capital securities and \$248,000 in common securities and invested the proceeds in \$8.25 million 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 December	Subordinated debentures owed to Long-termSubordinatedInconsolidated borrowings debentures subsidiary trusts			
	31,	2014	\$ 42,502	\$ -
	2015	1,909	10,000	-
	2016	28,911	-	-
	2017	918	-	-
	2018	45,017	-	-
	Thereafter	4,235	6,800	19,589
		\$ 123,492	\$ 16,800	\$ 19,589

#### NOTE 11. SHARE BASED COMPENSATION

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.

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 three months of 2014 or 2013.

Table of Contents

36

---

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

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 three months of 2014 and 2013, our stock compensation expense and related deferred taxes were insignificant.

A summary of activity in our Plans during the first three months of 2014 and 2013 is as follows:

	For the Three Months Ended March 31,			
	2014		2013	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding, January 1	185,410	\$ 19.59	249,700	\$ 18.98
Granted	-	-	-	-
Exercised (3,200 )		4.63	(12,000 )	5.09
Forfeited	-	-	(1,750 )	19.69
Expired (2,300 )		17.43	(38,900 )	23.79
Outstanding, March 31	179,910	\$ 19.88	197,050	\$ 18.17

Other information regarding options outstanding and exercisable at March 31, 2014 is as follows:

Range of exercise price	# of shares	Options Outstanding			Options Exercisable		
		Wt. Avg. Remaining	Wt. Avg. Aggregate Intrinsic	Wt. Avg. Aggregate Intrinsic	# of shares	Wt. Avg. Aggregate Intrinsic	Wt. Avg. Aggregate Intrinsic
		WAEP	Life (yrs)	Value (in thousands)		WAEP	Value (in thousands)
2.54 - \$6.00	13,750	\$ 4.71	4.38	\$ 77	11,750	\$ 5.08	\$ 61
6.01 - 10.00	23,160	9.07	2.98	27	22,560	9.14	25
10.01 - 17.50	-	-	-	-	-	-	-
17.51 - 20.00	38,500	17.80	2.75	-	38,500	17.80	-
20.01 - 25.93	104,500	25.04	2.49	-	104,500	25.04	-
	179,910	19.88		\$ 104	177,310	20.12	\$ 86

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.

Table of Contents

37

---

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:

	March 31,
Dollars in thousands	2014
Commitments to extend credit:	
Revolving home equity and credit card lines	\$ 51,315
Construction loans	28,574
Other loans	35,788
Standby letters of credit	1,765
Total	\$ 117,442

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 March 31, 2014, that we and each of our subsidiaries met all capital adequacy requirements to which they were subject.

Table of Contents

38

---

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	Actual		Minimum Required Regulatory Capital			To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
As of March 31, 2014							
Total Capital (to risk weighted assets)							
Summit	\$ 144,071	14.2 %	\$ 81,024	8.0 %	\$ 101,280	10.0%	
Summit Community	157,724	15.6 %	80,974	8.0 %	101,217	10.0%	
Tier I Capital (to risk weighted assets)							
Summit	125,202	12.4 %	40,512	4.0 %	60,768	6.0%	
Summit Community	146,655	14.5 %	40,487	4.0 %	60,730	6.0%	
Tier I Capital (to average assets)							
Summit	125,202	9.0 %	55,399	4.0 %	69,249	5.0%	
Summit Community	146,655	10.6 %	55,394	4.0 %	69,242	5.0%	
As of December 31, 2013							
Total Capital (to risk weighted assets)							
Summit	144,202	14.5 %	79,638	8.0 %	99,547	10.0%	
Summit Community	156,473	15.7 %	79,627	8.0 %	99,534	10.0%	
Tier I Capital (to risk weighted assets)							
Summit	122,918	12.4 %	39,499	4.0 %	59,248	6.0%	
Summit Community	143,989	14.5 %	39,814	4.0 %	59,720	6.0%	

Tier I Capital (to average assets)									
Summit	122,918	8.9	%	55,151	4.0	%	68,938	5.0%	
Summit Community	143,989	10.4	%	55,150	4.0	%	68,938	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.

Under the Summit MOU, Summit has agreed among other things to:

- § 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 Summit’s MOU is included in Part I. Item 1A – Risk Factors on our Form 10-K for the year ended December 31, 2013.

Table of Contents

39

---

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

On October 25, 2012, the Bank entered into a revised MOU ("Bank MOU") which replaced the Bank MOU effective September 24, 2009 and subsequently amended on February 1, 2011. In general, the Bank MOU includes provisions substantially similar to those in the prior Bank MOU with the exception that several provisions deemed no longer applicable by the regulatory authorities were removed and a provision relative to reducing the Bank's levels of classified assets was added.

In summary, we have agreed, among other things, to address the following matters relative to the Bank:

- § maintaining a Board committee which monitors and promotes compliance with the provisions of the Bank MOU;
- § providing the Bank's regulatory authorities with updated reports of criticized assets and/or formal workout plans for all nonperforming borrower relationships with an aggregate outstanding balance exceeding \$1 million;
- § developing and submitting to regulatory authorities a written plan to reduce the Bank's risk exposure in each adversely classified credit relationship in excess of \$1 million and all OREO;
- § establishing procedures to report all loans with balances exceeding \$500,000 that have credit weaknesses or that fall outside of the Bank's policy;
  - § annually reviewing the organizational structure and operations of the Bank's loan department;
  - § maintaining an adequate allowance for loan and lease losses through charges to current operating income;
- § reviewing overall liquidity objectives and developing and submitting to regulatory authorities plans and procedures aimed to improve liquidity and reduce reliance on volatile liabilities;
- § preparing comprehensive budgets and earnings forecasts for the Bank and submitting reports comparing actual performance to the budget plan;
- § maintaining a minimum Tier 1 Leverage Capital ratio of at least 8% and a Total Risk-based Capital ratio of at least 11%;
  - § not paying any cash dividends without the prior written consent of the banking regulators; and,
- § providing quarterly progress reports to the Bank's regulatory authorities detailing steps taken to comply with the Bank MOU.

#### NOTE 14. SEGMENT INFORMATION

We operate two business segments: community banking and insurance & financial 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 & financial services segment includes 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.

Inter-segment revenue and expense consists of management fees allocated to the community banking and the insurance & financial services segments 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:

Table of Contents

40

---

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

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

In thousands	Three Months Ended March 31, 2014				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income	\$ 10,511	\$ -	\$ (473 )	\$ -	\$ 10,038
Provision for loan losses	1,000	-	-	-	1,000
Net interest income after provision for loan losses	9,511	-	(473 )	-	9,038
Other income	1,410	1,373	293	(293 )	2,783
Other expenses	7,349	1,028	414	(293 )	8,498
Income (loss) before income taxes	3,572	345	(594 )	-	3,323
Income tax expense (benefit)	982	121	(169 )	-	934
Net income (loss)	2,590	224	(425 )	-	2,389
Dividends on preferred shares	-	-	193	-	193
Net income (loss) applicable to common shares	\$ 2,590	\$ 224	\$ (618 )	\$ -	\$ 2,196
Inter-segment revenue (expense)	\$ (264 )	\$ (29 )	\$ 293	\$ -	\$ -
Average assets	\$ 1,442,219	\$ 5,978	\$ 160,346	\$ (216,040)	\$ 1,392,503

In thousands	Three Months Ended March 31, 2013				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income	\$ 10,226	\$ -	\$ (468 )	\$ -	\$ 9,758
Provision for loan losses	1,500	-	-	-	1,500
Net interest income after provision for loan losses	8,726	-	(468 )	-	8,258
Other income	1,444	1,304	272	(272 )	2,748
Other expenses	7,193	1,197	444	(272 )	8,562

Income (loss) before income taxes	2,977	107	(640 )	-	2,444
Income tax expense (benefit)	825	36	(210 )	-	651
Net income (loss)	2,152	71	(430 )	-	1,793
Dividends on preferred shares	-	-	194	-	194
Net income (loss) applicable to common shares	\$ 2,152	\$ 71	\$ (624 )	\$ -	\$ 1,599
Inter-segment revenue (expense)	\$ (245 )	\$ (27 )	\$ 272	\$ -	\$ -
Average assets	\$ 1,446,533	\$ 6,264	\$ 155,808	\$ (216,698)	\$ 1,391,907

## NOTE 15. DERIVATIVE FINANCIAL INSTRUMENTS

We use derivative instruments primarily to protect against the risk of adverse interest rate movements on the cash flows of certain liabilities. Derivative instruments represent contracts between parties that usually require little or no initial net investment and result in one party delivering cash or another type of asset to the other party based upon a notional amount and an underlying as specified in the contract. A notional amount represents the number of units of a specific item, such as currency units. An underlying represents a variable, such as an interest rate or price index. The amount of cash or other asset delivered from one party to the other is determined based upon the interaction of the notional amount of the contract with the underlying. Derivatives can also be implicit in certain contracts and commitments.

Table of Contents

41

---

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

As with any financial instrument, derivative instruments have inherent risks, primarily market and credit risk. Market risk associated with changes in interest rates is managed by establishing and monitoring limits as to the degree of risk that may be undertaken as part of our overall market risk monitoring process. Credit risk occurs when a counterparty to a derivative contract with an unrealized gain fails to perform according to the terms of the agreement. Credit risk is managed by monitoring the size and maturity structure of the derivative portfolio, and applying uniform credit standards to all activities with credit risk.

In accordance with ASC 815, Derivatives and Hedging, all derivative instruments are recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, depending on the type of hedge transaction.

Fair-value hedges – For transactions in which we are hedging changes in fair value of an asset, liability, or a firm commitment, changes in the fair value of the derivative instrument are generally offset in the income statement by changes in the hedged item's fair value.

Cash-flow hedges – For transactions in which we are hedging the variability of cash flows related to a variable-rate asset, liability, or a forecasted transaction, changes in the fair value of the derivative instrument are reported in other comprehensive income. The gains and losses on the derivative instrument, which are reported in comprehensive income, are reclassified to earnings in the periods in which earnings are impacted by the variability of cash flows of the hedged item.

The ineffective portion of all hedges is recognized in current period earnings.

Other derivative instruments – For risk management purposes that do not meet the hedge accounting criteria and, therefore, do not qualify for hedge accounting. These derivative instruments are accounted for at fair value with changes in fair value recorded in the income statement.

We have entered into two forward-starting, pay-fixed/receive LIBOR interest rate swaps. \$40 million notional with an effective date of July 18, 2016, was designated as a cash flow hedge of \$40 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of this swap we will pay a fixed rate of 2.98% for a 3 year period. \$30 million notional with an effective date of April 18, 2016, was designated as a cash flow hedge of \$30 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of this swap we will pay a fixed rate of 2.89% for a 4.5 year period.

A summary of our derivative financial instruments as of March 31, 2014 follows:

		March 31, 2014		
	Notional	Derivative Fair Value		Net
Dollars in thousands	Amount	Asset	Liability	Ineffective Hedge Gains/(Losses)
<b>CASH FLOW HEDGES</b>				
Pay-fixed/receive-variable interest rate swaps				
Long term borrowings	\$ 70,000	\$ -	\$ 408	\$ -
	\$ 70,000	\$ -	\$ 408	\$ -



On April 14, 2014, we entered into a \$40 million notional forward-starting, pay-fixed/receive LIBOR interest rate swap with an effective date of October 18, 2016, which was designated as a cash flow hedge of \$40 million of forecasted variable rate Federal Home Loan Bank advances. Under the terms of the swap we will pay a fixed rate of 2.841% for a 3 year period.

Table of Contents

42

---

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 2013 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 0.38% for the first three months in 2014 compared to the same period of 2013 while our net interest earnings on a tax equivalent basis increased 2.45%. 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 Ended March 31,	
Dollars in thousands	2014	2013
Community banking	\$ 2,590	\$ 2,152
Insurance & financial services	224	71
Parent and other	(618 )	(624)
	\$ 2,196	\$ 1,599

Consolidated  
net income  
(loss)

## 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

### Table of Contents

43

---

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

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.

Our most significant accounting policies are presented in the notes to the consolidated financial statements of our 2013 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 6 to the consolidated financial statements of our 2013 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 2013 Annual Report on Form 10-K.

**Goodwill:** Goodwill is subject to an analysis by reporting unit at least annually to determine whether write-downs of the recorded balances are necessary. Initially, an assessment of qualitative factors (Step 0) is performed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test is unnecessary. However, if we conclude otherwise, then we are required to perform the first step (Step 1) 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 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. Step 2 of impairment testing, which is necessary only if the reporting unit does not pass Step 1, 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.

**Community Banking –** During third quarter 2013, we performed the Step 0 assessment of our goodwill of our community banking reporting unit and determined that it was not more likely than not that the fair value was less than its carrying value. In performing the qualitative Step 0 assessments, we considered certain events and circumstances such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the

Table of Contents

44

---

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

fair value is less than its carrying amount. No indicators of impairment were noted as of September 30, 2013.

Insurance Services – During third quarter 2013, we performed the Step 0 assessment of our goodwill of our insurance services reporting unit. We considered certain events and circumstances specific to the reporting unit, such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the fair value of our insurance services reporting unit is less than its carrying value and deemed it necessary to perform the further 2-step impairment test. We performed an internal valuation 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%, and a discount rate of 10.0% was applied to the insurance services unit's estimated future cash flows. We did not fail this Step 1 test as of September 30, 2013, therefore Step 2 testing was not necessary.

We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Note 9 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 March 31, 2014, we had net deferred tax assets of \$12.0 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 March 31, 2014. 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.

Table of Contents

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

## RESULTS OF OPERATIONS

### Earnings Summary

Net income applicable to common shares for the three months ended March 31, 2014 increased to \$2.20 million, or \$0.25 per diluted share as compared to \$1.60 million or \$0.19 per diluted share for the same period of 2013. Earnings for the three months ended March 31, 2014 were positively impacted by lower provisions for loan losses. The provision for loan losses was \$1.0 million and \$1.5 million for the three months ended March 31, 2014 and 2013, respectively. Included in earnings for the three months ended March 31, 2014 was \$22,000 in realized securities losses and \$928,000 of charges resulting from the write down of a portion of our foreclosed properties to fair value. Returns on average equity and assets for the first three months of 2014 were 8.46% and 0.69%, respectively, compared with 6.55% and 0.52% for the same period of 2013.

### 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 \$10.4 million for the three months ended March 31, 2014 compared to \$10.1 million for the same period of 2013, representing an increase of \$248,000 or 2.45%. While our tax-equivalent earnings on interest earning assets decreased, this decrease was more than 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 0.38% from \$1.27 billion during the first three months of 2013 to \$1.26 billion for the first three months of 2014. Average interest bearing liabilities declined 0.55% from \$1.181 billion at March 31, 2013 to \$1.175 billion at March 31, 2014, at an average yield for the first three months of 2014 of 1.39% compared to 1.65% for the same period of 2013.

Our consolidated net interest margin increased to 3.33% for the three months ended March 31 2014, compared to 3.23% for the same period in 2013. 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 three months ended

March 31, 2014 compared to March 31, 2013, the yields on earning assets decreased 15 basis points, while the cost of our interest bearing funds decreased by 26 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.

### Table of Contents

46



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 Three Months Ended						
	March 31, 2014			March 31, 2013			
	Average Balance	Earnings/ Expense	Yield/ Rate		Average Balance	Earnings/ Expense	Yield/ Rate
Interest earning assets							
Loans, net of unearned income							
(1) Taxable	\$ 957,482	\$ 12,145	5.14 %		\$ 960,509	\$ 12,833	5.42%
(2) Tax-exempt	5,830	108	7.51 %		5,965	106	7.21%
Securities							
Taxable	216,900	1,281	2.40 %		216,306	1,030	1.93%
(2) Tax-exempt	75,437	864	4.64 %		79,147	961	4.92%
Federal funds sold and interest bearing deposits with other banks							
	8,923	2	0.09 %		7,510	1	0.05%
Total interest earning assets	1,264,572	14,400	4.62 %		1,269,437	14,931	4.77%
Noninterest earning assets							
Cash & due from banks	3,897				4,240		
Premises and equipment	20,582				21,101		
Other assets	116,421				114,701		
Allowance for loan losses	(12,969 )				(17,572 )		
Total assets	\$ 1,392,503				\$ 1,391,907		
Interest bearing liabilities							
Interest bearing demand deposits							
	\$ 186,982	\$ 52	0.11 %		\$ 174,724	\$ 70	0.16%
Savings deposits	208,529	319	0.62 %		195,556	309	0.64%
Time deposits	530,117	1,870	1.43 %		574,545	2,388	1.69%
Short-term borrowings							
	75,177	52	0.28 %		27,834	17	0.25%
Long-term borrowings							

and capital trust securities	174,559	1,739	4.04	%	209,255	2,027	3.93%
Total interest bearing liabilities	1,175,364	4,032	1.39	%	1,181,914	4,811	1.65%
Noninterest bearing liabilities and shareholders' equity							
Demand deposits	95,138				92,926		
Other liabilities	9,037				7,653		
Total liabilities	1,279,539				1,282,493		
Shareholders' equity - preferred	9,291				9,325		
Shareholders' equity - common	103,673				100,089		
Total liabilities and shareholders' equity	\$ 1,392,503				\$ 1,391,907		
Net interest earnings		\$ 10,368				\$ 10,120	
Net yield on interest earning assets			3.33	%			3.23%

(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 \$330,000 and \$362,000 for the periods ended

March 31, 2014 and March 31, 2013, respectively.

Table of Contents

47

---

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 Three Months Ended March 31, 2014 versus March 31, 2013		
	Volume	Rate	Net
Interest earned on:			
Loans			
Taxable	\$ (40 )	\$ (649 )	\$ (689)
Tax-exempt	(2 )	4	2
Securities			
Taxable	3	248	251
Tax-exempt	(44 )	(53 )	(97)
Federal funds sold and interest bearing deposits with other banks	-	2	2
Total interest earned on interest earning assets	(83 )	(448 )	(531)
Interest paid on:			
Interest bearing demand deposits	5	(23 )	(18)
Savings deposits	20	(10 )	10
Time deposits	(176 )	(342 )	(518)
Short-term borrowings	33	2	35
Long-term borrowings and capital trust securities	(344 )	56	(288)
Total interest paid on interest bearing	(462 )	(317 )	(779)

## liabilities

## Net interest

income	\$ 379	\$ (131 )	\$ 248
--------	--------	-----------	--------

## Noninterest Income

Total noninterest income increased to \$2.78 million for the first three months of 2014, compared to \$2.75 million for the same period of 2013. Further detail regarding noninterest income is reflected in the following table.

Table III -  
Noninterest Income

Dollars in thousands	For the Quarter Ended March 31,	
	2014	2013
Insurance commissions	\$ 1,181	\$ 1,184
Service fees related to deposit accounts	1,043	1,012
Realized securities gains (losses)	(22 )	42
Other-than-temporary impairment of securities	-	(54)
Bank owned life insurance income	270	238
Other	311	326
Total	\$ 2,783	\$ 2,748

Other-than-temporary impairment of securities – We do not anticipate material charges for other-than-temporary impairment of securities in the near term.

Table of Contents

48

---

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

## Noninterest Expense

Total noninterest expense decreased less than 1% for the three months ended March 31, 2014, as compared to the same period in 2013. Table IV below shows the breakdown of the changes.

Table IV -  
Noninterest Expense

Dollars in thousands	For the Quarter Ended March 31,			
	2014	Change		2013
	\$	\$	%	
Salaries, commissions, and employee benefits	\$ 3,980	\$ (137 )	-3.3 %	\$ 4,117
Net occupancy expense	541	85	18.6 %	456
Equipment expense	566	(32 )	-5.4 %	598
Professional fees	316	65	25.9 %	251
Amortization of intangibles	88	-	0.0 %	88
FDIC premiums	503	(37 )	-6.9 %	540
Foreclosed properties expense	253	(26 )	-9.3 %	279
Loss (gain) on sales of foreclosed properties	75	35	87.5 %	40
Write-downs of foreclosed properties	928	(1 )	-0.1 %	929
Other	1,248	(16 )	-1.3 %	1,264
<b>Total</b>	<b>\$ 8,498</b>	<b>\$ (64 )</b>	<b>-0.7 %</b>	<b>\$ 8,562</b>

## Credit Experience

While recent economic data points to a stabilizing real estate market, general economic conditions remain weak when compared to pre-2008 levels. As a result, we continue to experience elevated levels of loan delinquencies and nonperforming assets. Although Management anticipates loan delinquencies and nonperforming assets will remain higher than pre-recession levels, we do expect recent trends of improvement to continue.

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.

We recorded \$1.0 million and \$1.5 million provisions for loan losses for the first three months of 2014 and 2013, respectively. This decline is a result of lower levels of specific reserves necessary as a result of lower levels of

impaired loans at March 31, 2014 compared to March 31, 2013.

As illustrated in Table V below, our non-performing assets have decreased during the past 12 months.

Table of Contents

49

---

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

Table V - Summary of Non-Performing Assets Dollars in thousands	March 31,		December 31,
	2014	2013	2013
Accruing loans past due 90 days or more	\$ -	\$ -	\$ -
Nonaccrual loans			
Commercial	866	4,763	1,224
Commercial real estate	2,834	1,525	2,318
Commercial construction and development	3,653	-	3,782
Residential construction and development	6,599	13,076	9,048
Residential real estate	2,890	16,869	2,446
Consumer	73	72	128
Total nonaccrual loans	16,915	36,305	18,946
Foreclosed properties			
Commercial real estate	8,523	11,779	9,903
Commercial construction and development	11,097	16,670	11,125
Residential construction and development	20,640	21,929	20,485
Residential real estate	11,981	4,247	11,879
Total foreclosed properties	52,241	54,625	53,392
Reposessed assets	28	19	8
Total nonperforming assets	\$ 69,184	\$ 90,949	\$ 72,346
Total nonperforming loans as a			



percentage of total loans	1.74	%	3.77	%	1.99%
Total nonperforming assets as a percentage of total assets	4.92	%	6.54	%	5.22%
Allowance for loan losses as a percentage of nonperforming loans	65.44	%	46.88	%	66.82%
Allowance for loan losses as a percentage of period end loans	1.14	%	1.77	%	1.33%

The following table details the activity regarding our foreclosed properties for the three months ended March 31, 2014 and 2013.

Table VI - Foreclosed Property Activity	For the Three Months Ended March 31,	
Dollars in thousands	2014	2013
Balance January 1	\$ 53,392	\$ 56,172
Acquisitions	1,277	1,331
Improvements	-	73
Disposals	(1,500 )	(2,022)
Writedowns to fair value	(928 )	(929)
Balance March 31	\$ 52,241	\$ 54,625

Table of Contents

50

---

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 March 31, 2014.

Table IX - Significant Nonperforming Loan Relationships  
March 31,  
2014  
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
Eastern Panhandle WV	Residential development & undeveloped acreage	Mar. 2008 & June 2008	Jun. 2011	\$ 4,155	Collateral value	\$ 4,617 (1)	\$ 1,655	\$ 4,293
Eastern Panhandle WV	Commercial development & commercial real estate	Aug. 2006 & Apr. 2007	Aug. 2013	\$ 5,088	Collateral Value	\$ 8,600 (1)	\$ -	\$ -

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

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:

#### 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 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

#### Table of Contents

51

---

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

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 risk 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. 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 majority of these loans were underwritten in accordance with our loan-to-value policy guidelines which range from 70-85% at the time of

#### Table of Contents

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

origination. 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 March 31, 2014, approximately 71% of our impaired loans required no reserves or have been charged down to their fair value.

At March 31, 2014, December 31, 2013, and March 31, 2013, our allowance for loan losses totaled \$11.1 million, or 1.14% of total loans, \$12.7 million, or 1.33% of total loans and \$17.0 million, or 1.77% of total loans, respectively, and is considered adequate to cover our estimate of probable credit losses inherent in our loan portfolio. The decline is a result of lower average loan losses experienced over the past twelve quarters. Lower losses cause our historical charge-off factor of the quantitative reserve calculation to decline, thus requiring fewer quantitative reserves.

At March 31, 2014, December 31, 2013, and March 31, 2013, we had approximately \$52.2 million, \$53.4 million and \$54.6 million, 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.

## FINANCIAL CONDITION

Our total assets were \$1.41 billion at March 31, 2014, compared to \$1.39 billion at December 31, 2013, representing a 1.43% increase. Table VIII below serves to illustrate significant changes in our financial position between December 31, 2013 and March 31, 2014.

Table VIII - Summary of Significant Changes in Financial Position

	Balance December 31, 2013	Increase (Decrease)		Balance March 31, 2014
Dollars in thousands		Amount	Percentage	
<b>Assets</b>				
Securities available for sale	\$288,780	(6,915)	-2.4	% \$281,865
Loans, net of unearned interest	937,070	25,644	2.7	% 962,714
<b>Liabilities</b>				
Deposits	\$1,003,812	\$48,818	4.9	% \$1,052,630
Short-term borrowings	62,769	6,205	9.9	% 68,974
Long-term borrowings	163,516	(40,024)	-24.5	% 123,492

Loans increased \$25.6 million, or 2.7% during the first three months of 2014. We recently experienced modest loan growth and at present, we expect continued growth, but at a slower pace than that experienced during this most recent quarter.

Deposits increased approximately \$48.8 million during the first three months of 2014; savings deposits increased approximately \$35.4 million.

The decrease in long term borrowings is primarily attributable to maturities and repayments of long-term FHLB advances during the first three months of 2014.

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 March 31, 2014 and December 31, 2013.

Table of Contents

53

---

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

## 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 excess funds at correspondent banks, non-pledged securities, and available lines of credit with the FHLB, Federal Reserve Bank of Richmond and correspondent banks, which totaled approximately \$620 million or 44.1% of total consolidated assets at March 31, 2014.

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 borrow approximately \$471 million. As of March 31, 2014 and December 31, 2013, these advances totaled approximately \$43 million and \$83 million, respectively. At March 31, 2014, we had additional borrowing capacity of \$369 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 March 31, 2014 was approximately \$88 million, which is secured by a pledge of our consumer and commercial and industrial loan portfolios. We have a \$6 million unsecured line of credit with a correspondent bank. 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.

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.

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 March 31, 2014 totaled \$114.5 million compared to \$111.1 million at December 31, 2013.

Summit and Summit Community 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.

See Note 13 of the notes to the accompanying consolidated financial statements and Risks Relating to Our Business of the Risk Factors section of the 2013 Annual Report on Form 10K for specific details of the MOUs.

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.

### Table of Contents



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 March 31, 2014.

Table IX -  
Contractual  
Cash  
Obligations

	Long Term Debt	Capital Trust Securities	Operating Leases
Dollars in thousands			
2014	\$ 42,502	\$ -	\$ 204
2015	11,909	-	38
2016	28,911	-	-
2017	918	-	-
2018	45,017	-	-
Thereafter	11,035	19,589	-
Total	\$ 140,292	\$ 19,589	\$ 242

## 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 March 31, 2014 are presented in the following table.

Table X -  
Off-Balance  
Sheet  
Arrangements

	March 31, 2014
Dollars in thousands	
Commitments to extend credit:	
Revolving home equity and credit card lines	\$ 51,315
Construction loans	28,574
Other loans	35,788
Standby letters of credit	1,765
Total	\$ 117,442

Table of Contents

55

---

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 March 31, 2014. 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 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 limits shown below relative to reductions in net interest income over the ensuing twelve month period.

		Estimated % Change in Net Interest Income over:	
		0 - 12 Months	13 - 24 Months
Change in Interest Rates	Policy	Actual	Actual

Down				
100 basis				
points (1)	-7	%	-0.25	% -1.10%
Up 200				
basis				
points (1)	-10	%	-4.09	% -5.17%
Up 400				
basis				
points (2)	-15	%	-3.30	% -9.18%

(1) assumes a parallel shift  
in the yield curve over 12  
months

(2) assumes a parallel shift  
in the yield curve over 24  
months

Table of Contents

56

---

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 March 31, 2014, 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 March 31, 2014 were effective. There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

57

---

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, 2013.

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 17 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 Sarbanes-Oxley Act Section  
32.2 906 Certification of Chief  
Financial Officer

Exhibit Interactive Data File (XBRL)  
101

Table of Contents

58

---



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: May 12, 2014

Table of Contents

59

---

## EXHIBIT INDEX

Exhibit No.	Description	Page Number
(3)	Articles of Incorporation and By-laws:	
	(i) Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.	(a)
	(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.

[Table of Contents](#)



