SUMMIT FINANCIAL GROUP INC
Form 10-Q
November 12, 2013

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

FORM 10 – Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013.
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 jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

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

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

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

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 þNo o

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 o	Accelerated filero
Non-accelerated filer o	Smaller reporting companyþ

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

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
7,451,022 shares outstanding as of November 5, 2013

Summit Financial Group, Inc. and Subsidiaries
Table of Contents

Summit Financial Group, Inc. and Subsidiaries
Table of Contents

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

Dollars in thousands	September 30, 2013 (unaudited)	December 31, 2012 (*)	September 30, 2012 (unaudited)
ASSETS			
Cash and due from banks	$ 4,571	$ 3,833	$ 3,752
Interest bearing deposits with other banks	11,532	10,969	13,441
Cash and cash equivalents	16,103	14,802	17,193
Securities available for sale	291,258	281,539	291,992
Other investments	8,004	14,658	16,100
Loans held for sale	602	226	213
Loans, net	939,169	937,168	940,933
Property held for sale	45,303	56,172	56,033
Premises and equipment, net	20,780	21,129	21,264
Accrued interest receivable	5,364	5,621	5,352
Intangible assets	8,036	8,300	8,387
Cash surrender value of life insurance policies	35,257	29,553	30,065
Other assets	17,911	17,936	16,554
Total assets	$ 1,387,787	$ 1,387,104	$ 1,404,086
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Deposits			
Non interest bearing	$ 99,109	$ 100,592	$ 96,764
Interest bearing	917,626	926,533	930,543
Total deposits	1,016,735	1,027,125	1,027,307
Short-term borrowings	54,163	3,958	20,957
Long-term borrowings	163,540	203,268	203,744
Subordinated debentures	16,800	16,800	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	8,155	7,809	8,361
Total liabilities	1,278,982	1,278,549	1,296,758
Commitments and Contingencies			

Shareholders' Equity				
Preferred stock and related surplus - authorized 250,000 shares;				
Series 2009, 8% Non-cumulative convertible preferred stock,				
par value $1.00; issued 3,710 shares		3,519	3,519	3,519
Series 2011, 8% Non-cumulative convertible preferred stock,				
par value $1.00; issued 2013 - 11,938, 2012 - 12,000 shares		5,776	5,807	5,807
Common stock and related surplus - authorized 20,000,000 shares;				
$2.50 par value; issued and outstanding 2013 - 7,448,422 and				
2012 - 7,425,472 shares		24,632	24,520	24,520
Retained earnings		74,541	69,841	67,929
Accumulated other comprehensive income		337	4,868	5,553
Total shareholders' equity		108,805	108,555	107,328
Total liabilities and shareholders' equity	$	1,387,787	$ 1,387,104	$ 1,404,086

(*) - December 31, 2012 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

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

Dollars in thousands, except per share amounts	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Interest income				
Interest and fees on loans				
Taxable	$ 12,469	$ 13,572	$ 38,037	$ 41,812
Tax-exempt	63	76	197	243
Interest and dividends on securities				
Taxable	896	1,340	2,852	4,593
Tax-exempt	616	594	1,832	1,986
Interest on interest bearing deposits with other banks	1	7	4	30
Total interest income	14,045	15,589	42,922	48,664
Interest expense				
Interest on deposits	2,487	3,067	8,074	10,140
Interest on short-term borrowings	24	8	50	25
Interest on long-term borrowings and subordinated debentures	1,996	2,579	5,997	8,575
Total interest expense	4,507	5,654	14,121	18,740
Net interest income	9,538	9,935	28,801	29,924
Provision for loan losses	1,000	2,000	3,500	6,002
Net interest income after provision for loan losses	8,538	7,935	25,301	23,922
Other income				
Insurance commissions	1,057	1,052	3,373	3,352
Service fees related to deposit accounts	1,106	1,074	3,202	3,163
Realized securities gains	132	760	116	2,245
Other	606	514	1,741	1,649
Total other-than-temporary impairment loss on securities	(38)	(233)	(155)	(1,115)
Portion of loss recognized in other comprehensive income	-	194	37	740
Net impairment loss recognized in earnings	(38)	(39)	(118)	(375)
Total other income	2,863	3,361	8,314	10,034
Other expense				
Salaries, commissions, and employee benefits	4,050	3,940	12,155	11,733

Net occupancy expense	454	476	1,387	1,445
Equipment expense	578	573	1,724	1,777
Professional fees	263	292	885	872
Amortization of intangibles	88	88	263	263
FDIC premiums	503	510	1,558	1,532
Foreclosed properties expense	262	356	836	935
(Gain) loss on sale of foreclosed properties	(17)	(16)	546	583
Write-down of foreclosed properties	654	2,571	3,078	6,114
Other	1,396	1,237	3,900	3,749
Total other expense	8,231	10,027	26,332	29,003
Income before income taxes	3,170	1,269	7,283	4,953
Income tax expense	898	272	2,001	1,345
Net Income	2,272	997	5,282	3,608
Dividends on preferred shares	194	194	582	583
Net Income applicable to common shares	$ 2,078	$ 803	$ 4,700	$ 3,025
Basic earnings per common share	$ 0.28	$ 0.11	$ 0.63	$ 0.41
Diluted earnings per common share	$ 0.24	$ 0.10	$ 0.55	$ 0.38

See Notes to Consolidated Financial Statements

5

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

	For the Three Months Ended September 30,	
Dollars in thousands	2013	2012
Net income	$ 2,272	$ 997
Other comprehensive income (loss):		
Net unrealized (loss) on cashflow hedge of ($117), net of deferred taxes of $43	(74)	-
Non-credit related other-than-temporary impairment on available for sale debt securities - 2013 - $0, net of deferred taxes of $0; 2012 - $194, net of deferred taxes of $74	-	(120)
Net unrealized gain (loss) on available for sale debt securities of: 2013 - ($681) net of deferred taxes of $252 and reclassification adjustment for net realized gains included in net income of $132; 2012 - $1,513, net of deferred taxes of $575 and reclassification adjustment for net realized gains included in net income of $760	(429)	938
Total comprehensive income	$ 1,769	$ 1,815

For the Nine Months Ended September 30,

Dollars in thousands	2013		2012	
Net income	$	5,282	$	3,608
Other comprehensive income (loss):				
Net unrealized (loss) on cashflow hedge of ($117), net of deferred taxes of $43		(74)		-
Non-credit related other-than-temporary impairment on available for sale debt securities - 2013 - $37, net of deferred taxes of $14; 2012 - $740, net of deferred taxes of $281		(23)		(459)
Net unrealized gain (loss) on available for sale debt securities of: 2013 - ($7,038) net of deferred taxes of $2,604 and reclassification adjustment for net realized gains included in net income of $116; 2012 - $3,539, net of deferred taxes of $1,345 and reclassification adjustment for net realized gains included in net income of $2,245		(4,434)		2,194
Total comprehensive income	$	751	$	5,343

See Notes to Consolidated Financial Statements

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

Dollars in thousands, except per share amounts	Series 2009 Preferred Stock and Related Surplus	Series 2011 Preferred Stock and Related Surplus	Common Stock and Related Surplus	Retained Earnings	Accumulated Other Compre-hensive Income	Total Share-holders' Equity
Balance, December 31, 2012	$ 3,519	$ 5,807	$ 24,520	$ 69,841	$ 4,868	$ 108,555
Nine Months Ended September 30, 2013						
Comprehensive income:						
Net income	-	-	-	5,282	-	5,282
Other comprehensive income (loss)					(4,531)	(4,531)
Total comprehensive income (loss)						751
Exercise of stock options	-	-	80	-	-	80
Stock compensation expense	-	-	1	-	-	1
Series 2009 Preferred Stock cash dividends declared ($60.00 per share)	-	-	-	(223)	-	(223)
Series 2011 Preferred Stock cash dividends declared ($30.00 per share)	-	-	-	(359)	-	(359)
Conversion of Series 2011 Preferred Stock to Common Stock	-	(31)	31	-		
Balance, September 30, 2013	$ 3,519	$ 5,776	$ 24,632	$ 74,541	$ 337	$ 108,805
Balance, December 31, 2011	$ 3,519	$ 5,807	$ 24,518	$ 64,904	$ 3,818	$ 102,566
Nine Months Ended September 30, 2012						
Comprehensive income:						
Net income	-	-	-	3,608	-	3,608

Other comprehensive income					1,735	1,735
Total comprehensive income						5,343
Stock compensation expense	-	-	2	-	-	2
Series 2009 Preferred Stock cash dividends declared ($60.00 per share)	-	-	-	(223)	-	(223)
Series 2011 Preferred Stock cash dividends declared ($30.00 per share)	-	-	-	(360)	-	(360)
Balance, September 30, 2012	$ 3,519	$ 5,807	$ 24,520	$ 67,929	$ 5,553	$ 107,328

See Notes to Consolidated Financial Statements

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

Dollars in thousands	Nine Months Ended September 30, 2013	September 30, 2012
Cash Flows from Operating Activities		
Net income	$ 5,282	$ 3,608
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	878	989
Provision for loan losses	3,500	6,002
Stock compensation expense	1	2
Deferred income tax expense (benefit)	1,248	(1,172)
Loans originated for sale	(7,963)	(5,463)
Proceeds from loans sold	7,587	5,251
Securities gains	(116)	(2,245)
Other-than-temporary impairment of securities	118	375
Loss on disposal of assets	535	583
Write down of foreclosed properties	3,078	6,114
Amortization of securities premiums (accretion of discounts), net	4,698	3,181
Amortization of goodwill and purchase accounting adjustments, net	272	272
Decrease in accrued interest receivable	257	431
Increase in cash surrender value of bank owned life insurance	(704)	(781)
(Increase) decrease in other assets	2,354	(971)

Decrease in other liabilities	(748)	(140)
Net cash provided by operating activities	20,277	16,036
Cash Flows from Investing Activities		
Proceeds from maturities and calls of securities available for sale	1,258	4,056
Proceeds from sales of securities available for sale	41,188	64,567
Principal payments received on securities available for sale	50,650	47,584
Purchases of securities available for sale	(111,443)	(120,114)
Purchases of other investments	(2,541)	-
Redemption of Federal Home Loan Bank Stock	5,922	3,048
Net principal payments received from (loans made to) customers	(8,371)	13,736
Purchases of premises and equipment	(528)	(170)
Proceeds from disposal of premises and equipment	11	-
Proceeds from sales of other repossessed assets & property held for sale	10,339	6,998
Purchase of life insurance contracts	(5,000)	-
Net cash provided by investing activities	(18,515)	19,705
Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and savings accounts	9,759	15,662
Net decrease in time deposits	(20,149)	(4,856)
Net increase in short-term borrowings	50,205	5,002
Proceeds from long-term borrowings	3,454	-
Repayment of long-term borrowings	(43,228)	(66,510)
Exercise of stock options	80	-
Dividends paid on preferred stock	(582)	(537)

Net cash (used in) financing activities		(461)		(51,239)
Increase (decrease) in cash and cash equivalents		1,301		(15,498)
Cash and cash equivalents:				
Beginning		14,802		32,691
Ending	$	16,103	$	17,193

(Continued)

See Notes to Consolidated Financial Statements

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

Dollars in thousands	Nine Months Ended September 30, 2013	September 30, 2012
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 14,526	$ 19,335
Income taxes	$ 1,098	$ 1,834
Supplemental Schedule of Noncash Investing and Financing Activities		
Other assets acquired in settlement of loans	$ 2,871	$ 5,266

See Notes to Consolidated Financial Statements

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 September 30, 2013 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 2012 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2012 and September 30, 2012, as previously presented, have been reclassified to conform to current year classifications.

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU No. 2013-02, Comprehensive Income (Topic 220) – Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income amended authoritative guidance related to the reporting of reclassifications out of other comprehensive earnings. The new guidance sets requirements for presentation for significant items reclassified to net earnings during the period presented. The new guidance was effective for annual and interim periods beginning on January 1, 2013 and did not have an effect on our financial statements.

ASU 2013-10, “Derivatives and Hedging (Topic 815) – Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes” permits the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate (“LIBOR”). ASU 2013-10 is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013 and is not expected to have a significant impact on our financial statements.

NOTE 3. FAIR VALUE MEASUREMENTS

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

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

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

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

Accordingly, securities available-for-sale and derivative financial instruments 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.

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. At September 30, 2013, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with ASC Topic 310, impaired loans where an allowance is established based on the fair value of collateral requires classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When a current appraised value is not available and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

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

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

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

Dollars in thousands	Balance at September 30, 2013	Fair Value Measurements Using: Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	$ 28,430	$ -	$ 28,430	$ -
Mortgage backed securities:				
Government sponsored agencies	150,787	-	150,787	-
Nongovernment sponsored entities	13,440	-	13,440	-
State and political subdivisions	15,011	-	15,011	-
Corporate debt securities	3,950	-	3,950	-

Other equity securities		77		-		77		-
Tax-exempt state and political subdivisions		79,563		-		79,563		-
Tax-exempt mortgage-backed securities		-		-		-		-
Total available for sale securities	$	291,258	$	-	$	291,258	$	-
Derivative financial instrument								
Interest rate swap	$	(117)	$	-	$	(117)	$	-

Dollars in thousands	Balance at December 31, 2012	Fair Value Measurements Using: Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	$ 29,020	$ -	$ 29,020	$ -
Mortgage backed securities:				
Government sponsored agencies	136,570	-	136,570	-
Nongovernment sponsored agencies	15,745	-	15,745	-
State and political subdivisions	12,169	-	12,169	-
Corporate debt securities	1,950	-	1,950	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	83,270	-	83,270	-
Tax-exempt mortgage backed securities	2,738	-	2,738	-
Total available for sale securities	$ 281,539	$ -	$ 281,539	$ -

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended September 30, 2013.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

Dollars in thousands	Total at September 30, 2013	Fair Value Measurements Using: Level 1	Level 2	Level 3
Residential mortgage loans held for sale	$ 602	$ -	$ 602	$ -
Impaired loans				
Commercial	$ 5,456	$ -	$ 3,731	$ 1,725

Commercial real estate		17,109		-		3,998		13,111
Construction and development		24,128		-		21,629		2,499
Residential real estate		22,632		-		17,341		5,291
Consumer		40		-		-		40
Total impaired loans	$	69,365	$	-	$	46,699	$	22,666
OREO								
Commercial	$	-	$	-	$	-	$	-
Commercial real estate		9,961		-		9,961		-
Construction and development		31,747		-		31,747		-
Residential real estate		3,595		-		3,595		-
Consumer		-		-		-		-
Total OREO	$	45,303	$	-	$	45,303	$	-

Dollars in thousands	Total at December 31, 2012	Fair Value Measurements Using: Level 1	Level 2	Level 3
Residential mortgage loans held for sale	$ 226	$ -	$ 226	$ -
Impaired loans				
Commercial	$ 10,856	$ -	$ 5,013	$ 5,843
Commercial real estate	25,435	-	16,331	9,104
Construction and development	27,352	-	24,578	2,774
Residential real estate	24,442	-	21,625	2,817
Consumer	50	-	-	50
Total impaired loans	$ 88,135	$ -	$ 67,547	$ 20,588
OREO				
Commercial	$ -	$ -	$ -	$ -
Commercial real estate	11,835	-	11,047	788
Construction and development	40,671	-	35,978	4,693
Residential real estate	3,666	-	3,666	-
Consumer	-	-	-	-
Total OREO	$ 56,172	$ -	$ 50,691	$ 5,481

Our policy with respect to troubled debt restructurings ("TDRs"), included in impaired loans, is to appraise any underlying collateral at the time of restructure, and then only obtain periodic reappraisals if the TDR is not performing in accordance with the terms of the restructure. Substantially all Level 3 fair values of impaired loans in the above tables are performing TDRs.

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.

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

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

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

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

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

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

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

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

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

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

Derivative financial instruments: The fair value of the interest rate swap 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:

	September 30, 2013		December 31, 2012	
Dollars in thousands	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	$ 16,103	$ 16,103	$ 14,802	$ 14,802
Securities available for sale	291,258	291,258	281,539	281,539
Other investments	8,004	8,004	14,658	14,658
Loans held for sale	602	602	226	226
Loans, net	939,169	965,070	937,168	965,454
Accrued interest receivable	5,364	5,364	5,621	5,621
	$ 1,260,500	$ 1,286,401	$ 1,254,014	$ 1,282,300
Financial liabilities				
Deposits	$ 1,016,735	$ 1,045,084	$ 1,027,125	$ 1,064,957
Short-term borrowings	54,163	54,163	3,958	3,958
Long-term borrowings	163,540	175,237	203,268	220,175
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	1,473	1,473	1,877	1,877

Derivative financial liabilities		117		117		-		-
	$	1,272,417	$	1,312,463	$	1,272,617	$	1,327,356

15

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

NOTE 4. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

	For the Three Months Ended September 30,					
	2013			2012		
Dollars in thousands, except per share amounts	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share
Net income	$ 2,272			$ 997		
Less preferred stock dividends	(194)			(194)		
Basic EPS	$ 2,078	7,443,865	$ 0.28	$ 803	7,425,472	$ 0.11
Effect of dilutive securities:						
Stock options	-	7,819		-	1,261	
Series 2011 convertible preferred stock	120	1,495,728		120	1,500,000	
Series 2009 convertible preferred stock	74	674,545		74	674,545	
Diluted EPS	$ 2,272	9,621,957	$ 0.24	$ 997	9,601,278	$ 0.10

	For the Nine Months Ended September 30,					
	2013			2012		
Dollars in thousands, except per share amounts	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share
Net income	$ 5,282			$ 3,608		
Less preferred stock dividends	(582)			(583)		
Basic EPS	$ 4,700	7,438,216	$ 0.63	$ 3,025	7,425,472	$ 0.41
Effect of dilutive securities:						
Stock options	-	7,316		-	1,081	
Series 2011 convertible preferred stock	359	1,498,251		360	1,500,000	

Series 2009 convertible preferred stock		223	674,545				223	674,545		
Diluted EPS	$	5,282	9,618,328	$	0.55	$	3,608	9,601,098	$	0.38

Stock option grants and the convertible preferred shares are disregarded in this computation if they are determined to be anti-dilutive. Our anti-dilutive stock options at September 30, 2013 and 2012 totaled 170,500 shares and 289,380 shares, respectively.

NOTE 5. SECURITIES

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at September 30, 2013, December 31, 2012, and September 30, 2012 are summarized as follows:

	September 30, 2013			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
Available for Sale				
Taxable debt securities:				
U. S. Government agencies and corporations	$ 27,740	$ 757	$ 67	$ 28,430
Residential mortgage-backed securities:				
Government-sponsored agencies	149,569	2,444	1,226	150,787
Nongovernment-sponsored agencies	13,134	315	9	13,440
State and political subdivisions:				
General obligations	9,064	-	383	8,681
Water and sewer revenues	3,234	1	91	3,144
Other revenues	3,298	-	112	3,186
Corporate debt securities	3,970	25	45	3,950
Total taxable debt securities	210,009	3,542	1,933	211,618
Tax-exempt debt securities:				
State and political subdivisions:				
General obligations	49,569	1,048	1,112	49,505
Water and sewer revenues	10,132	89	290	9,931
Lease revenues	8,869	1	441	8,429
Lottery/casino revenues	4,457	68	166	4,359
Other revenues	7,490	61	212	7,339
Total tax-exempt debt securities	80,517	1,267	2,221	79,563
Equity securities	77	-	-	77
Total available for sale securities	$ 290,603	$ 4,809	$ 4,154	$ 291,258

Notes to Consolidated Financial Statements (unaudited)

	December 31, 2012			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
Available for Sale				
Taxable debt securities				
U. S. Government agencies				
and corporations	$ 28,128	$ 892	$ -	$ 29,020
Residential mortgage-backed securities:				
Government-sponsored agencies	133,812	3,250	492	136,570
Nongovernment-sponsored entities	15,380	509	144	15,745
State and political subdivisions:				
General obligations	8,847	58	57	8,848
Water and sewer revenues	1,920	-	32	1,888
Other revenues	1,420	13	-	1,433
Corporate debt securities	1,959	29	38	1,950
Total taxable debt securities	191,466	4,751	763	195,454
Tax-exempt debt securities				
State and political subdivisions:				
General obligations	54,948	3,259	145	58,062
Water and sewer revenues	5,773	171	47	5,897
Lease revenues	6,910	159	13	7,056
Lottery/casino revenues	4,500	305	9	4,796
Other revenues	7,272	210	23	7,459
Residential mortgage-backed securities:				
Government-sponsored agencies	2,738	-	-	2,738
Total tax-exempt debt securities	82,141	4,104	237	86,008
Equity securities	77	-	-	77
Total available for sale securities	$ 273,684	$ 8,855	$ 1,000	$ 281,539

	September 30, 2012			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
Available for Sale				
Taxable debt securities:				
U. S. Government agencies				
and corporations	$ 25,857	$ 1,009	$ 4	$ 26,862
Residential mortgage-backed securities:				

Government-sponsored agencies		150,233		3,741		453		153,521
Nongovernment-sponsored agencies		21,199		712		290		21,621
State and political subdivisions		10,176		57		56		10,177
Corporate debt securities		1,955		29		74		1,910
Total taxable debt securities		209,420		5,548		877		214,091
Tax-exempt debt securities:								
State and political subdivisions		70,678		4,358		70		74,966
Residential mortgage-backed securities:								
Government-sponsored agencies		2,858		-		-		2,858
Total tax-exempt debt securities		73,536		4,358		70		77,824
Equity securities		77		-		-		77
Total available for sale securities	$	283,033	$	9,906	$	947	$	291,992

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.

	September 30, 2013			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
West Virginia	$ 14,286	$ 97	$ 267	$ 14,116
Illinois	10,435	59	535	9,959
California	8,102	107	241	7,968
Texas	7,155	234	178	7,211
Washington	4,409	110	80	4,439

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.

The maturities, amortized cost and estimated fair values of securities at September 30, 2013, are summarized as follows:

	Available for Sale	
	Amortized	Estimated
Dollars in thousands	Cost	Fair Value
Due in one year or less	$ 68,076	$ 68,631
Due from one to five years	88,188	89,189
Due from five to ten years	33,174	33,187
Due after ten years	101,088	100,174
Equity securities	77	77
	$ 290,603	$ 291,258

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 nine months ended September 30, 2013 are as follows:

Dollars in thousands	Sales	Calls and Maturities	Principal Payments	Gains	Losses
Securities available for sale	$ 41,188	$ 1,258	$ 50,650	$ 362	$ 246

During the three and nine months ended September 30, 2013 and 2012, we recorded other-than-temporary impairment losses on residential mortgage-backed nongovernment sponsored entity securities as follows:

In thousands	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Total other-than-temporary impairment losses	$ (38)	$ (233)	$ (155)	$ (1,115)
Portion of loss recognized in other comprehensive income	-	194	37	740
Net impairment losses recognized in earnings	$ (38)	$ (39)	$ (118)	$ (375)

Activity related to the credit component recognized on debt securities available for sale for which a portion of other-than-temporary impairment was recognized in other comprehensive income for the three and nine months ended September 30, 2013 is as follows:

In thousands	Three Months Ended September 30, 2013 Total	Nine Months Ended September 30, 2013 Total
Beginning Balance	$ 2,984	$ 2,904
Additions for the credit component on debt securities in which other-than-temporary impairment was not previously recognized	38	118
Securities sold during the period	-	-
Ending Balance	$ 3,022	$ 3,022

At September 30, 2013, our debt securities with other-than-temporary impairment in which only the amount of loss related to credit was recognized in earnings consisted solely of residential mortgage-backed securities issued by nongovernment-sponsored entities. We utilize third party vendors to estimate the portion of loss attributable to credit using a discounted cash flow models. The vendors estimate cash flows of the underlying collateral of each mortgage-backed security using models that incorporate their best estimates of current key assumptions, such as default rates, loss severity and prepayment rates. Assumptions utilized vary widely from security to security, and are influenced by such factors as underlying loan interest rates, geographical location of underlying borrowers, collateral type and other borrower characteristics.

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

Provided below is a summary of securities available for sale which were in an unrealized loss position at September 30, 2013 and December 31, 2012, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income.

	September 30, 2013					
	Less than 12 months		12 months or more		Total	
Dollars in thousands	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	$ 7,770	$ (67)	$ -	$ -	$ 7,770	$ (67)
Residential mortgage-backed securities:						
Government-sponsored agencies	48,957	(1,011)	11,754	(215)	60,711	(1,226)
Nongovernment-sponsored entities	355	(1)	858	(8)	1,213	(9)
State and political subdivisions:						
General obligations	5,806	(316)	876	(67)	6,682	(383)
Water and sewer revenues	634	(35)	1,175	(56)	1,809	(91)
Other revenues	3,185	(112)	-	-	3,185	(112)
Corporate debt securities	2,954	(45)	-	-	2,954	(45)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	21,134	(1,112)	-	-	21,134	(1,112)
Water and sewer revenues	6,505	(290)	-	-	6,505	(290)
Lease revenues	7,522	(424)	366	(17)	7,888	(441)
Lottery/casino revenues	3,292	(166)	-	-	3,292	(166)
Other revenues	5,407	(212)	-	-	5,407	(212)
Total temporarily impaired securities	113,521	(3,791)	15,029	(363)	128,550	(4,154)
Other-than-temporarily impaired securities						
Taxable debt securities						
Residential mortgage-backed securities:						
Nongovernment-sponsored entities	-	-	-	-	-	-
Total other-than-temporarily impaired securities	-	-	-	-	-	-
Total	$ 113,521	$ (3,791)	$ 15,029	$ (363)	$ 128,550	$ (4,154)

21

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

	December 31, 2012					
	Less than 12 months		12 months or more		Total	
Dollars in thousands	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	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage-backed securities:						
Government-sponsored agencies	36,498	(414)	8,997	(78)	45,495	(492)
Nongovernment-sponsored entities	-	(4)	1,478	(14)	1,478	(18)
State and political subdivisions:						
General obligations	2,526	(57)	-	-	2,526	(57)
Water and sewer revenues	1,240	(28)	387	(4)	1,627	(32)
Other revenues	-	-	-	-	-	-
Corporate debt securities	-	-	962	(38)	962	(38)
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	11,926	(145)	-	-	11,926	(145)
Water and sewer revenues	2,534	(47)	-	-	2,534	(47)
Lease revenues	1,013	(13)	-	-	1,013	(13)
Lottery/casino revenues	1,777	(9)	-	-	1,777	(9)
Other revenues	2,684	(23)	-	-	2,684	(23)
Other equity securities	-	-	-	-	-	-
Total temporarily impaired securities	60,198	(740)	11,824	(134)	72,022	(874)
Other-than-temporarily impaired securities						
Taxable debt securities						
Residential mortgage-backed securities:						
Nongovernment-sponsored entities	265	(6)	593	(120)	858	(126)
Total other-than-temporarily impaired securities	265	(6)	593	(120)	858	(126)
Total	$ 60,463	$ (746)	$ 12,417	$ (254)	$ 72,880	$ (1,000)

We held 127 available for sale securities having an unrealized loss at September 30, 2013. We do not intend to sell these securities, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost bases. We believe that this decline in value is primarily attributable to the lack of market liquidity and to changes in market interest rates and not due to credit quality. Accordingly, no additional other-than-temporary impairment charge to earnings is warranted at this time.

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".

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:

Dollars in thousands	September 30, 2013	December 31, 2012	September 30, 2012
Commercial	$ 83,844	$ 85,829	$ 88,997
Commercial real estate			
Owner-occupied	151,260	154,252	150,090
Non-owner occupied	279,412	276,082	279,132
Construction and development			
Land and land development	73,089	79,335	82,857
Construction	12,323	3,772	2,087
Residential real estate			
Non-jumbo	215,058	216,714	215,584
Jumbo	59,701	61,567	62,748
Home equity	53,674	53,263	53,455
Consumer	20,472	20,586	21,290
Other	3,375	3,701	2,513
Total loans, net of unearned fees	952,208	955,101	958,753
Less allowance for loan losses	13,039	17,933	17,820
Loans, net	$ 939,169	$ 937,168	$ 940,933

The following table presents the contractual aging of the recorded investment in past due loans by class as of September 30, 2013 and 2012 and December 31, 2012.

At September 30, 2013

Dollars in thousands	Past Due 30-59 days	60-89 days	> 90 days	Total	Current	Recorded Investment > 90 days and Accruing
Commercial	$ 10	$ 111	$ 1,583	$ 1,704	$ 82,140	$ -
Commercial real estate						
Owner-occupied	846	229	432	1,507	149,753	-
Non-owner occupied	587	244	-	831	278,581	-
Construction and development						
Land and land development	154	-	8,669	8,823	64,266	-
Construction	-	-	38	38	12,285	-
Residential mortgage						
Non-jumbo	3,467	2,031	2,225	7,723	207,335	-
Jumbo	-	-	9,000	9,000	50,701	-
Home equity	214	49	24	287	53,387	-
Consumer	197	77	91	365	20,107	-
Other	50	-	-	50	3,325	-
Total	$ 5,525	$ 2,741	$ 22,062	$ 30,328	$ 921,880	$ -

At December 31, 2012

Dollars in thousands	Past Due 30-59 days	60-89 days	> 90 days	Total	Current	Recorded Investment > 90 days and Accruing
Commercial	$ 225	$ 5	$ 2,294	$ 2,524	$ 83,305	$ -
Commercial real estate						
Owner-occupied	57	-	1,023	1,080	153,172	-
Non-owner occupied	182	193	908	1,283	274,799	-

Construction and development						
Land and land development	-	-	11,795	11,795	67,540	-