

SUMMIT FINANCIAL GROUP INC  
Form 10-Q  
May 06, 2016  
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, 2016

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 (IRS Employer  
incorporation or organization) Identification No.)  
300 North Main Street  
Moorefield, West Virginia 26836  
(Address of principal executive offices) (Zip Code)  
(304) 530-1000  
(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

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  
10,681,880 shares outstanding as of April 30, 2016

---

Table of Contents

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1. Financial Statements</b>	
Consolidated balance sheets March 31, 2016 (unaudited), December 31, 2015, and March 31, 2015 (unaudited)	<u>4</u>
Consolidated statements of income for the three months ended March 31, 2016 and 2015 (unaudited)	<u>5</u>
Consolidated statements of comprehensive income for the three months ended March 31, 2016 and 2015 (unaudited)	<u>6</u>
Consolidated statements of shareholders' equity for the three months ended March 31, 2016 and 2015 (unaudited)	<u>7</u>
Consolidated statements of cash flows for the three months ended March 31, 2016 and 2015 (unaudited)	<u>8</u>
Notes to consolidated financial statements (unaudited)	<u>10</u>
<b>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</b>	<u>41</u>
<b>Item 3. Quantitative and Qualitative Disclosures about Market Risk</b>	<u>51</u>
<b>Item 4. Controls and Procedures</b>	<u>52</u>

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings	<u>53</u>
Item 1A. Risk Factors	<u>53</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>53</u>

SIGNATURES	<u>54</u>
------------	-----------

EXHIBIT INDEX	<u>55</u>
---------------	-----------

## Consolidated Balance Sheets (unaudited)

	March 31, 2016 (unaudited)	December 31, 2015 (*)	March 31, 2015 (unaudited)
Dollars in thousands			
<b>ASSETS</b>			
Cash and due from banks	\$4,005	\$3,625	\$3,850
Interest bearing deposits with other banks	12,655	5,862	8,437
Cash and cash equivalents	16,660	9,487	12,287
Securities available for sale	271,515	280,792	282,135
Other investments	10,099	8,949	7,247
Loans held for sale, net	610	779	85
Loans, net	1,096,790	1,079,331	1,039,669
Property held for sale	24,684	25,567	34,368
Premises and equipment, net	21,589	21,572	20,208
Accrued interest receivable	5,230	5,544	5,564
Intangible assets	7,448	7,498	7,648
Cash surrender value of life insurance policies	37,989	37,732	36,961
Other assets	15,954	15,178	14,320
<b>Total assets</b>	<b>\$1,508,568</b>	<b>\$1,492,429</b>	<b>\$1,460,492</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Liabilities</b>			
<b>Deposits</b>			
Non interest bearing	\$122,378	\$119,010	\$117,049
Interest bearing	972,166	947,699	941,259
<b>Total deposits</b>	<b>1,094,544</b>	<b>1,066,709</b>	<b>1,058,308</b>
Short-term borrowings	153,448	171,394	148,985
Long-term borrowings	75,103	75,581	77,013
Subordinated debentures	—	—	5,000
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	19,765	15,412	15,708
<b>Total liabilities</b>	<b>1,362,449</b>	<b>1,348,685</b>	<b>1,324,603</b>
<b>Commitments and Contingencies</b>			
<b>Shareholders' Equity</b>			
Preferred stock, \$1.00 par value, authorized 250,000 shares	—	—	—
Common stock and related surplus, \$2.50 par value; authorized 20,000,000 shares; issued: 10,854,809 shares 2016, 10,853,566 shares December 2015, and 10,586,242 shares March 2015; outstanding: 10,681,880 shares 2016, 10,671,744 shares December 2015, and 10,586,242 shares March 2015	45,829	45,741	43,072
Unallocated common stock held by Employee Stock Ownership Plan - 2016 - 172,929, December 2015 - 181,822 shares	(1,867)	(1,964)	—
Retained earnings	103,418	100,423	91,176
Accumulated other comprehensive income	(1,261)	(456)	1,641
<b>Total shareholders' equity</b>	<b>146,119</b>	<b>143,744</b>	<b>135,889</b>

Total liabilities and shareholders' equity	\$1,508,568	\$1,492,429	\$1,460,492
--	-------------	-------------	-------------

(\* ) - December 31, 2015 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

Table of Contents

4

---

## Consolidated Statements of Income (unaudited)

Dollars in thousands, except per share amounts	For the Three Months Ended March 31,	
	2016	2015
Interest income		
Interest and fees on loans		
Taxable	\$13,291	\$12,733
Tax-exempt	145	115
Interest and dividends on securities		
Taxable	1,084	1,282
Tax-exempt	642	612
Interest on interest bearing deposits with other banks	3	1
Total interest income	15,165	14,743
Interest expense		
Interest on deposits	2,170	2,071
Interest on short-term borrowings	240	112
Interest on long-term borrowings and subordinated debentures	976	1,040
Total interest expense	3,386	3,223
Net interest income	11,779	11,520
Provision for loan losses	250	250
Net interest income after provision for loan losses	11,529	11,270
Other income		
Insurance commissions	924	1,128
Service fees related to deposit accounts	978	976
Realized securities gains	393	480
Bank owned life insurance income	256	261
Other	255	294
Total other income	2,806	3,139
Other expense		
Salaries, commissions, and employee benefits	4,682	4,187
Net occupancy expense	540	499
Equipment expense	656	535
Professional fees	472	335
Amortization of intangibles	50	50
FDIC premiums	300	330
Merger expense	112	—
Foreclosed properties expense	124	208
(Gain) loss on sale of foreclosed properties	(6	) 150
Write-down of foreclosed properties	109	572
Other	1,515	1,338
Total other expense	8,554	8,204
Income before income taxes	5,781	6,205
Income tax expense	1,719	1,920
Net Income	\$4,062	\$4,285
Basic earnings per common share	\$0.38	\$0.49
Diluted earnings per common share	\$0.38	\$0.41

See Notes to Consolidated Financial Statements

Table of Contents

5

---



Consolidated Statement of Comprehensive Income (unaudited)

	For the Three Months Ended March 31,	
Dollars in thousands	2016	2015
Net income	\$4,062	\$4,285
Other comprehensive income (loss):		
Net unrealized loss on cashflow hedge of:		
2016 - (\$2,321), net of deferred taxes of (\$859); 2015 - (\$1,412), net of deferred taxes of (\$522)	(1,462 )	(890 )
Net unrealized gain on available for sale debt securities of:		
2016 - \$1,043, net of deferred taxes of \$386 and reclassification adjustment for net realized gains included in net income of \$393; 2015 - \$729, net of deferred taxes of \$270 and reclassification adjustment for net realized gains included in net income of \$480	657	459
Total comprehensive income	\$3,257	\$3,854

See Notes to Consolidated Financial Statements

Table of Contents

6

---

## 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	Unallocated Common Stock Held by ESOP	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2015	\$—	\$—	\$45,741	\$ (1,964 )	\$100,423	\$ (456 )	\$143,744
Three Months Ended March 31, 2016							
Comprehensive income:							
Net income	—	—	—	—	4,062	—	4,062
Other comprehensive loss	—	—	—	—	—	(805 )	(805 )
Total comprehensive income	—	—	—	—	—	—	3,257
Stock compensation expense	—	—	50	—	—	—	50
Unallocated ESOP shares committed to be released - 8,893 shares	—	—	18	97	—	—	115
Common stock issuances from reinvested dividends	—	—	20	—	(20 )	—	—
Common stock cash dividends declared (\$0.10 per share)	—	—	—	—	(1,047 )	—	(1,047 )
Balance, March 31, 2016	\$—	\$—	\$45,829	\$ (1,867 )	\$103,418	\$ (1,261 )	\$146,119
Balance, December 31, 2014	\$3,419	\$5,764	\$32,670	\$—	\$87,719	\$2,072	\$131,644
Three Months Ended March 31, 2015							
Comprehensive income:							
Net income	—	—	—	—	4,285	—	4,285
Other comprehensive loss	—	—	—	—	—	(431 )	(431 )
Total comprehensive income	—	—	—	—	—	—	3,854
Conversion of Series 2009 Preferred Stock to common stock	(3,419 )	—	3,413	—	—	—	(6 )
Conversion of Series 2011 Preferred Stock to common stock	—	(5,764 )	5,757	—	—	—	(7 )
Issuance of 237,753 shares of common stock	—	—	2,312	—	—	—	2,312
Repurchase and retirement of 100,000 shares of common stock	—	—	(1,080 )	—	—	—	(1,080 )
Common stock cash dividends declared (\$0.08 per share)	—	—	—	—	(828 )	—	(828 )
Balance, March 31, 2015	\$—	\$—	\$43,072	\$—	\$91,176	\$1,641	\$135,889

See Notes to Consolidated Financial Statements

Table of Contents

7

---

## Consolidated Statements of Cash Flows (unaudited)

Dollars in thousands	Three Months Ended	
	March 31, 2016	March 31, 2015
<b>Cash Flows from Operating Activities</b>		
Net income	\$4,062	\$4,285
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	295	260
Provision for loan losses	250	250
Stock compensation expense	50	—
Deferred income tax expense (benefit)	(102)	81
Loans originated for sale	(2,332)	(536)
Proceeds from loans sold	2,501	978
Securities gains	(393)	(480)
(Gain) loss on disposal of assets	(6)	152
Write down of foreclosed properties	109	572
Amortization of securities premiums (accretion of discounts), net	1,121	1,252
Amortization of intangibles, net	50	53
Decrease in accrued interest receivable	315	274
Increase in cash surrender value of bank owned life insurance	(256)	(261)
Increase in other assets	(727)	(746)
Increase in other liabilities	1,302	1,420
Net cash provided by operating activities	6,239	7,554
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities and calls of securities available for sale	55	365
Proceeds from sales of securities available for sale	33,787	26,835
Principal payments received on securities available for sale	8,170	8,621
Purchases of securities available for sale	(32,418)	(35,166)
Purchases of other investments	(5,149)	(2,736)
Proceeds from sales & redemptions of other investments	3,999	1,671
Net loans made to customers	(16,864)	(20,822)
Purchases of premises and equipment	(312)	(409)
Proceeds from sales of other repossessed assets & property held for sale	1,302	3,595
Net cash (used in) investing activities	(7,430)	(18,046)
<b>Cash Flows from Financing Activities</b>		
Net increase (decrease) in demand deposit, NOW and savings accounts	18,395	(1,706)
Net increase (decrease) in time deposits	9,439	(1,313)
Net increase (decrease) in short-term borrowings	(17,945)	25,352
Repayment of long-term borrowings	(478)	(477)
Repayment of subordinated debt	—	(11,800)
Net proceeds from issuance of common stock	—	2,298
Retirement of common stock	—	(1,080)
Dividends paid on common stock	(1,047)	(814)
Dividends paid on preferred stock	—	(191)
Net cash provided by financing activities	8,364	10,269
Increase (decrease) in cash and cash equivalents	7,173	(223)
Cash and cash equivalents:		

Beginning	9,487	12,510
Ending	\$16,660	\$12,287

(Continued)

See Notes to Consolidated Financial Statements

Table of Contents

8

---

Consolidated Statements of Cash Flows (unaudited) - continued

Dollars in thousands	Three Months Ended	
	March 31, 2016	March 31, 2015
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$3,434	\$ 3,242
Income taxes	\$—	\$ 128
Supplemental Schedule of Noncash Investing and Financing Activities		
Real property and other assets acquired in settlement of loans	\$—	\$ 714

See Notes to Consolidated Financial Statements

Table of Contents

9

---



## 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, 2016 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 2015 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2015 and March 31, 2015, as previously presented, have been reclassified to conform to current year classifications.

## NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) - Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 is effective for us beginning January 1, 2016, though early adoption is permitted, and is not expected to have a significant impact on our financial statements.

ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30) - Simplifying the Presentation of Debt Issuance Costs specifies that debt issuance costs related to a recognized liability are to be reported in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. ASU 2015-03 is effective for years beginning after December 31, 2015 and is not expected to have a material impact on our financial statements.

The guidance of ASU No. 2015-03 did not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance for debt issuance costs related to line-of-credit arrangements within the update, in ASU 2015-15, Interest—Imputation of Interest (Subtopic 835-30) - Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting), issued in August 2015, the SEC staff stated that they would not object to any entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.

ASU 2015-16, Business Combinations (Topic 805) – Simplifying the Accounting for Measurement-Period Adjustments requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the

income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at the acquisition date reflecting the portion of the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. Under previous guidance, adjustments to provisional amounts identified during the measurement period are to be recognized retrospectively. ASU 2015-16 became effective for us on January 1, 2016 and did not have a significant impact on our financial statements.

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to

Table of Contents

10

---

be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-01 will be effective for us on January 1, 2018 and is not expected to have a significant impact on our financial statements.

ASU 2016-02, Leases (Topic 842) will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model and ASC Topic 606, Revenue from Contracts with Customers. ASU 2016-02 will be effective for us on January 1, 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. We are currently evaluating the potential impact of ASU 2016-02 on our financial statements.

ASU 2016-05, Derivatives and Hedging (Topic 815) Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships, clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under ASC Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. ASU 2016-05 will be effective for us on January 1, 2017 and is not expected to have a significant impact on our financial statements.

ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, requires that all excess tax benefits and tax deficiencies related to share-based payment awards be recognized as income tax expense or benefit in the income statement during the period in which they occur. Previously, such amounts were recorded in the pool of excess tax benefits included in additional paid-in capital, if such pool was available. Because excess tax benefits are no longer recognized in additional paid-in capital, the assumed proceeds from applying the treasury stock method when computing earnings per share should exclude the amount of excess tax benefits that would have previously been recognized in additional paid-in capital. Additionally, excess tax benefits should be classified along with other income tax cash flows as an operating activity rather than a financing activity, as was previously the case. ASU 2016-09 also provides that an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. ASU 2016-09 changes the threshold to qualify for equity classification (rather than as a liability) to permit withholding up to the maximum statutory tax rates (rather than the minimum as was previously the case) in the applicable jurisdictions. ASU 2016-09 will be effective on January 1, 2017 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 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 loss 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 discounted cash flows or collateral value exceeds the recorded investments in such loans. These loans are carried at recorded loan investment, and therefore are not included in the following tables of loans measured at fair value. Impaired loans internally graded as substandard, doubtful, or loss are evaluated using the fair value of collateral method. All other impaired loans are measured for impairment using the discounted cash flows 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.

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.

Foreclosed properties: Foreclosed properties 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 foreclosed properties 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 foreclosed properties 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

Table of Contents

12

---

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 and liabilities measured at fair value on a recurring basis.

Dollars in thousands	Balance at March 31, 2016	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
		Available for sale securities		
U.S. Government sponsored agencies	\$ 20,939	\$—	\$20,939	\$—
Mortgage backed securities:				
Government sponsored agencies	153,893	—	153,893	—
Nongovernment sponsored entities	7,164	—	7,164	—
State and political subdivisions	250	—	250	—
Corporate debt securities	13,915	—	8,031	5,884
Other equity securities	77	—	77	—
Tax-exempt state and political subdivisions	75,277	—	75,277	—
Total available for sale securities	\$ 271,515	\$—	\$265,631	\$5,884

#### Derivative financial liabilities

Dollars in thousands	Balance at December 31, 2015	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
		Interest rate swaps	\$ 8,238	\$—
Available for sale securities				
U.S. Government sponsored agencies	\$ 21,475	\$—	\$21,475	\$—
Mortgage backed securities:				
Government sponsored agencies	146,734	—	146,734	—
Nongovernment sponsored entities	7,885	—	7,885	—
State and political subdivisions	1,953	—	1,953	—
Corporate debt securities	14,226	—	8,367	5,859
Other equity securities	77	—	77	—
Tax-exempt state and political subdivisions	88,442	—	88,442	—
Total available for sale securities	\$ 280,792	\$—	\$274,933	\$5,859

#### Derivative financial liabilities

Interest rate swaps	\$ 5,072	\$—	\$5,072	\$—
---------------------	----------	-----	---------	-----

#### 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

---



Dollars in thousands	Balance at March 31, 2016	Fair Value Measurements Using:	
		Level 1	Level 2 3
Residential mortgage loans held for sale	\$ 610	\$—	\$—
Collateral-dependent impaired loans			
Commercial	\$ —	\$—	\$—
Commercial real estate	360	—	360
Construction and development	1,013	—	—
Residential real estate	121	—	—
Total collateral-dependent impaired loans	\$ 1,494	\$—	\$360
Foreclosed properties			
Commercial real estate	976	—	—
Construction and development	18,347	—	—
Residential real estate	506	—	—
Total foreclosed properties	\$ 19,829	\$—	\$—

Dollars in thousands	Balance at December 31, 2015	Fair Value Measurements Using:	
		Level 1	Level 2 3
Residential mortgage loans held for sale	\$ 779	\$—	\$—
Collateral-dependent impaired loans			
Commercial	\$ —	\$—	\$—
Commercial real estate	627	—	627
Construction and development	1,054	—	1,054
Residential real estate	279	—	—
Total collateral-dependent impaired loans	\$ 1,960	\$—	\$1,681
Foreclosed properties			
Commercial real estate	1,103	—	—
Construction and development	18,477	—	58
Residential real estate	314	—	—
Total foreclosed properties	\$ 19,894	\$—	\$58

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.

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.

Table of Contents

14

---

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:

Dollars in thousands	March 31, 2016		December 31, 2015	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial assets</b>				
Cash and cash equivalents	\$16,660	\$16,660	\$9,487	\$9,487
Securities available for sale	271,515	271,515	280,792	280,792
Other investments	10,099	10,099	8,949	8,949
Loans held for sale, net	610	610	779	779
Loans, net	1,096,790	1,109,243	1,079,331	1,084,955
Accrued interest receivable	5,230	5,230	5,544	5,544
	\$1,400,904	\$1,413,357	\$1,384,882	\$1,390,506
<b>Financial liabilities</b>				
Deposits	\$1,094,544	\$1,116,367	\$1,066,709	\$1,077,510
Short-term borrowings	153,448	153,448	171,394	171,394
Long-term borrowings	75,103	79,917	75,581	80,506
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589	19,589
Accrued interest payable	778	778	826	826
Derivative financial liabilities	8,238	8,238	5,072	5,072
	\$1,351,700	\$1,378,337	\$1,339,171	\$1,354,897

[Table of Contents](#)



## NOTE 4. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

Dollars in thousands, except per share amounts	For the Three Months Ended March 31,					
	2016		2015			
	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share
Net income	\$4,062			\$4,285		
Basic EPS	\$4,062	10,671,856	\$0.38	\$4,285	8,815,961	\$0.49
Effect of dilutive securities:						
Stock options		7,445			8,567	
Stock appreciation rights		—			—	
Series 2011 convertible preferred stock	—	—		—	1,158,250	
Series 2009 convertible preferred stock	—	—		—	510,545	
Diluted EPS	\$4,062	10,679,301	\$0.38	\$4,285	10,493,323	\$0.41

Stock option and stock appreciation right (SAR) 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 March 31, 2016 and 2015 totaled 57,000 shares and 128,900 shares, respectively, and our anti-dilutive SARs at March 31, 2016 were 166,717.

## NOTE 5. SECURITIES

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at March 31, 2016, December 31, 2015, and March 31, 2015 are summarized as follows:

Dollars in thousands	March 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available for Sale				
Taxable debt securities				
U.S. Government and agencies and corporations	\$19,757	\$1,231	\$49	\$20,939
Residential mortgage-backed securities:				
Government-sponsored agencies	151,895	2,594	596	153,893
Nongovernment-sponsored entities	7,162	58	56	7,164
State and political subdivisions				
Water and sewer revenues	250	—	—	250
Corporate debt securities	14,539	38	662	13,915
Total taxable debt securities	193,603	3,921	1,363	196,161
Tax-exempt debt securities				
State and political subdivisions				
General obligations	40,103	1,926	45	41,984
Water and sewer revenues	7,547	216	—	7,763
Lease revenues	6,284	223	—	6,507

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

Special tax revenues	3,022	64	—	3,086
Sales tax revenues	2,899	72	—	2,971
Other revenues	12,588	381	3	12,966
Total tax-exempt debt securities	72,443	2,882	48	75,277
Equity securities	77	—	—	77
Total available for sale securities	\$266,123	\$6,803	\$1,411	\$271,515

Table of Contents

16

---

Dollars in thousands	December 31, 2015			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Available for Sale				
Taxable debt securities				
U.S. Government and agencies and corporations	\$20,461	\$1,063	\$49	\$21,475
Residential mortgage-backed securities:				
Government-sponsored agencies	145,586	1,943	795	146,734
Nongovernment-sponsored entities	7,836	82	33	7,885
State and political subdivisions				
Water and sewer revenues	250	—	—	250
Other revenues	1,729	—	26	1,703
Corporate debt securities	14,494	—	268	14,226
Total taxable debt securities	190,356	3,088	1,171	192,273
Tax-exempt debt securities				
State and political subdivisions				
General obligations	52,490	1,767	41	54,216
Water and sewer revenues	7,614	172	—	7,786
Lease revenues	8,671	187	1	8,857
Special tax revenues	4,532	72	—	4,604
Other revenues	12,703	290	14	12,979
Total tax-exempt debt securities	86,010	2,488	56	88,442
Equity securities	77	—	—	77
Total available for sale securities	\$276,443	\$5,576	\$1,227	\$280,792

Dollars in thousands	March 31, 2015			Estimated Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Available for Sale				
Taxable debt securities:				
U.S. Government and agencies and corporations	\$21,650	\$1,227	\$40	\$22,837
Residential mortgage-backed securities:				
Government-sponsored agencies	153,904	3,412	501	156,815
Nongovernment-sponsored agencies	11,034	105	71	11,068
State and political subdivisions:				
General obligations	1,617	34	—	1,651
Water and sewer revenues	1,969	21	—	1,990
Lottery/casino revenues	3,084	9	28	3,065
Other revenues	1,697	67	—	1,764
Corporate debt securities	6,675	—	10	6,665
Total taxable debt securities	201,630	4,875	650	205,855
Tax-exempt debt securities:				
State and political subdivisions:				
General obligations	47,947	2,050	136	49,861
Water and sewer revenues	10,302	278	1	10,579
Special tax revenues	2,272	53	—	2,325
Lottery/casino revenues	2,800	163	—	2,963

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

Other revenues	10,246	313	14	10,545
Total tax-exempt debt securities	73,567	2,857	151	76,273
Equity securities	7	—	—	7
Total available for sale securities	\$275,204	\$7,732	\$ 801	\$282,135

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.

Table of Contents

17

---



March 31, 2016				
Dollars in thousands	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Illinois	\$ 10,803	\$ 441	\$ 10	\$ 11,234
Michigan	9,473	202	4	9,671
West Virginia	7,676	133	—	7,809
Texas	7,173	406	—	7,579
Washington	5,429	202	—	5,631

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 March 31, 2016, are summarized as follows:

Dollars in thousands	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 58,168	\$ 58,981
Due from one to five years	103,471	105,032
Due from five to ten years	18,437	18,932
Due after ten years	85,970	88,493
Equity securities	77	77
	\$ 266,123	\$ 271,515

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, 2016 are as follows:

Dollars in thousands	Proceeds from			Gross realized	
	Sales	Calls and Maturities	Principal Payments	Gains	Losses
Securities available for sale	\$ 33,787	\$ 55	\$ 8,170	\$ 562	\$ 169

We held 53 available for sale securities having an unrealized loss at March 31, 2016. 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.

Table of Contents

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, 2016 and December 31, 2015, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income.

Dollars in thousands	March 31, 2016					
	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	\$983	\$ (2 )	\$3,017	\$ (47 )	\$4,000	\$ (49 )
Residential mortgage-backed securities:						
Government-sponsored agencies	39,180	(446 )	10,647	(150 )	49,827	(596 )
Nongovernment-sponsored entities	2,141	(12 )	2,530	(44 )	4,671	(56 )
Corporate debt securities	6,993	(662 )	—	—	6,993	(662 )
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	4,065	(45 )	—	—	4,065	(45 )
Other revenues	1,164	(3 )	—	—	1,164	(3 )
Total temporarily impaired securities	54,526	(1,170 )	16,194	(241 )	70,720	(1,411 )
Total other-than-temporarily impaired securities	—	—	—	—	—	—
Total	\$54,526	\$ (1,170 )	\$16,194	\$ (241 )	\$70,720	\$ (1,411 )

Dollars in thousands	December 31, 2015					
	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	\$2,104	\$ (2 )	\$3,151	\$ (47 )	\$5,255	\$ (49 )
Residential mortgage-backed securities:						
Government-sponsored agencies	52,970	(569 )	8,672	(226 )	61,642	(795 )
Nongovernment-sponsored entities	2,298	—	2,819	(33 )	5,117	(33 )
State and political subdivisions:						
Other revenues	1,702	(26 )	—	—	1,702	(26 )
Corporate debt securities	8,367	(268 )	—	—	8,367	(268 )
Tax-exempt debt securities						
State and political subdivisions:						
General obligations	5,977	(41 )	—	—	5,977	(41 )
Lease revenues	576	(1 )	—	—	576	(1 )
Other revenues	1,218	(14 )	—	—	1,218	(14 )
Total temporarily impaired securities	75,212	(921 )	14,642	(306 )	89,854	(1,227 )
Total other-than-temporarily impaired securities	—	—	—	—	—	—

Total \$75,212 \$ (921 ) \$14,642 \$ (306 ) \$89,854 \$ (1,227 )

Table of Contents

19

---

## 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	March 31, 2016	December 31, 2015	March 31, 2015
Commercial	\$ 101,742	\$ 97,201	\$ 89,928
Commercial real estate			
Owner-occupied	202,680	203,555	180,269
Non-owner occupied	353,351	337,294	325,764
Construction and development			
Land and land development	66,483	65,500	66,558
Construction	7,997	9,970	19,094
Residential real estate			
Non-jumbo	221,368	221,750	219,938
Jumbo	50,057	50,313	50,492
Home equity	74,097	74,300	68,894
Consumer	19,095	19,251	18,485
Other	11,235	11,669	11,074
Total loans, net of unearned fees	1,108,105	1,090,803	1,050,496
Less allowance for loan losses	11,315	11,472	10,827
Loans, net	\$ 1,096,790	\$ 1,079,331	\$ 1,039,669

Table of Contents

20

---

The following table presents the contractual aging of the recorded investment in past due loans by class as of March 31, 2016 and 2015 and December 31, 2015.

Dollars in thousands	At March 31, 2016			Total	Current	> 90 days and Accruing
	Past Due 30-59 days	60-89 days	> 90 days			
Commercial	\$39	\$468	\$179	\$686	\$101,056	\$ —
Commercial real estate						
Owner-occupied	272	497	822	1,591	201,089	—
Non-owner occupied	153	—	749	902	352,449	—
Construction and development						
Land and land development	178	41	4,739	4,958	61,525	—
Construction	—	—	—	—	7,997	—
Residential mortgage						
Non-jumbo	2,555	832	1,906	5,293	216,075	—
Jumbo	—	—	—	—	50,057	—
Home equity	—	453	71	524	73,573	—
Consumer	70	21	117	208	18,887	—
Other	—	—	—	—	11,235	—
Total	\$3,267	\$2,312	\$8,583	\$14,162	\$1,093,943	\$ —

Dollars in thousands	At December 31, 2015			Total	Current	> 90 days and Accruing
	Past Due 30-59 days	60-89 days	> 90 days			
Commercial	\$345	\$26	\$632	\$1,003	\$96,198	\$ —
Commercial real estate						
Owner-occupied	158	386	437	981	202,574	—
Non-owner occupied	1	—	856	857	336,437	—
Construction and development						
Land and land development	1,182	194	4,547	5,923	59,577	—
Construction	—	—	—	—	9,970	—
Residential mortgage						
Non-jumbo	2,276	2,647	1,591	6,514	215,236	—
Jumbo	—	—	—	—	50,313	—
Home equity	374	172	100	646	73,654	—
Consumer	155	41	92	288	18,963	9
Other	—	—	—	—	11,669	—
Total	\$4,491	\$3,466	\$8,255	\$16,212	\$1,074,591	\$ 9

Table of Contents

21

Dollars in thousands	At March 31, 2015			Total	Current	> 90 days and Accruing
	Past Due 30-59 days	60-89 days	> 90 days			
Commercial	\$388	\$—	\$744	\$1,132	\$88,796	\$ —
Commercial real estate						
Owner-occupied	119	—	629	748	179,521	—
Non-owner occupied	664	—	406	1,070	324,694	—
Construction and development						
Land and land development	1,376	1,361	4,980	7,717	58,841	—
Construction	—	—	—	—	19,094	—
Residential mortgage						
Non-jumbo	2,891	1,090	1,888	5,869	214,069	—
Jumbo	—	—	713	713	49,779	—
Home equity	395	—	172	567	68,327	—
Consumer	139	62	22	223	18,262	—
Other	—	—	—	—	11,074	—
Total	\$5,972	\$2,513	\$9,554	\$18,039	\$1,032,457	\$ —

Nonaccrual loans: The following table presents the nonaccrual loans included in the net balance of loans at March 31, 2016, December 31, 2015 and March 31, 2015.

Dollars in thousands	March 31,		December
	2016	2015	31, 2015
Commercial	\$430	\$788	\$853
Commercial real estate			
Owner-occupied	822	934	437
Non-owner occupied	5,318	406	5,518
Construction and development			
Land & land development	5,467	5,333	5,623
Construction	—	—	—
Residential mortgage			
Non-jumbo	3,023	3,429	2,987
Jumbo	—	713	—
Home equity	225	349	258
Consumer	121	65	83
Total	\$15,406	\$12,017	\$15,759

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.

Table of Contents

22

---



## Method Used to Measure Impairment of Impaired Loans

Dollars in thousands

Loan Category	March 31,		December	Method used to measure impairment
	2016	2015	31, 2015	
Commercial	\$36	\$44	\$ 41	Fair value of collateral
	164	337	201	Discounted cash flow
Commercial real estate				
Owner-occupied	1,271	5,665	783	Fair value of collateral
	7,104	9,056	7,616	Discounted cash flow
Non-owner occupied	5,529	1,633	5,728	Fair value of collateral
	7,665	6,184	7,722	Discounted cash flow
Construction and development				
Land & land development	6,444	11,733	6,597	Fair value of collateral
	2,160	2,286	2,177	Discounted cash flow
Residential mortgage				
Non-jumbo	1,800	1,719	1,753	Fair value of collateral
	4,608	4,677	4,378	Discounted cash flow
Jumbo	3,739	5,672	3,869	Fair value of collateral
	868	884	871	Discounted cash flow
Home equity	186	186	186	Fair value of collateral
	523	523	523	Discounted cash flow
Consumer	—	2	—	Fair value of collateral
	62	78	68	Discounted cash flow
Total	\$42,159	\$50,679	\$ 42,513	

Table of Contents

23

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

The following tables present loans individually evaluated for impairment at March 31, 2016, December 31, 2015 and March 31, 2015.

Dollars in thousands	March 31, 2016			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$200	\$200	\$ —	\$200	\$ 9
Commercial real estate					
Owner-occupied	5,446	5,446	—	5,446	211
Non-owner occupied	11,352	11,353	—	11,353	299
Construction and development					
Land & land development	7,451	7,452	—	7,452	163
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	4,060	4,071	—	3,824	169
Jumbo	3,740	3,739	—	3,739	178
Home equity	710	709	—	709	32
Consumer	62	62	—	62	5
Total without a related allowance	\$33,021	\$33,032	\$ —	\$32,785	\$ 1,066
With a related allowance					
Commercial	\$—	\$—	\$ —	\$—	\$ —
Commercial real estate					
Owner-occupied	2,929	2,929	89	2,929	112
Non-owner occupied	1,841	1,841	151	1,841	71
Construction and development					
Land & land development	1,152	1,152	139	1,152	—
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,337	2,337	187	2,337	112
Jumbo	867	868	31	868	43
Home equity	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$9,126	\$9,127	\$ 597	\$9,127	\$ 338
Total					
Commercial	\$30,371	\$30,373	\$ 379	\$30,373	\$ 865
Residential real estate	11,714	11,724	218	11,477	534
Consumer	62	62	—	62	5
Total	\$42,147	\$42,159	\$ 597	\$41,912	\$ 1,404

Table of Contents

24

---

Dollars in thousands	December 31, 2015			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$242	\$242	\$ —	\$319	\$ 17
Commercial real estate					
Owner-occupied	5,401	5,402	—	5,438	191
Non-owner occupied	10,740	10,741	—	9,982	310
Construction and development					
Land & land development	7,635	7,635	—	9,497	263
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	3,590	3,600	—	3,316	160
Jumbo	3,871	3,869	—	4,412	181
Home equity	709	709	—	709	32
Consumer	68	68	—	72	6
Total without a related allowance	\$32,256	\$32,266	\$ —	\$33,745	\$ 1,160
With a related allowance					
Commercial	\$—	\$—	\$ —	\$—	\$ —
Commercial real estate					
Owner-occupied	2,997	2,997	45	3,003	135
Non-owner occupied	2,709	2,709	386	2,728	72
Construction and development					
Land & land development	1,139	1,139	85	1,154	—
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,530	2,531	226	2,552	114
Jumbo	871	871	34	878	43
Home equity	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$10,246	\$10,247	\$ 776	\$10,315	\$ 364
Total					
Commercial	\$30,863	\$30,865	\$ 516	\$32,121	\$ 988
Residential real estate					
Consumer	68	68	—	72	6
Total	\$42,502	\$42,513	\$ 776	\$44,060	\$ 1,524

Table of Contents



Dollars in thousands	March 31, 2015			Average Impaired Balance	Interest Income Recognized while impaired
	Recorded Investment	Unpaid Principal Balance	Related Allowance		
Without a related allowance					
Commercial	\$381	\$381	\$ —	\$381	\$ 21
Commercial real estate					
Owner-occupied	9,312	9,312	—	5,364	180
Non-owner occupied	5,183	5,185	—	3,858	180
Construction and development					
Land & land development	13,121	13,121	—	13,121	436
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	3,763	3,772	—	3,772	167
Jumbo	5,669	5,672	—	5,672	235
Home equity	710	709	—	709	31
Consumer	80	80	—	80	7
Total without a related allowance	\$38,219	\$38,232	\$ —	\$32,957	\$ 1,257
With a related allowance					
Commercial	\$—	\$—	\$ —	\$—	\$ —
Commercial real estate					
Owner-occupied	5,409	5,409	255	5,409	215
Non-owner occupied	2,632	2,632	21	2,632	123
Construction and development					
Land & land development	898	898	176	898	—
Construction	—	—	—	—	—
Residential real estate					
Non-jumbo	2,623	2,624	276	2,624	119
Jumbo	883	884	43	884	44
Home equity	—	—	—	—	—
Consumer	—	—	—	—	—
Total with a related allowance	\$12,445	\$12,447	\$ 771	\$12,447	\$ 501
Total					
Commercial	\$36,936	\$36,938	\$ 452	\$31,663	\$ 1,155
Residential real estate					
Consumer	80	80	—	80	7
Total	\$50,664	\$50,679	\$ 771	\$45,404	\$ 1,758

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 \$30.3 million, of which \$29.2 million were current with respect to restructured contractual payments at March 31, 2016, and \$30.5 million, of which \$28.9 million were current with respect to restructured contractual payments at December 31, 2015. 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, 2016, there were no loans restructured during the three months ended March 31, 2015 . 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

26

---

Dollars in thousands	For the Three Months Ended March 31, 2016	
	Pre-modification Number of Recorded Modifications	Post-modification Recorded Investment
Commercial	— \$ —	\$ —
Commercial real estate		
Owner-occupied	—	—
Non-owner occupied	—	—
Construction and development		
Land & land development	—	—
Construction	—	—
Residential real estate		
Non-jumbo	1 250	250
Jumbo	—	—
Home equity	—	—
Consumer	—	—
Total	1 \$ 250	\$ 250

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, 2016	
	Recorded Number of Defaults at Default Date	Investment
Commercial	— \$ —	
Commercial real estate		
Owner-occupied	—	
Non-owner occupied	—	
Construction and development		
Land & land development	1 1,182	
Construction	—	
Residential real estate		
Non-jumbo	—	
Jumbo	—	
Home equity	—	
Consumer	—	
Total	1 \$ 1,182	

[Table of Contents](#)





The following table details the activity regarding TDRs by loan type for the three months ended March 31, 2016, and the related allowance on TDRs.

For the Three Months Ended March 31, 2016

Dollars in thousands	Construction & Land Development		Commercial Real Estate			Residential Real Estate				Other	Total
	Land Development	Construction	Commercial	Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity	Consumer		
<b>Troubled debt restructurings</b>											
Balance January 1, 2016	\$ 4,188	\$ —	-\$ 242	\$ 9,314	\$ 6,059	\$ 5,496	\$ 4,634	\$ 523	\$ 68	\$ —	-\$ 30,524
Additions	—	—	—	—	—	250	—	—	—	—	250
Charge-offs	—	—	—	—	—	(52 )	—	—	—	—	(52 )
Net (paydowns) advances	(191 )	—	(42 )	(33 )	(45 )	(29 )	(27 )	—	(6 )	—	(373 )
Transfer into foreclosed properties	—	—	—	—	—	—	—	—	—	—	—
Refinance out of TDR status	—	—	—	—	—	—	—	—	—	—	—
Balance, March 31, 2016	\$ 3,997	\$ —	-\$ 200	\$ 9,281	\$ 6,014	\$ 5,665	\$ 4,607	\$ 523	\$ 62	\$ —	-\$ 30,349
<b>Allowance related to troubled debt restructurings</b>											
	\$ —	\$ —	\$ —	\$ 153	\$ 10	\$ 187	\$ 31	\$ —	\$ —	\$ —	-\$ 381

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.

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.

Table of Contents

28

---

## 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	3/31/2016	12/31/2015	3/31/2016	12/31/2015	3/31/2016	12/31/2015	3/31/2016	12/31/2015	3/31/2016	12/31/2015
Pass	\$58,189	\$57,155	\$7,997	\$9,970	\$100,120	\$95,174	\$200,487	\$202,226	\$346,784	\$329,861
OLEM (Special Mention)	1,528	1,598	—	—	1,310	1,295	536	546	939	1,602
Substandard	6,766	6,747	—	—	312	732	1,657	783	5,628	5,831
Doubtful	—	—	—	—	—	—	—	—	—	—
Loss	—	—	—	—	—	—	—	—	—	—
Total	\$66,483	\$65,500	\$7,997	\$9,970	\$101,742	\$97,201	\$202,680	\$203,555	\$353,351	\$337,294

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			
	3/31/2016	12/31/2015	3/31/2015	3/31/2016	12/31/2015	3/31/2015
Residential real estate						
Non-jumbo	\$218,345	\$218,763	\$216,509	\$3,023	\$2,987	\$3,429
Jumbo	50,057	50,313	49,779	—	—	713
Home Equity	73,872	74,042	68,545	225	258	349
Consumer	18,960	19,149	18,420	135	102	65
Other	11,235	11,669	11,074	—	—	—
Total	\$372,469	\$373,936	\$364,327	\$3,383	\$3,347	\$4,556

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

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 or is considered 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. Beginning in 2014, for purposes of loans that have been modified in a troubled debt restructuring and not internally graded as substandard, doubtful, or loss("performing TDRs") we began measuring impairment using the discounted cash flows method. Under this method, a specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over its discounted cash flows.

#### 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,

#### Table of Contents

29

---

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

#### Qualitative Reserve for Loans Collectively Evaluated

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

An analysis of the allowance for loan losses for the three month periods ended March 31, 2016 and 2015, and for the year ended December 31, 2015 is as follows:

	Three Months Ended March 31,		Year Ended December 31,
Dollars in thousands	2016	2015	2015
Balance, beginning of year	\$11,472	\$11,167	\$ 11,167
Losses:			
Commercial	260	77	77
Commercial real estate			
Owner occupied	—	266	559
Non-owner occupied	101	—	178
Construction and development			
Land and land development	—	180	457
Construction	—	—	—
Residential real estate			
Non-jumbo	120	160	417
Jumbo	—	—	208
Home equity	11	32	76
Consumer	15	43	69
Other	53	24	110
Total	560	782	2,151
Recoveries:			
Commercial	59	2	10
Commercial real estate			
Owner occupied	8	3	290
Non-owner occupied	3	2	13
Construction and development			
Land and land development	5	11	456
Construction	—	—	—
Real estate - mortgage			
Non-jumbo	36	7	107

Jumbo	—	95	96
Home equity	1	1	3
Consumer	15	49	105
Other	26	22	126
Total	153	192	1,206
Net losses	407	590	945
Provision for loan losses	250	250	1,250
Balance, end of period	\$11,315	\$10,827	\$ 11,472

Table of Contents

30

---

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

Activity in the allowance for loan losses by loan class during the first three months of 2016 is as follows:

Dollars in thousands	Construction & Land Development		Commercial	Commercial Real Estate		Residential Real Estate				Other	Total
	Land Development	Construction		Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity	Consumer		
Allowance for loan losses											
Beginning balance	\$2,852	\$15	\$780	\$1,589	\$2,977	\$1,253	\$1,593	\$253	\$60	\$100	\$11,472
Charge-offs	—	—	260	—	101	120	—	11	15	53	560
Recoveries	5	—	59	8	3	36	—	1	15	26	153
Provision	(1,207)	(3)	328	98	1,014	(56)	3	28	—	45	250
Ending balance	\$1,650	\$12	\$907	\$1,695	\$3,893	\$1,113	\$1,596	\$271	\$60	\$118	\$11,315
Allowance related to:											
Loans individually evaluated for impairment											
	\$139	\$—	\$—	\$89	\$151	\$188	\$31	\$—	\$—	\$—	\$598
Loans collectively evaluated for impairment											
	1,511	12	907	1,606	3,742	925	1,565	271	60	118	10,717
Total	\$1,650	\$12	\$907	\$1,695	\$3,893	\$1,113	\$1,596	\$271	\$60	\$118	\$11,315
Loans individually evaluated for impairment											
	\$8,604	\$—	\$200	\$8,375	\$13,194	\$6,408	\$4,607	\$709	\$62	\$—	\$42,159
Loans collectively evaluated for impairment											
	57,879	7,997	101,542	194,305	340,157	214,960	45,450	73,388	19,033	11,235	\$1,065,946
Total	\$66,483	\$7,997	\$101,742	\$202,680	\$353,351	\$221,368	\$50,057	\$74,097	\$19,095	\$11,235	\$1,108,105

NOTE 8. GOODWILL AND OTHER INTANGIBLE ASSETS

The following tables present our goodwill by reporting unit at March 31, 2016 and other intangible assets by reporting unit at March 31, 2016 and December 31, 2015.

Dollars in thousands	Goodwill Activity		Total
	Community Banking	Insurance Services	



Balance, January 1, 2016	\$1,488	\$ 4,710	\$6,198
Acquired goodwill, net	—	—	—
Balance, March 31, 2016	\$1,488	\$ 4,710	\$6,198

Dollars in thousands	Other Intangible Assets March 31, 2016			December 31, 2015		
	Communit Banking	Insurance Services	Total	Communit Banking	Insurance Services	Total
Unidentifiable intangible assets						
Gross carrying amount	\$2,268	\$ —	\$2,268	\$2,268	\$ —	\$2,268
Less: accumulated amortization	2,268	—	2,268	2,268	—	2,268
Net carrying amount	\$—	\$ —	\$—	\$—	\$ —	\$—
Identifiable intangible assets						
Gross carrying amount	\$—	\$ 3,000	\$3,000	\$—	\$ 3,000	\$3,000
Less: accumulated amortization	—	1,750	1,750	—	1,700	1,700
Net carrying amount	\$—	\$ 1,250	\$1,250	\$—	\$ 1,300	\$1,300

We recorded amortization expense of approximately \$50,000 for the three months ended March 31, 2016 relative to our other intangible assets. Annual amortization is expected to approximate \$200,000 for each of the years ending 2016 through 2020.

Table of Contents

## NOTE 9. DEPOSITS

The following is a summary of interest bearing deposits by type as of March 31, 2016 and 2015 and December 31, 2015:

Dollars in thousands	March 31, 2016	December 31, 2015	March 31, 2015
Demand deposits, interest bearing	\$ 210,878	\$ 215,721	\$ 196,606
Savings deposits	286,695	266,825	257,687
Time deposits	474,593	465,153	486,966
Total	\$ 972,166	\$ 947,699	\$ 941,259

Included in time deposits are deposits acquired through a third party (“brokered deposits”) totaling \$138.8 million, \$126.5 million and \$139.5 million at March 31, 2016, December 31, 2015, and March 31, 2015, respectively.

A summary of the scheduled maturities for all time deposits as of March 31, 2016 is as follows:

Dollars in thousands	
Nine month period ending December 31, 2016	\$ 178,643
Year ending December 31, 2017	101,517
Year ending December 31, 2018	69,566
Year ending December 31, 2019	41,780
Year ending December 31, 2020	42,061
Thereafter	41,026
Total	\$ 474,593

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, 2016:

Dollars in thousands	Amount	Percent
Three months or less	\$ 56,301	15.9 %
Three through six months	27,534	7.8 %
Six through twelve months	70,482	19.9 %
Over twelve months	199,870	56.4 %
Total	\$ 354,187	100.00%

## NOTE 10. BORROWED FUNDS

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

Dollars in thousands	Three Months Ended March 31,			
	2016		2015	
	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit
Balance at March 31	\$ 150,000	\$ 3,448	\$ 141,550	\$ 7,435
Average balance outstanding for the period	165,102	3,446	139,590	5,189
Maximum balance outstanding at any month end during period	188,450	3,448	141,780	7,435
Weighted average interest rate for the period	0.58 %	0.50 %	0.32 %	0.25 %
Weighted average interest rate for balances outstanding at March 31	0.57 %	0.50 %	0.31 %	0.25 %

Table of Contents

32

---

Dollars in thousands	Year Ended December 31, 2015			
	Short-term FHLB Advances	Federal Funds Purchased	and Lines of Credit	
Balance at December 31	\$ 167,950	\$ 3,444		
Average balance outstanding for the period	146,412	4,690		
Maximum balance outstanding at any month end during period	171,160	7,438		
Weighted average interest rate for the period	0.43	% 0.50	%	
Weighted average interest rate for balances outstanding at December 31	0.35	% 0.26	%	

Long-term borrowings: Our long-term borrowings of \$75.1 million, \$75.6 million and \$77.0 million at March 31, 2016, December 31, 2015, and March 31, 2015 respectively, consisted primarily of advances from the Federal Home Loan Bank (“FHLB”) and structured reverse repurchase agreements with two unaffiliated institutions. All FHLB advances are collateralized primarily by similar amounts of residential mortgage loans, certain commercial loans, mortgage backed securities and securities of U. S. Government agencies and corporations.

Dollars in thousands	Balance		
	Balance at March 31, 2016	2015	at December 31, 2015
Long-term FHLB advances	\$ 846	\$ 951	\$ 873
Long-term reverse repurchase agreements	72,000	72,000	72,000
Term loan	2,257	4,062	2,708
Total	\$ 75,103	\$ 77,013	\$ 75,581

The term loan at March 31, 2016 is secured by the common stock of our subsidiary bank and bears a variable interest rate of prime minus 50 basis points with a final maturity of 2017. Our long term FHLB borrowings and reverse repurchase agreements bear both fixed and variable rates and mature in varying amounts through the year 2026.

The average interest rate paid on long-term borrowings for the three month period ended March 31, 2016 was 4.41% compared to 4.32% for the first three months of 2015.

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, 2016, December 31, 2015, and March 31, 2015.

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 345basis points for SFG Capital Trust I, 3 month LIBOR plus 280basis points for SFG Capital Trust II, and 3 month LIBOR plus 145basis 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:

Table of Contents

33

---

Dollars in thousands	Long-term borrowings	Subordinated debentures owed to unconsolidated subsidiary trusts
Year Ending December 31, 2016	\$ 28,433	\$ —
2017	918	—
2018	45,017	—
2019	18	—
2020	19	—
Thereafter	698	19,589
	\$ 75,103	\$ 19,589

#### NOTE 11. SHARE BASED COMPENSATION

The 2014 Long-Term Incentive Plan (“2014 LTIP”) was adopted by our shareholders in May 2014 to enhance the ability of the Company to attract and retain exceptionally qualified individuals to serve as key employees. The LTIP provides for the issuance of up to 500,000 shares of common stock, in the form of equity awards including stock options, restricted stock, restricted stock units, stock appreciation rights (“SARs”), performance units, other stock-based awards or any combination thereof, to our key employees.

Stock options awarded under the 2009 Officer Stock Option Plan and the 1998 Officer Stock Option Plan (collectively, the “Plans”) were not altered by the 2014 LTIP, and remain subject to the terms of the Plans. However, under the terms of the 2014 LTIP, all shares of common stock remaining issuable under the Plans at the time the 2014 LTIP was adopted ceased to be available for future issuance.

Under the 2014 LTIP and the Plans, stock options and SARs have generally been granted with an exercise price equal to the fair value of Summit's common stock on the grant date. We periodically grant employee stock options to individual employees. During second quarter 2015, we granted 166,717 SARs that become exercisable ratably over five years (20% per year) and expire ten years after the grant date. There were no grants of stock options or SARs in first quarter 2016 or first quarter 2015.

The fair value of our employee stock options and SARs granted under the Plans 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 and SARs granted but are not considered by the model. Because our employee stock options and SARs 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 and SARs at the time of grant. The assumptions used to value SARs issued during 2015 were a risk-free interest rate of 1.96%, an expected dividend yield of 2.75%, an expected common stock volatility of 61.84%, and an expected life of 10 years.

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 2016 and 2015, our stock compensation expense and related deferred taxes were insignificant.

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

A summary of activity in our Plans during the first three months of 2016 and 2015 is as follows:

	For the Three Months Ended March 31, 2016		2015	
	Options/ SARS	Weighted-Average Exercise Price	Options/ SARS	Weighted-Average Exercise Price
Outstanding, January 1	244,147	\$ 14.05	157,170	\$ 20.43
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited	—	—	—	—
Expired	—	—	—	—
Outstanding, March 31	244,147	\$ 14.05	157,170	\$ 20.43

Table of Contents

34

---

Other information regarding awards outstanding and exercisable at March 31, 2016 is as follows:

Options/SARs Outstanding					Options/SARs Exercisable			
Range of exercise price	# of awards	WAEP	Wted. Avg. Remaining Contractual Life (yrs)	Aggregate Intrinsic Value (in thousands)	# of awards	WAEP	Aggregate Intrinsic Value (in thousands)	
\$2.54 - \$6.00	7,750	\$ 3.75	4.93	\$ 91	7,750	\$ 3.75	\$ 91	
6.01 - 10.00	12,680	8.71	2.40	86	12,680	8.71	86	
10.01 - 17.50	166,717	12.01	9.07	—	—	—	—	
17.51 - 20.00	23,400	17.80	1.76	—	23,400	17.80	—	
20.01 - 25.93	33,600	25.93	2.19	—	33,600	25.93	—	
	244,147	14.05		\$ 177	77,430	18.43	\$ 177	

## 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.

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:

Dollars in thousands	March 31, 2016
Commitments to extend credit:	
Revolving home equity and credit card lines	\$ 59,628
Construction loans	32,721
Other loans	54,643
Standby letters of credit	3,900
Total	\$ 150,892

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.

#### Legal Contingencies

On May 13, 2014, the ResCap Liquidating Trust (“ResCap”), as successor to Residential Funding Company, LLC f/k/a Residential Funding Corporation (“RFC”), filed a complaint against Summit Financial Mortgage, LLC (“Summit Mortgage”), a former

#### Table of Contents

35

---

residential mortgage subsidiary of Summit whose operations were discontinued in 2007, in the United States Bankruptcy Court for the Southern District of New York and subsequently amended its complaint on July 25, 2014. The Amended Complaint asserts the following three causes of action related to Summit Mortgage's origination and subsequent sale of mortgage loans to Residential Funding Corporation: 1) Summit Mortgage breached its representations and warranties made in the contract governing the sale of the mortgage loans to RFC; 2) an indemnification claim against Summit Mortgage for damages paid by ResCap to settle claims in RFC's bankruptcy proceeding which allegedly relate to mortgage loans Summit Mortgage sold to RFC; 3) a claim for damages against Summit Community Bank, Inc., former parent of Summit Mortgage, arising out of a guaranty in which the Bank guaranteed Summit Mortgage's full performance under the contract governing the sale of mortgage loans to RFC. Summit has filed a motion to dismiss the case. Based upon the applicable statute of limitations, the Court granted our motion to dismiss the breach of contract claim with respect to loans Summit sold to RFC prior to March 14, 2006. The court otherwise denied our motion to dismiss on the grounds that the other arguments raised factual questions that could not be decided on a motion to dismiss. An estimate as to possible loss resulting from the Amended Complaint cannot be provided at this time because such an estimate cannot be made. Summit intends to defend these claims vigorously.

We are not a party to any other litigation except for matters that arise in the normal course of business. While it is impossible to ascertain the ultimate resolution or range of financial liability with respect to these contingent matters, in the opinion of management, the outcome of these matters will not have a significant adverse effect on the consolidated financial statements.

#### 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, 2016, that we and each of our subsidiaries met all capital adequacy requirements to which they were subject.

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.

The Basel III Capital Rules became effective for us on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of March 31, 2016, our capital levels remained characterized as "well-capitalized" under the new rules. See the Capital Requirements section included in Part I Item 1 Business of our 2015 Annual Report on Form 10-K for further discussion of Basel III.

#### Table of Contents

36

---

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

The following table presents Summit's, as well as our subsidiary, Summit Community Bank's ("Summit Community"), actual and required minimum capital amounts and ratios as of March 31, 2016 and December 31, 2015 under the Basel III Capital Rules. The minimum required capital levels presented below reflect the minimum required capital levels (inclusive of the full capital conservation buffers) that will be effective as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual		Minimum Required Capital - Basel III Fully Phased-in		Minimum Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Dollars in thousands						
As of March 31, 2016						
CET1 (to risk weighted assets)						
Summit	\$140,888	11.9%	\$82,875	7.0 %	\$76,956	6.5 %
Summit Community	160,433	13.6%	82,576	7.0 %	76,678	6.5 %
Tier I Capital (to risk weighted assets)						
Summit	159,888	13.5%	100,670	8.5 %	94,748	8.0 %
Summit Community	160,433	13.6%	100,271	8.5 %	94,372	8.0 %
Total Capital (to risk weighted assets)						
Summit	171,202	14.5%	123,974	10.5 %	118,070	10.0%
Summit Community	171,747	14.5%	124,369	10.5 %	118,446	10.0%
Tier I Capital (to average assets)						
Summit	159,888	10.7%	59,771	4.0 %	74,714	5.0 %
Summit Community	160,433	10.7%	59,975	4.0 %	74,969	5.0 %

	Actual		Minimum Required Capital - Basel III Fully Phased-in		Minimum Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Dollars in thousands						
As of December 31, 2015						
CET1 (to risk weighted assets)						
Summit	137,849	11.8%	81,775	7.0 %	75,934	6.5 %
Summit Community	158,081	13.6%	81,365	7.0 %	75,553	6.5 %
Tier I Capital (to risk weighted assets)						
Summit	156,849	13.4%	99,494	8.5 %	93,641	8.0 %
Summit Community	158,081	13.6%	98,801	8.5 %	92,989	8.0 %
Total Capital (to risk weighted assets)						
Summit	168,321	14.4%	122,734	10.5 %	116,890	10.0%
Summit Community	169,553	14.5%	122,780	10.5 %	116,933	10.0%
Tier I Capital (to average assets)						
Summit	156,849	10.7%	58,635	4.0 %	73,294	5.0 %
Summit Community	158,081	10.8%	58,549	4.0 %	73,186	5.0 %

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.

Table of Contents

37

---

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:

Dollars in thousands	Three Months Ended March 31, 2016				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income (loss)	\$11,938	\$ —	\$(159)	\$—	\$11,779
Provision for loan losses	250	—	—	—	250
Net interest income (loss) after provision for loan losses	11,688	—	(159)	—	11,529
Other income	1,757	1,049	389	(389)	2,806
Other expenses	7,274	1,055	614	(389)	8,554
Income (loss) before income taxes	6,171	(6)	(384)	—	5,781
Income tax expense (benefit)	1,843	(2)	(122)	—	1,719
Net income (loss)	\$4,328	\$ (4)	\$(262)	\$—	\$4,062
Inter-segment revenue (expense)	\$(361)	\$(28)	\$389	\$—	\$—
Average assets	\$1,526,926	\$ 5,866	\$171,028	\$(198,706)	\$1,505,114

Dollars in thousands	Three Months Ended March 31, 2015				
	Community Banking	Insurance & Financial Services	Parent	Eliminations	Total
Net interest income	\$11,751	\$ —	\$(231)	\$—	\$11,520
Provision for loan losses	250	—	—	—	250
Net interest income after provision for loan losses	11,501	—	(231)	—	11,270
Other income	1,849	1,290	283	(283)	3,139
Other expenses	6,857	1,055	575	(283)	8,204
Income (loss) before income taxes	6,493	235	(523)	—	6,205
Income tax expense (benefit)	2,035	64	(179)	—	1,920
Net income (loss)	\$4,458	\$ 171	\$(344)	\$—	\$4,285
Inter-segment revenue (expense)	\$(256)	\$(27)	\$283	\$—	\$—
Average assets	\$1,488,109	\$ 5,893	\$168,954	\$(208,885)	\$1,454,071

#### 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 and the fair values of certain assets. 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.

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

Table of Contents

38

---

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 three 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. \$40 million notional with an effective date of October 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 the swap we will pay a fixed rate of 2.84% for a 3 year period.

We have entered into two pay fixed/receive variable interest rate swaps to hedge fair value variability of two commercial fixed rate loans with the same principal, amortization, and maturity terms of the underlying loans, which are designated as fair value hedges. Under the terms of an \$9.95 million notional swap with an effective date of January 15, 2015, we will pay a fixed rate of 4.33% for a 10 year period. Under the terms of an \$11.3 million notional swap with an effective date of December 18, 2015, we will pay a fixed rate of 4.30% for a 10 year period.

A summary of our derivative financial instruments as of March 31, 2016 and December 31, 2015 follows:

	March 31, 2016		
	Notional	Derivative	Net Ineffective
Dollars in thousands	Amount	Fair Value	Hedge
		As a	Gains/(Losses)
		Liability	
<b>CASH FLOW HEDGES</b>			
Pay-fixed/receive-variable interest rate swaps			

Long term borrowings	\$ 110,000	\$ -7,391	\$	—
----------------------	------------	-----------	----	---

FAIR VALUE HEDGES

Pay-fixed/receive-variable interest rate swaps

Commercial loans	\$ 21,250	\$ -847	\$	—
------------------	-----------	---------	----	---

Table of Contents

39

---



Dollars in thousands	December 31, 2015		Net Ineffective Hedge Gains/(Losses)
	Notional Amount	Derivative Fair Value Asset/Liability	
<b>CASH FLOW HEDGES</b>			
Pay-fixed/receive-variable interest rate swaps			
Long term borrowings	\$ 110,000	\$— \$ 5,071	\$ —
<b>FAIR VALUE HEDGES</b>			
Pay-fixed/receive-variable interest rate swaps			
Commercial loans	\$21,250	\$94 \$ 95	\$ —

**NOTE 16. EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP")**

On July 30, 2015, our ESOP purchased 225,000 shares of Summit Financial Group Inc. common stock in a privately negotiated transaction, at \$10.80 per share for a total purchase price of \$2,430,000. On July 21, 2015, our Board of Directors approved the company lending to our ESOP \$2,250,000 to partially finance the purchase, and was used to purchase 208,333 unallocated shares.

In accordance with ASC 718, Compensation - Stock Compensation, this purchase of unallocated ESOP shares will be shown as a reduction of shareholders' equity, similar to a purchase of treasury stock. The loan receivable from the ESOP to the Company is not reported as an asset nor is the debt of the ESOP reported as a liability on the Company's Consolidated Balance Sheets. Cash dividends on allocated shares (those credited to ESOP participants' accounts) are recorded as a reduction of shareholders' equity and distributed directly to participants' accounts. Cash dividends on unallocated shares (those held by the ESOP not yet credited to participants' accounts) are used to pay a portion of the ESOPs debt service requirements.

Unallocated ESOP shares will be allocated to ESOP participants ratably as the ESOP's loan is repaid. When the shares are committed to be released and become available for allocation to plan participants, the then fair value of such shares will be charged to compensation expense. Unallocated shares owned by the Company's ESOP are not considered to be outstanding for the purpose of computing earnings per share.

The ESOP shares as of March 31 as are follows:

ESOP Shares	At March 31,	
	2016	2015
Allocated shares	406,371	321,449
Shares committed to be released	8,893	—
Unallocated shares	172,929	—
Total ESOP shares	588,193	321,449
Market value of unallocated shares (in thousands)	\$2,675	\$ —

**NOTE 17. PENDING ACQUISITION**

On February 29, 2016, we entered into a Definitive Merger Agreement between Summit Community Bank, Inc., a wholly-owned subsidiary of Summit, and Highland County Bankshares, Inc. ("HCB"). Pursuant to the terms of the merger agreement, Summit Community Bank, Inc. will acquire all of the outstanding shares of common stock of HCB in exchange for cash in the amount of \$38.00 per share, subject to an adjustment if HCB's adjusted shareholders' equity

as of the effective date of the merger deviates materially from the target determined by the parties. HCB's assets approximated \$130 million at March 31, 2016.

We anticipate the acquisition will close in the third quarter of 2016, subject to customary closing conditions, including regulatory approval and approval of HCB's shareholders. Following the consummation of the merger, HCB's wholly-owned subsidiary First and Citizens Bank will be consolidated with Summit Community Bank.

Table of Contents

40

---

## 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 2014 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 increased by 4.39% for the first three months in 2016 compared to the same period of 2015 while our net interest earnings on a tax equivalent basis increased 2.45%. Our tax equivalent net interest margin decreased 9 basis points as our yield on interest earning assets declined 10 basis points while our cost of interest bearing funds increased 1 basis point.

## 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	2016	2015
Community banking	\$4,328	\$4,458
Insurance & financial services	(4 )	171
Parent	(262 )	(344 )
Consolidated net income	\$4,062	\$4,285

## CRITICAL ACCOUNTING POLICIES

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

Our most significant accounting policies are presented in the notes to the consolidated financial statements of our 2015 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

Table of Contents

41

---

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 2015 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 2015 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 2015, 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 fair value is less than its carrying amount. No indicators of impairment were noted as of September 30, 2015.

**Insurance Services –** During third quarter 2015, 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, 2015, 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.

Table of Contents

42

---

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, 2016, we had net deferred tax assets of \$12.2 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, 2016. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. However, our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryback/carryforward periods available under applicable law is not sufficient to cover the amount of net deferred tax assets, such assets may become impaired.

## RESULTS OF OPERATIONS

### Earnings Summary

Net income applicable to common shares for the three months ended March 31, 2016 decreased to \$4.06 million, or \$0.38 per diluted share as compared to \$4.29 million or \$0.41 per diluted share for the same period of 2015. Earnings for the quarter ended March 31, 2016 were positively impacted by increased net interest income, and lower write-downs of foreclosed properties to their fair values while being negatively impacted by lower insurance commission revenues and higher noninterest expenses. Included in earnings for the three months ended March 31, 2016 was \$6,000 in gains on the sales of foreclosed properties, and \$109,000 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 2016 were 11.10% and 1.08%, respectively, compared with 12.79% and 1.18% for the same period of 2015.

### 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 \$12.2 million for the three months ended March 31, 2016, or \$291,000 or 2.45% more than the \$11.9 million for the same period of 2015. Our tax-equivalent earnings on interest earning assets increased \$454,000, while the cost of interest bearing liabilities also increased \$163,000 (see Table II).

Average interest earning assets increased 4.4% from \$1.34 billion during the first three months of 2015 to \$1.40 billion for the first three months of 2016, while average interest bearing liabilities increased 2.7% from \$1.19 billion at March 31, 2015 to \$1.22 billion at March 31, 2016. The growth in interest earning assets outpaced the growth in interest bearing liabilities, and was funded primarily by reductions in property held for sale, growth in deposits, increased short term borrowings, and growth in equity.

Our consolidated net interest margin decreased to 3.50% for the three months ended March 31, 2016, compared to 3.59% for the same period in 2015, as the yields on earning assets decreased 10 basis points, while the cost of our interest bearing funds increased by 1 basis point.

Assuming no significant change in market interest rates, we anticipate modest growth in our net interest income to continue over the near term due to growth in the volume of interest earning assets, primarily loans, coupled with

expected moderate improvement in net interest margin over the same period. 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

43

---



Table I - Average Balance Sheet and Net Interest Income Analysis

Dollars in thousands	March 31, 2016			March 31, 2015		
	Average Balance	Earnings/ Expense	Yield/ Rate	Average Balance	Earnings/ Expense	Yield/ Rate
<b>Interest earning assets</b>						
<b>Loans, net of unearned fees (1)</b>						
Taxable	\$1,089,083	\$ 13,291	4.91 %	\$1,035,610	\$ 12,734	4.99 %
Tax-exempt (2)	15,824	220	5.59 %	12,567	174	5.62 %
<b>Securities</b>						
Taxable	209,365	1,083	2.08 %	211,471	1,281	2.46 %
Tax-exempt (2)	79,314	974	4.94 %	76,012	927	4.95 %
Federal funds sold and interest bearing deposits with other banks	8,092	3	0.15 %	7,081	1	0.06 %
<b>Total interest earning assets</b>	<b>1,401,678</b>	<b>15,571</b>	<b>4.47 %</b>	<b>1,342,741</b>	<b>15,117</b>	<b>4.57 %</b>
<b>Noninterest earning assets</b>						
Cash & due from banks	3,762			3,679		
Premises and equipment	21,594			20,203		
Property held for sale	25,465			36,791		
Other assets	64,177			61,894		
Allowance for loan losses	(11,562 )			(11,237 )		
<b>Total assets</b>	<b>\$1,505,114</b>			<b>\$1,454,071</b>		
<b>Interest bearing liabilities</b>						
Interest bearing demand deposits	\$209,733	\$ 83	0.16 %	199,840	58	0.12 %
Savings deposits	277,396	506	0.73 %	254,398	428	0.68 %
Time deposits	471,597	1,581	1.35 %	485,975	1,585	1.32 %
Short-term borrowings	168,548	240	0.57 %	144,779	112	0.31 %
Long-term borrowings and capital trust securities	95,052	976	4.13 %	105,741	1,040	3.99 %
<b>Total interest bearing liabilities</b>	<b>1,222,326</b>	<b>3,386</b>	<b>1.11 %</b>	<b>1,190,733</b>	<b>3,223</b>	<b>1.10 %</b>
<b>Noninterest bearing liabilities and shareholders' equity</b>						
Demand deposits	120,464			115,198		
Other liabilities	15,928			14,096		
<b>Total liabilities</b>	<b>1,358,718</b>			<b>1,320,027</b>		
Shareholders' equity - preferred	—			7,244		
Shareholders' equity - common	146,396			126,800		
<b>Total liabilities and shareholders' equity</b>	<b>\$1,505,114</b>			<b>\$1,454,071</b>		
Net interest earnings		\$ 12,185			\$ 11,894	
Net yield on interest earning assets			3.50 %			3.59 %

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

- Interest income on tax-exempt securities and loans has been adjusted assuming an effective tax rate of 34% for all (2) periods presented. The tax equivalent adjustment resulted in an increase in interest income of \$406,000 and \$374,000 for the periods ended March 31, 2016 and 2015, respectively.

Table of Contents

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

Dollars in thousands	For the Three Months Ended		
	March 31, 2016 versus March 31, 2015		
	Increase (Decrease)		
	Due to Change in:		
	Volume	Rate	Net
Interest earned on:			
Loans			
Taxable	\$738	\$(181)	\$557
Tax-exempt	47	(1)	46
Securities			
Taxable	(12)	(186)	(198)
Tax-exempt	48	(1)	47
Federal funds sold and interest bearing deposits with other banks	—	2	2
Total interest earned on interest earning assets	821	(367)	454
Interest paid on:			
Interest bearing demand deposits	3	22	25
Savings deposits	42	36	78
Time deposits	(40)	36	(4)
Short-term borrowings	22	106	128
Long-term borrowings and capital trust securities	(102)	38	(64)
Total interest paid on interest bearing liabilities	(75)	238	163
Net interest income	\$896	\$(605)	\$291

## Noninterest Income

Total noninterest income decreased to \$2.8 million for the first three months of 2016, compared to \$3.1 million for the same period of 2015. Further detail regarding noninterest income is reflected in the following table.

Table III - Noninterest Income

Dollars in thousands	For the Quarter Ended March 31,	
	2016	2015
Insurance commissions	\$924	\$1,128
Service fees related to deposit accounts	978	976
Realized securities gains	393	480
Bank owned life insurance income	256	261
Other	255	294
Total	\$2,806	\$3,139

## Noninterest Expense

Total noninterest expense decreased 4.3% for the three months ended March 31, 2016, as compared to the same period in 2015, with lower write-downs of foreclosed properties and lower foreclosed properties expense having the largest

positive impacts and higher salaries, commissions, and employee benefits having the largest negative impact. Table IV below shows the breakdown of the changes.

Table of Contents

45

---

Table IV - Noninterest Expense

Dollars in thousands	For the Quarter Ended March 31,			
	2016	Change		2015
	\$	%		
Salaries, commissions, and employee benefits	\$4,682	\$495	11.8	% \$4,187
Net occupancy expense	540	41	8.2	% 499
Equipment expense	656	121	22.6	% 535
Professional fees	472	137	40.9	% 335
Amortization of intangibles	50	—	—	% 50
FDIC premiums	300	(30 )	(9.1 )	% 330
Merger expense	112	112	n/a	—
Foreclosed properties expense	124	(84 )	(40.4 )	% 208
(Gain) loss on sales of foreclosed properties	(6 )	(156 )	(104.0)	% 150
Write-downs of foreclosed properties	109	(463 )	(80.9 )	% 572
Other	1,515	177	13.2	% 1,338
Total	\$8,554	\$350	4.3	% \$8,204

Salaries, commissions, and employee benefits: These expenses are 11.8% higher in first three months of 2016 compared to first three months of 2015 due to an increase in number of employees, general merit raises, and increased incentive accruals based upon performance. In accordance with our policies, substantially all salary and wage merit raises are awarded at the beginning of the second quarter of each year.

Foreclosed properties expense: Management expects foreclosed properties expense to trend lower than in recent years due to lower levels of foreclosed properties.

Write-downs of foreclosed properties: Management anticipates write-downs of foreclosed properties to their fair values to trend lower in 2016 than in recent years.

#### Credit Experience

As a result of a historically slow economic recovery, our foreclosed properties portfolio remains elevated relative to our peers. Prior elevated levels of nonperforming loans have returned to acceptable levels. Management expects net reductions in foreclosed properties to continue, although not as rapid as over the past two years.

For purposes of this discussion, we define nonperforming assets to include foreclosed properties, other repossessed assets, and nonperforming loans, which is comprised of loans 90 days or more past due and still accruing interest and nonaccrual loans. Performing TDRs are excluded from nonperforming loans.

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 \$250,000 provisions for loan losses for the first three months of both 2016 and 2015. These smaller provisions are a result of lower average loan losses experienced over the past sixteen quarters. Lower losses cause our historical charge-off factor of the quantitative reserve calculation to decline, thus requiring fewer quantitative reserves.

#### Table of Contents



As illustrated in Table V below, our non-performing assets have decreased since year end 2015.

Table V - Summary of Non-Performing Assets

Dollars in thousands	March 31,		December 31,	
	2016	2015	2015	
Accruing loans past due 90 days or more	\$—	\$—	\$9	
Nonaccrual loans				
Commercial	430	788	853	
Commercial real estate	6,140	1,340	5,955	
Commercial construction and development	—	—	—	
Residential construction and development	5,467	5,333	5,623	
Residential real estate	3,248	4,491	3,245	
Consumer	121	65	83	
Total nonaccrual loans	15,406	12,017	15,759	
Foreclosed properties				
Commercial	—	110	—	
Commercial real estate	976	3,658	1,300	
Commercial construction and development	8,717	10,191	8,717	
Residential construction and development	13,808	17,590	14,069	
Residential real estate	1,183	2,819	1,481	
Total foreclosed properties	24,684	34,368	25,567	
Reposessed assets	—	54	5	
Total nonperforming assets	\$40,090	\$46,439	\$41,340	
Total nonperforming loans as a percentage of total loans	1.39	% 1.14	% 1.45	%
Total nonperforming assets as a percentage of total assets	2.66	% 3.18	% 2.77	%
Allowance for loan losses as a percentage of nonperforming loans	73.45	% 90.10	% 72.75	%
Allowance for loan losses as a percentage of period end loans	1.02	% 1.03	% 1.05	%

The following table details the activity regarding our foreclosed properties for the three and three months ended March 31, 2016 and 2015.

Table VI - Foreclosed Property Activity

Dollars in thousands	For the Three Months Ended March 31,	
	2016	2015
Beginning balance	\$25,567	\$37,529
Acquisitions	—	714
Improvements	329	16
Disposals	(1,103 )	(3,320 )
Writedowns to fair value	(109 )	(572 )
Balance March 31	\$24,684	\$34,367

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 and to Note 7 for a summary of the methodology we employ on a quarterly basis to evaluate the overall adequacy of our allowance for loan losses.

#### 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 in the accompanying Note 7 to the financial statements.

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

Table of Contents

47

---

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 origination. The fair values of the underlying collateral value or the discounted cash flows remain in excess of the recorded investment in many of our nonperforming loans, and therefore, no specific reserve allocation is required.

At March 31, 2016, December 31, 2015, and March 31, 2015, our allowance for loan losses totaled \$11.3 million, or 1.02% of total loans, \$11.5 million, or 1.05% of total loans and \$10.8 million, or 1.03% of total loans, respectively, and is considered adequate to cover our estimate of probable credit losses inherent in our loan portfolio.

At March 31, 2016, December 31, 2015, and March 31, 2015, we had approximately \$24.7 million, \$25.6 million and \$34.4 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 \$1.51 billion at March 31, 2016, compared to \$1.49 billion at December 31, 2015, representing a 1.08% increase. Table VIII below serves to illustrate significant changes in our financial position between December 31, 2015 and March 31, 2016.

Table VIII - Summary of Significant Changes in Financial Position

	Balance December 31, 2015	Balance March 31, 2016	Increase (Decrease)	
Dollars in thousands			Amount	Percentage
<b>Assets</b>				
Securities available for sale	\$280,792	\$271,515	(9,277 )	(3.3 )%
Loans, net of unearned interest	1,079,331	1,096,790	17,459	1.6 %
<b>Liabilities</b>				
Deposits	\$1,066,709	\$1,094,544	27,835	2.6 %
Short-term borrowings	171,394	153,448	(17,946)	(10.5 )%
Long-term borrowings	75,581	75,103	(478 )	(0.6 )%

Loan growth of 1.6% during the first three months of 2016 occurred principally in the commercial real estate portfolio, and was funded primarily with deposits.



Deposits increased approximately \$27.8 million during the first three months of 2016; checking deposits decreased approximately \$1.5 million while savings and time deposits increased \$19.9 million and \$9.4 million, respectively.

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, 2016 and December 31, 2015.

Table of Contents

48

---

## LIQUIDITY AND CAPITAL RESOURCES

Liquidity reflects our ability to ensure the availability of adequate funds to meet loan commitments and deposit withdrawals, as well as provide for other transactional requirements. Liquidity is provided primarily by funds invested in cash and due from banks (net of float and reserves), Federal funds sold, non-pledged securities, and available lines of credit with the Federal Home Loan Bank of Pittsburgh (“FHLB”) and Federal Reserve Bank of Richmond, which totaled approximately \$635 million or 42.09% of total consolidated assets at March 31, 2016.

Our liquidity strategy is to fund loan growth with deposits and other borrowed funds while maintaining an adequate level of short- and medium-term investments to meet normal daily loan and deposit activity. As a member of the FHLB, we have access to approximately \$550 million. As of March 31, 2016 and December 31, 2015, these advances totaled approximately \$151 million and \$169 million, respectively. At March 31, 2016, we had additional borrowing capacity of \$399 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, 2016 was approximately \$96 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, 2016 totaled \$146.1 million compared to \$143.7 million at December 31, 2015.

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.

## 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, 2016.

Table IX - Contractual Cash Obligations

Dollars in thousands	Long Term Debt	Capital Trust Securities	Operating Leases
2016	\$28,433	\$ —	\$ 228

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

2017	918	—	250
2018	45,017	—	162
2019	18	—	136
2020	19	—	23
Thereafter	698	19,589	—
Total	\$75,103	\$ 19,589	\$ 799

Table of Contents

49

---

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, 2016 are presented in the following table.

Table X - Off-Balance Sheet Arrangements	March 31, 2016
Dollars in thousands	
Commitments to extend credit:	
Revolving home equity and credit card lines	\$59,628
Construction loans	32,721
Other loans	54,643
Standby letters of credit	3,900
Total	\$150,892

Table of Contents

50

---

## 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, 2016. 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.

Change in	Policy	Estimated % Change in Net Interest Income over:			
		0 - 12 Months		13 - 24 Months	
Interest Rates		Actual	Actual		
Down 100 basis points (1)	-7	% 0.23	% -0.34	%	%
Up 200 basis points (1)	-10	% -3.05	% -1.99	%	%
Up 400 basis points (2)	-15	% -2.44	% -4.32	%	%

(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

51

---

## CONTROLS AND PROCEDURES

Our management, including the Chief Executive Officer and Chief Financial Officer, has conducted as of March 31, 2016, 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, 2016 were effective. There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### Table of Contents

52

---

Part II. Other Information

Item 1. Legal Proceedings

Refer to Note 12 of the Notes to the Consolidated Financial Statements in Part I, Item 1 for information regarding legal proceedings not reportable under this Item.

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, 2015.

Item 6. Exhibits

Exhibit  
3.i Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.

Exhibit  
3.ii Articles of Amendment 2009

Exhibit  
3.iii Articles of Amendment 2011

Exhibit  
3.iv Amended and Restated By-Laws of Summit Financial Group, Inc.

Exhibit  
11 Statement re: Computation of Earnings per Share – Information contained in Note 4 to the Consolidated Financial Statements on page 15 of this Quarterly Report is incorporated herein by reference.

Exhibit  
31.1 Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer

Exhibit  
31.2 Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer

Exhibit  
32.1 Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer

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

Exhibit  
101 Interactive Data File (XBRL)

Table of Contents

53

---



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. Markwood  
Julie R. Markwood,  
Vice President and Chief Accounting Officer

Date: May 5, 2016

Table of Contents

54

---

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

55