

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

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## 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
Total assets	\$1,508,568	\$1,492,429	\$1,460,492
<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
Total deposits	1,094,544	1,066,709	1,058,308
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
Total liabilities	1,362,449	1,348,685	1,324,603
<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
Total shareholders' equity	146,119	143,744	135,889

Total liabilities and shareholders' equity	\$1,508,568	\$ 1,492,429	\$1,460,492
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(\* ) - December 31, 2015 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

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## 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

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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

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## 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

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## 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)

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Consolidated Statements of Cash Flows (unaudited) - continued

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

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## 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

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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

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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	\$—
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#### 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.

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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	—	1,013
Residential real estate	121	—	121
Total collateral-dependent impaired loans	\$ 1,494	\$—	\$—
Foreclosed properties			
Commercial real estate	976	—	976
Construction and development	18,347	—	18,347
Residential real estate	506	—	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	—	279
Total collateral-dependent impaired loans	\$ 1,960	\$—	\$—
Foreclosed properties			
Commercial real estate	1,103	—	1,103
Construction and development	18,477	—	18,419
Residential real estate	314	—	314
Total foreclosed properties	\$ 19,894	\$—	\$—

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.

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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

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## 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

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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

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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

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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.

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March 31, 2016				
Dollars in thousands	Amortized Cost	Unrealized		Estimated Fair Value
		Gains	Losses	
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.

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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 )

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## 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

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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

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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.

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## 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	

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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

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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

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	March 31, 2015				
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
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	13,648	13,661	319	13,661	596
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.

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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	

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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.

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## 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,

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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

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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	Construc-tion		Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity			Con-sumer
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											
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								