

SUMMIT FINANCIAL GROUP INC
Form 10-Q
November 10, 2008

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 September 30, 2008.

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES
EXCHANGE ACT OF 1934 For the transition period from _____ to _____.

Commission File Number 0-16587

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

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

55-0672148
(IRS Employer
Identification No.)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

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Indicate the number of shares outstanding of each of the issuer's classes of Common Stock as of the latest practicable date.

Common Stock, \$2.50 par value
7,410,791 shares outstanding as of November 4, 2008

Summit Financial Group, Inc. and Subsidiaries
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| | Exhibits | |
| | Exhibit 11 | Statement re: Computation of Earnings per Share – Information contained in Note 5 to the Consolidated Financial Statements on page 14 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 |
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Summit Financial Group, Inc. and Subsidiaries
Consolidated Balance Sheets (unaudited)

| Dollars in thousands | September 30, 2008 (unaudited) | December 31, 2007 (*) | September 30, 2007 (unaudited) |
|--|--------------------------------------|------------------------------|---|
| ASSETS | | | |
| Cash and due from banks | \$ 24,077 | \$ 21,285 | \$ 13,435 |
| Interest bearing deposits with other banks | 321 | 77 | 179 |
| Federal funds sold | 56 | 181 | 2,499 |
| Securities available for sale | 305,962 | 283,015 | 263,836 |
| Other investments | 21,686 | 17,051 | 15,453 |
| Loans held for sale, net | 378 | 1,377 | 1,596 |
| Loans, net | 1,145,606 | 1,052,489 | 986,437 |
| Property held for sale | 2,232 | 2,058 | 810 |
| Premises and equipment, net | 22,294 | 22,130 | 22,004 |
| Accrued interest receivable | 7,082 | 7,191 | 7,239 |
| Intangible assets | 9,792 | 10,055 | 10,143 |
| Other assets | 27,839 | 18,413 | 16,794 |
| Assets related to discontinued operations | - | 214 | 254 |
| Total assets | \$ 1,567,325 | \$ 1,435,536 | \$ 1,340,679 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| Liabilities | | | |
| Deposits | | | |
| Non interest bearing | \$ 70,353 | \$ 65,727 | \$ 65,230 |
| Interest bearing | 874,871 | 762,960 | 763,369 |
| Total deposits | 945,224 | 828,687 | 828,599 |
| Short-term borrowings | 98,316 | 172,055 | 124,699 |
| Long-term borrowings | 414,427 | 315,738 | 263,679 |
| Subordinated debentures owed to unconsolidated subsidiary trusts | 19,589 | 19,589 | 19,589 |
| Other liabilities | 9,259 | 9,241 | 10,218 |
| Liabilities related to discontinued operations | - | 806 | 420 |
| Total liabilities | 1,486,815 | 1,346,116 | 1,247,204 |
| Commitments and Contingencies | | | |
| Shareholders' Equity | | | |
| Preferred stock and related surplus, \$1.00 par value; authorized 250,000 shares | - | - | - |
| Common stock and related surplus, \$2.50 par value; | | | |

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authorized 20,000,000 shares, issued
and outstanding

| | | | |
|--|--------------|--------------|--------------|
| 2008 - 7,410,791; issued December | | | |
| 2007 - 7,408,941 shares; | | | |
| issued September 2007 - 7,402,666 | | | |
| shares | 24,409 | 24,391 | 24,376 |
| Retained earnings | 62,487 | 65,077 | 69,104 |
| Accumulated other comprehensive | | | |
| income (loss) | (6,386) | (48) | (5) |
| Total shareholders' equity | 80,510 | 89,420 | 93,475 |
| Total liabilities and shareholders' equity | \$ 1,567,325 | \$ 1,435,536 | \$ 1,340,679 |

(*) - December 31, 2007 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Dollars in thousands, except per share amounts | | | | |
| Interest income | | | | |
| Interest and fees on loans | | | | |
| Taxable | \$ 18,413 | \$ 19,794 | \$ 57,824 | \$ 57,349 |
| Tax-exempt | 114 | 127 | 349 | 363 |
| Interest and dividends on securities | | | | |
| Taxable | 3,563 | 2,898 | 9,920 | 8,216 |
| Tax-exempt | 545 | 548 | 1,735 | 1,616 |
| Interest on interest bearing deposits with other banks | 1 | 3 | 4 | 12 |
| Interest on Federal funds sold | 1 | 6 | 4 | 31 |
| Total interest income | 22,637 | 23,376 | 69,836 | 67,587 |
| Interest expense | | | | |
| Interest on deposits | 6,704 | 8,627 | 20,263 | 26,537 |
| Interest on short-term borrowings | 671 | 1,180 | 2,161 | 3,098 |
| Interest on long-term borrowings and subordinated debentures | 4,878 | 3,573 | 14,715 | 9,226 |
| Total interest expense | 12,253 | 13,380 | 37,139 | 38,861 |
| Net interest income | 10,384 | 9,996 | 32,697 | 28,726 |
| Provision for loan losses | 12,000 | 525 | 14,750 | 1,305 |
| Net interest income after provision for loan losses | (1,616) | 9,471 | 17,947 | 27,421 |
| Other income | | | | |
| Insurance commissions | 1,337 | 1,303 | 3,939 | 1,719 |
| Service fees | 828 | 788 | 2,395 | 2,141 |
| Realized securities (losses) | (6) | - | (6) | - |
| Other-than-temporary impairment of securities | (4,495) | - | (6,036) | - |
| Net cash settlement on interest rate swaps | - | (181) | (171) | (544) |
| Change in fair value of interest rate swap | - | 742 | 705 | 695 |
| Gain (loss) on sale of assets | (99) | 1 | 137 | (31) |
| Other | 260 | 253 | 838 | 679 |
| Total other income | (2,175) | 2,906 | 1,801 | 4,659 |
| Other expense | | | | |
| Salaries and employee benefits | 4,113 | 4,054 | 12,695 | 10,518 |
| Net occupancy expense | 489 | 466 | 1,407 | 1,292 |
| Equipment expense | 538 | 496 | 1,606 | 1,436 |
| Supplies | 236 | 283 | 671 | 652 |
| Professional fees | 173 | 176 | 473 | 543 |
| Amortization of intangibles | 88 | 87 | 263 | 163 |
| Other | 1,648 | 1,258 | 4,407 | 3,584 |
| Total other expense | 7,285 | 6,820 | 21,522 | 18,188 |
| Income (loss) before income taxes | (11,076) | 5,557 | (1,774) | 13,892 |
| Income tax expense (benefit) | (3,402) | 1,802 | (518) | 4,223 |

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| | | | | |
|---|------------|----------|------------|----------|
| Income (loss) from continuing operations | (7,674) | 3,755 | (1,256) | 9,669 |
| Discontinued Operations | | | | |
| Exit costs | - | - | - | 123 |
| Operating income (loss) | - | (200) | - | (798) |
| Income from discontinued operations before income tax expense (benefit) | - | (200) | - | (675) |
| Income tax expense (benefit) | - | (69) | - | (231) |
| Loss from discontinued operations | - | (131) | - | (444) |
| Net Income (loss) | \$ (7,674) | \$ 3,624 | \$ (1,256) | \$ 9,225 |
| Basic earnings from continuing operations per common share | | | | |
| | \$ (1.04) | \$ 0.51 | \$ (0.17) | \$ 1.34 |
| Basic earnings per common share | \$ (1.04) | \$ 0.49 | \$ (0.17) | \$ 1.28 |
| Diluted earnings from continuing operations per common share | | | | |
| | \$ (1.03) | \$ 0.50 | \$ (0.17) | \$ 1.33 |
| Diluted earnings per common share | \$ (1.03) | \$ 0.49 | \$ (0.17) | \$ 1.27 |
| Dividends per common share | \$ - | \$ - | \$ 0.18 | \$ 0.17 |

See Notes to Consolidated Financial Statements

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

| Dollars in thousands, except per share amounts | Common Stock and Related Surplus | Retained Earnings | Accumulated Other Compre- hensive Income | Total Share- holders' Equity |
|---|---|----------------------|--|---------------------------------------|
| Balance, December 31, 2007 | \$ 24,391 | \$ 65,077 | \$ (48) | \$ 89,420 |
| Nine Months Ended September 30, 2008 | | | | |
| Comprehensive income: | | | | |
| Net income (loss) | - | (1,256) | - | (1,256) |
| Other comprehensive income, net of deferred tax benefit of (\$3,885): | | | | |
| Net unrealized loss on securities of (\$6,332), net of reclassification adjustment for gains included in net income of (\$6) | - | - | (6,338) | (6,338) |
| Total comprehensive income | | | | (7,594) |
| Exercise of stock options | 9 | | | 9 |
| Stock compensation expense | 9 | - | - | 9 |
| Cash dividends declared (\$0.18 per share) | - | (1,334) | - | (1,334) |
| Balance, September 30, 2008 | \$ 24,409 | \$ 62,487 | \$ (6,386) | \$ 80,510 |
| Balance, December 31, 2006 | | | | |
| Balance, December 31, 2006 | \$ 18,021 | \$ 61,083 | \$ (352) | \$ 78,752 |
| Nine Months Ended September 30, 2007 | | | | |
| Comprehensive income: | | | | |
| Net income | - | 9,225 | - | 9,225 |
| Other comprehensive income, net of deferred tax benefit of \$213: | | | | |
| Net unrealized gain on securities of \$560: | - | - | 347 | 347 |
| Total comprehensive income | | | | 9,572 |
| Issuance of 317,686 shares at \$19.93 per share | 6,331 | | | 6,331 |
| Exercise of stock options | - | - | - | - |
| Stock compensation expense | 24 | | | 24 |
| Cash dividends declared (\$0.17 per share) | - | (1,204) | - | (1,204) |
| Balance, September 30, 2007 | \$ 24,376 | \$ 69,104 | \$ (5) | \$ 93,475 |

See Notes to Consolidated Financial Statements

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

| Dollars in thousands | Nine Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2008 | September 30, 2007 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$ (1,256) | \$ 9,225 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation | 1,196 | 1,141 |
| Provision for loan losses | 14,750 | 1,555 |
| Stock compensation expense | 9 | 24 |
| Deferred income tax (benefit) | (3,541) | 244 |
| Loans originated for sale | (4,902) | (16,698) |
| Proceeds from loans sold | 5,957 | 24,162 |
| (Gain) on sales of loans held for sale | (56) | (631) |
| Securities losses | 6 | - |
| Writedown of preferred stock | 6,036 | |
| Change in fair value of derivative instruments | (705) | (540) |
| Exit costs related to discontinued operations | - | (123) |
| Loss (gain) on disposal of premises, equipment and other assets | (137) | 31 |
| Amortization of securities premiums, net | (307) | (113) |
| Amortization of goodwill and purchase accounting adjustments, net | 272 | 171 |
| Increase(Decrease) in accrued interest receivable | 109 | (891) |
| (Increase) in other assets | (5,312) | (472) |
| Increase(decrease) in other liabilities | 3,247 | (607) |
| Net cash provided by (used in) operating activities | 15,366 | 16,478 |
| Cash Flows from Investing Activities | | |
| Net (increase) decrease in interest bearing deposits with other banks | (243) | 92 |
| Proceeds from maturities and calls of securities available for sale | 18,776 | 13,596 |
| Proceeds from sales of securities available for sale | 1,141 | - |
| Principal payments received on securities available for sale | 23,426 | 21,868 |
| Purchases of securities available for sale | (85,237) | (63,518) |
| Purchases of other investments | (11,953) | (11,719) |
| Redemption of Federal Home Loan Bank Stock | 10,309 | 9,030 |
| Net (increase) decrease in Federal funds sold | 125 | (1,982) |
| Net loans made to customers | (109,840) | (72,659) |
| Purchases of premises and equipment | (1,394) | (672) |
| Proceeds from sales of other assets | 2,048 | 168 |
| Proceeds from early termination of interest rate swap | 212 | - |
| Net cash acquired in acquisitions | - | 233 |
| Net cash provided by (used in) investing activities | (152,630) | (105,563) |
| Cash Flows from Financing Activities | | |

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| | | |
|--|-----------|-----------|
| Net increase(decrease) in demand deposit, NOW and savings accounts | (17,982) | 4,573 |
| Net increase(decrease) in time deposits | 134,516 | (64,720) |
| Net increase(decrease) in short-term borrowings | (73,738) | 64,270 |
| Proceeds from long-term borrowings | 131,281 | 110,000 |
| Repayment of long-term borrowings | (32,697) | (22,430) |
| Exercise of stock options | 9 | - |
| Dividends paid | (1,334) | (1,204) |
| Net cash provided by financing activities | 140,055 | 90,489 |
| Increase (decrease) in cash and due from banks | 2,791 | 1,404 |
| Cash and due from banks: | | |
| Beginning | 21,286 | 12,031 |
| Ending | \$ 24,077 | \$ 13,435 |

(Continued)

See Notes to Consolidated Financial Statements

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

| Dollars in thousands | Nine Months Ended | |
|--|--------------------------|--------------------------|
| | September 30, 2008 | September 30, 2007 |
| Supplemental Disclosures of Cash Flow Information | | |
| Cash payments for: | | |
| Interest | \$ 37,170 | \$ 37,984 |
| Income taxes | \$ 3,690 | \$ 3,472 |
| Supplemental Schedule of Noncash Investing and Financing Activities | | |
| Other assets acquired in settlement of loans | \$ 1,972 | \$ 891 |

See Notes to Consolidated Financial Statements

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

Note 1. Basis of Presentation

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

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

The results of operations for the nine months ended September 30, 2008 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 2007 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2007 and September 30, 2007, as previously presented, have been reclassified to conform to current year classifications.

Note 2. Significant New Accounting Pronouncements

In September 2006, the FASB issued Statement 157, Fair Value Measurements (SFAS 157). SFAS 157 replaces various definitions of fair value in existing accounting literature with a single definition, establishes a framework for measuring fair value in generally accepted accounting principles, and requires additional disclosures about fair value measurements. SFAS 157 does not expand the use of fair value to any new circumstances. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS 157 on January 1, 2008 and the adoption of this statement did not have a material effect on our financial statements. See Note 3 for a discussion of our fair value measurements.

In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2, "Effective Date of FASB Statement No. 157." This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

On October 10, 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for that Asset is not Active. This FSP clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective immediately and includes prior period financial statements that have not yet been issued and therefore is effective as of September 30, 2008. The adoption of this FSP did not have a material impact on our financial statements or our fair value determinations.

In February 2007, the FASB issued Statement of Financial Accounting Standard 159 (SFAS 159), The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value at specified

election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) is applicable on an instrument by instrument basis, with certain exceptions, (ii) is irrevocable (unless a new election date occurs), and (iii) is applied only to entire

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

instruments and not to portions of instruments. We adopted SFAS 159 on January 1, 2008 and the adoption of this statement did not have a material effect on our financial statements.

In December 2007, the FASB issued Statement 141 (revised 2007) (SFAS 141R), Business Combinations. SFAS 141R will significantly change how the acquisition method will be applied to business combinations. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. Reversals of deferred income tax valuation allowances and income tax contingencies will be recognized in earnings subsequent to the measurement period. The allowance for loan losses of an acquiree will not be permitted to be recognized by the acquirer. Additionally, SFAS 141(R) will require new and modified disclosures surrounding subsequent changes to acquisition-related contingencies, contingent consideration, noncontrolling interests, acquisition-related transaction costs, fair values and cash flows not expected to be collected for acquired loans, and an enhanced goodwill rollforward. We will be required to prospectively apply SFAS 141(R) to all business combinations completed on or after January 1, 2009. Early adoption is not permitted. We are currently evaluating SFAS 141(R) and have not determined the impact it will have on our financial statements.

Note 3. Fair Value Measurements

SFAS 157 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. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

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

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

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

Accordingly, securities available-for-sale and derivatives 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.

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

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.

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

Loans: We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan," (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2008, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require 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 an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

Derivative Assets and Liabilities: Substantially all derivative instruments held or issued by us for risk management or customer-initiated activities are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, we measure fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. We classify derivative instruments held or issued for risk management or customer-initiated activities as Level 2. Examples of Level 2 derivatives are interest rate swaps.

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 | Total at September 30, 2008 | Fair Value Measurements Using: | | |
|-------------------------------|-----------------------------------|--------------------------------|------------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| Available for sale securities | \$ 305,962 | \$ - | \$ 305,962 | \$ - |

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| | | | | |
|---------------------|-------|------|-------|------|
| Derivatives | 29 | - | 29 | - |
| Liabilities: | | | | |
| Derivatives | \$ 34 | \$ - | \$ 34 | \$ - |

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

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

| Dollars in thousands | Total at September 30, 2008 | Fair Value Measurements Using: | | |
|----------------------|-----------------------------------|--------------------------------|---------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Loans held for sale | \$ 378 | \$ - | \$ 378 | \$ - |
| Impaired loans | 46,197 | - | - | 46,197 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral-dependent loans, had a carrying amount of \$57,194,000, with a valuation allowance of \$10,997,000, resulting in an additional provision for loan losses of \$10,807,000 for nine months ended September 30, 2008.

Note 4. Discontinued Operations

As of January 1, 2008 we no longer have activity related to discontinued operations. The following table lists the assets and liabilities of Summit Mortgage included in the balance sheet as assets and liabilities related to discontinued operations.

| Dollars in thousands | December 31, 2007 | September 30, 2007 |
|--|-------------------------|--------------------------|
| Assets: | | |
| Loans held for sale, net | \$ - | \$ - |
| Loans, net | - | - |
| Premises and equipment, net | - | - |
| Property held for sale | - | - |
| Other assets | 214 | 254 |
| Total assets | \$ 214 | \$ 254 |
| Liabilities: | | |
| Accrued expenses and other liabilities | \$ 806 | \$ 420 |
| Total liabilities | \$ 806 | \$ 420 |

The results of Summit Mortgage are presented as discontinued operations in a separate category on the income statements following the results from continuing operations. The income (loss) from discontinued operations for the three and nine months ended September 30, 2007 is presented below.

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

Statements of Income from Discontinued Operations

| Dollars in thousands | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2007 |
|---|---|--|
| Interest income | \$ (3) | \$ 131 |
| Interest expense | - | 45 |
| Net interest income | (3) | 86 |
| Provision for loan losses | - | 250 |
| Net interest income after provision for loan losses | (3) | (164) |
| Noninterest income | | |
| Mortgage origination revenue | (4) | 812 |
| (Loss) on sale of assets | - | (51) |
| Total noninterest income | (4) | 761 |
| Noninterest expense | | |
| Salaries and employee benefits | - | 542 |
| Net occupancy expense | (12) | (3) |
| Equipment expense | 5 | 28 |
| Professional fees | 179 | 376 |
| Postage | - | - |
| Advertising | - | 98 |
| Impairment of long-lived assets | - | - |
| Exit costs | - | (123) |
| Other | 21 | 354 |
| Total noninterest expense | 193 | 1,272 |
| Income (loss) before income tax expense | (200) | (675) |
| Income tax expense (benefit) | (69) | (231) |
| Income (loss) from discontinued operations | \$ (131) | \$ (444) |

Included in liabilities related to discontinued operations in the accompanying consolidated financial statements is an accrual for exit costs related to the discontinuance of the mortgage banking segment. During fourth quarter 2006, we accrued \$1,859,000 for exit costs, which was comprised of costs related to operating lease terminations, vendor contract terminations, and severance payments. The changes in that accrual are as follows:

Dollars in thousands

Total

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| | Operating Lease Terminations | Vendor Contract Terminations | Severance Payments | |
|-----------------------------|------------------------------------|------------------------------------|-----------------------|--------|
| Balance, December 31, 2007 | \$ 586 | \$ - | \$ - | \$ 586 |
| Less: | | | | |
| Payments from the accrual | (586) | - | - | (586) |
| Reversal of over accrual | - | - | - | - |
| Balance, September 30, 2008 | \$ - | \$ - | \$ - | \$ - |

Summit Financial Group, Inc. and Subsidiaries
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Note 5. Earnings per Share

The computations of basic and diluted earnings per share follow:

| Dollars in thousands , except per share amounts | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Numerator for both basic and diluted earnings per share: | | | | |
| Income from continuing operations | \$ (7,674) | \$ 3,755 | \$ (1,256) | \$ 9,669 |
| Income (loss) from discontinued operations | - | (131) | - | (444) |
| Net Income | \$ (7,674) | \$ 3,624 | \$ (1,256) | \$ 9,225 |
| Denominator | | | | |
| Denominator for basic earnings per share - | | | | |
| weighted average common shares outstanding | 7,410,791 | 7,399,213 | 7,409,986 | 7,190,875 |
| Effect of dilutive securities: | | | | |
| Stock options | 34,451 | 59,302 | 37,327 | 61,903 |
| | 34,451 | 59,302 | 37,327 | 61,903 |
| Denominator for diluted earnings per share - | | | | |
| weighted average common shares outstanding and | | | | |
| assumed conversions | 7,445,242 | 7,458,515 | 7,447,313 | 7,252,778 |
| Basic earnings per share from continuing operations | \$ (1.04) | \$ 0.51 | \$ (0.17) | \$ 1.34 |
| Basic earnings per share from discontinued operations | - | (0.02) | - | (0.06) |
| Basic earnings per share | \$ (1.04) | \$ 0.49 | \$ (0.17) | \$ 1.28 |
| Diluted earnings per share from continuing operations | \$ (1.03) | \$ 0.51 | \$ (0.17) | \$ 1.34 |
| Diluted earnings per share from discontinued operations | - | (0.02) | - | (0.06) |
| Diluted earnings per share | \$ (1.03) | \$ 0.49 | \$ (0.17) | \$ 1.27 |

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

Note 6. Securities

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at September 30, 2008, December 31, 2007, and September 30, 2007 are summarized as follows:

| Dollars in thousands | Amortized Cost | September 30, 2008 | | Estimated Fair Value |
|----------------------------------|-------------------|--------------------|-----------|-------------------------|
| | | Gains | Losses | |
| Available for Sale | | | | |
| Taxable: | | | | |
| U. S. Government agencies | | | | |
| and corporations | \$ 40,979 | \$ 130 | \$ 858 | \$ 40,251 |
| Mortgage-backed securities: | | | | |
| Issued by | | | | |
| government-sponsored agencies | 147,992 | 1,510 | 708 | 148,794 |
| Issued by | | | | |
| nongovernment-sponsored agencies | 75,022 | 91 | 8,508 | 66,605 |
| State and political subdivisions | 3,759 | 20 | - | 3,779 |
| Corporate debt securities | 349 | 5 | - | 354 |
| Other equity securities | 986 | - | - | 986 |
| Total taxable | 269,087 | 1,756 | 10,074 | 260,769 |
| Tax-exempt: | | | | |
| State and political subdivisions | 46,740 | 327 | 2,306 | 44,761 |
| Fannie Mae and Freddie Mac | | | | |
| preferred stock | 432 | - | - | 432 |
| Total tax-exempt | 47,172 | 327 | 2,306 | 45,193 |
| Total | \$ 316,259 | \$ 2,083 | \$ 12,380 | \$ 305,962 |

| Dollars in thousands | Amortized Cost | December 31, 2007 | | Estimated Fair Value |
|-------------------------------|-------------------|-------------------|--------|-------------------------|
| | | Gains | Losses | |
| Available for Sale | | | | |
| Taxable: | | | | |
| U. S. Government agencies | | | | |
| and corporations | \$ 45,871 | \$ 420 | \$ 77 | \$ 46,214 |
| Mortgage-backed securities: | | | | |
| Issued by | | | | |
| government-sponsored agencies | 117,039 | 1,073 | 668 | 117,444 |

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| | | | | |
|--|------------|----------|----------|------------|
| Issued by | | | | |
| nongovernment-sponsored agencies | 63,799 | 221 | 683 | 63,337 |
| State and political subdivisions | 3,759 | 26 | - | 3,785 |
| Corporate debt securities | 1,348 | 18 | 30 | 1,336 |
| Other equity securities | 844 | - | - | 844 |
| Total taxable | 232,660 | 1,758 | 1,458 | 232,960 |
| Tax-exempt: | | | | |
| State and political subdivisions | 43,960 | 880 | 335 | 44,505 |
| Fannie Mae and Freddie Mac preferred stock | 6,470 | - | 920 | 5,550 |
| Total tax-exempt | 50,430 | 880 | 1,255 | 50,055 |
| Total | \$ 283,090 | \$ 2,638 | \$ 2,713 | \$ 283,015 |

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

| Dollars in thousands | Amortized Cost | September 30, 2007 | | Estimated Fair Value |
|---|-------------------|---------------------|-----------------|-------------------------|
| | | Unrealized Gains | Losses | |
| Available for Sale | | | | |
| Taxable: | | | | |
| U. S. Government agencies | | | | |
| and corporations | \$ 38,414 | \$ 86 | \$ 150 | 38,350 |
| Mortgage-backed securities: | | | | |
| Issued by | | | | |
| government-sponsored agencies | 106,606 | 520 | 1,183 | 105,943 |
| Issued by | | | | |
| nongovernment-sponsored agencies | 63,401 | 246 | 736 | 62,911 |
| State and political subdivisions | 3,759 | 16 | - | 3,775 |
| Corporate debt securities | 1,675 | 15 | 14 | 1,676 |
| Other equity securities | 844 | - | - | 844 |
| Total taxable | 214,699 | 883 | 2,083 | 213,499 |
| Tax-exempt: | | | | |
| State and political subdivisions | 44,669 | 818 | 122 | 45,365 |
| Fannie Mae and Freddie Mac preferred stock | 4,472 | 525 | 25 | 4,972 |
| Total tax-exempt | 49,141 | 1,343 | 147 | 50,337 |
| Total | \$ 263,840 | \$ 2,226 | \$ 2,230 | \$ 263,836 |

The maturities, amortized cost and estimated fair values of securities at September 30, 2008, are summarized as follows:

| Dollars in thousands | Available for Sale | |
|----------------------------|--------------------|-------------------------|
| | Amortized Cost | Estimated Fair Value |
| Due in one year or less | \$ 57,353 | \$ 56,227 |
| Due from one to five years | 123,028 | 120,575 |
| Due from five to ten years | 76,253 | 73,193 |
| Due after ten years | 58,206 | 54,548 |
| Equity securities | 1,419 | 1,419 |
| | \$ 316,259 | \$ 305,962 |

During third quarter 2008, we recognized an other-than-temporary non-cash impairment charge of \$4.5 million related to our investments in preferred stock issuances of Fannie Mae and Freddie Mac which we continue to own. Our total impairment charge on these securities was \$6.0 million for the nine months ended September 30, 2008.

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

Note 7. Loans

Loans are summarized as follows:

| Dollars in thousands | September 30, 2008 | December 31, 2007 | September 30, 2007 |
|------------------------------------|--------------------------|----------------------|--------------------------|
| Commercial | \$ 115,106 | \$ 92,599 | \$ 87,018 |
| Commercial real estate | 423,982 | 384,478 | 352,396 |
| Construction and development | 225,582 | 225,270 | 212,570 |
| Residential real estate | 366,989 | 322,640 | 305,016 |
| Consumer | 31,433 | 31,956 | 33,254 |
| Other | 6,240 | 6,641 | 6,794 |
| Total loans | 1,169,332 | 1,063,584 | 997,048 |
| Less unearned income | 2,293 | 1,903 | 1,884 |
| Total loans net of unearned income | 1,167,039 | 1,061,681 | 995,164 |
| Less allowance for loan losses | 21,433 | 9,192 | 8,727 |
| Loans, net | \$ 1,145,606 | \$ 1,052,489 | \$ 986,437 |

Note 8. Allowance for Loan Losses

An analysis of the allowance for loan losses for the six month periods ended September 30, 2008 and 2007, and for the year ended December 31, 2007 is as follows:

| Dollars in thousands | Nine Months Ended | | Year Ended December 31, 2007 |
|------------------------------|-----------------------|-----------------------|--|
| | September 30, 2008 | September 30, 2007 | |
| Balance, beginning of period | \$ 9,192 | \$ 7,511 | \$ 7,511 |
| Losses: | | | |
| Commercial | 145 | 50 | 50 |
| Commercial real estate | 869 | 59 | 154 |
| Construction and development | - | - | 80 |
| Residential real estate | 1,260 | 569 | 618 |
| Consumer | 277 | 133 | 216 |
| Other | 142 | 135 | 160 |
| Total | 2,693 | 946 | 1,278 |
| Recoveries: | | | |
| Commercial | 2 | 2 | 2 |
| Commercial real estate | 13 | 10 | 14 |

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| | | | |
|--|-----------|----------|----------|
| Construction and development | - | 20 | 20 |
| Residential real estate | 29 | 7 | 15 |
| Consumer | 42 | 36 | 57 |
| Other | 98 | 90 | 104 |
| Total | 184 | 165 | 212 |
| Net losses | 2,509 | 781 | 1,066 |
| Provision for loan losses | 14,750 | 1,555 | 2,055 |
| Reclassification of reserves related to loans previously reflected in discontinued operations | - | 442 | 692 |
| Balance, end of period | \$ 21,433 | \$ 8,727 | \$ 9,192 |

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Note 9. Goodwill and Other Intangible Assets

The following tables present our goodwill at September 30, 2008 and other intangible assets at September 30, 2008, December 31, 2007, and September 30, 2007.

| Dollars in thousands | Goodwill Activity |
|-----------------------------|----------------------|
| Balance, January 1, 2008 | \$ 6,198 |
| Acquired goodwill, net | - |
| Balance, September 30, 2008 | \$ 6,198 |

| Dollars in thousands | Other Intangible Assets | | |
|---|--------------------------|-------------------------|--------------------------|
| | September 30, 2008 | December 31, 2007 | September 30, 2007 |
| Unidentifiable intangible assets | | | |
| Gross carrying amount | \$ 2,267 | \$ 2,267 | \$ 2,267 |
| Less: accumulated amortization | 1,423 | 1,310 | 1,272 |
| Net carrying amount | \$ 844 | \$ 957 | \$ 995 |
| Identifiable intangible assets | | | |
| Gross carrying amount | \$ 3,000 | \$ 3,000 | \$ 3,000 |
| Less: accumulated amortization | 250 | 100 | 50 |
| Net carrying amount | \$ 2,750 | \$ 2,900 | \$ 2,950 |

We recorded amortization expense of approximately \$176,000 for the nine months ended September 30, 2008 relative to our other intangible assets. Annual amortization is expected to be approximately \$351,000 for each of the years ending 2008 through 2011.

Note 10. Deposits

The following is a summary of interest bearing deposits by type as of September 30, 2008 and 2007 and December 31, 2007:

| Dollars in thousands | September 30, 2008 | December 31, 2007 | September 30, 2007 |
|----------------------|--------------------------|-------------------------|--------------------------|
|----------------------|--------------------------|-------------------------|--------------------------|

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| | | | | | | |
|----------------------------------|----|---------|----|---------|----|---------|
| Interest bearing demand deposits | \$ | 182,383 | \$ | 222,825 | \$ | 230,491 |
| Savings deposits | | 58,678 | | 40,845 | | 39,596 |
| Retail time deposits | | 352,155 | | 322,899 | | 303,316 |
| Brokered time deposits | | 281,655 | | 176,391 | | 189,966 |
| Total | \$ | 874,871 | \$ | 762,960 | \$ | 763,369 |

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Brokered deposits represent certificates of deposit acquired through a third party. The following is a summary of the maturity distribution of certificates of deposit in denominations of \$100,000 or more as of September 30, 2008:

| Dollars in thousands | Amount | Percent |
|---------------------------|------------|---------|
| Three months or less | \$ 39,716 | 11.7% |
| Three through six months | 49,058 | 14.5% |
| Six through twelve months | 85,187 | 25.2% |
| Over twelve months | 164,291 | 48.6% |
| Total | \$ 338,252 | 100.0% |

A summary of the scheduled maturities for all time deposits as of September 30, 2008 is as follows:

| Dollars in thousands | |
|--|------------|
| Three month period ending December 31, 2008 | \$ 132,971 |
| Year ending December 31, 2009 | 310,041 |
| Year ending December 31, 2010 | 95,111 |
| Year ending December 31, 2011 | 60,521 |
| Year ending December 31, 2012 | 31,513 |
| Thereafter | 3,653 |
| | \$ 633,810 |

Note 11. Borrowed Funds

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

| Nine Months Ended September 30, 2008 | | |
|--------------------------------------|------------|--|
| Short-term FHLB | Repurchase | Federal Funds Purchased and Lines |

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| Dollars in thousands | Advances | Agreements | of Credit |
|---|-----------|------------|-----------|
| Balance at September 30 | \$ 96,689 | \$ 587 | \$ 1,040 |
| Average balance outstanding for the period | 105,123 | 4,123 | 979 |
| Maximum balance outstanding at | | | |
| any month end during period | 146,821 | 11,458 | 3,584 |
| Weighted average interest rate for the period | 2.63% | 1.79% | 4.67% |
| Weighted average interest rate for balances | | | |
| outstanding at September 30 | 1.92% | 0.55% | 4.50% |

Summit Financial Group, Inc. and Subsidiaries
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| Dollars in thousands | Year Ended December 31, 2007 | | |
|---|--------------------------------|--------------------------|---|
| | Short-term FHLB Advances | Repurchase Agreements | Federal Funds Purchased and Lines of Credit |
| Balance at December 31 | \$ 159,168 | \$ 10,370 | \$ 2,517 |
| Average balance outstanding for the period | 86,127 | 7,005 | 2,305 |
| Maximum balance outstanding at any month end during period | 159,168 | 11,080 | 3,047 |
| Weighted average interest rate for the period | 4.03% | 3.86% | 7.45% |
| Weighted average interest rate for balances outstanding at December 31 | 3.80% | 3.13% | 6.75% |

| Dollars in thousands | Nine Months Ended September 30, 2007 | | |
|--|--------------------------------------|--------------------------|---|
| | Short-term FHLB Advances | Repurchase Agreements | Federal Funds Purchased and Lines of Credit |
| Balance at September 30 | \$ 117,361 | \$ 5,211 | \$ 2,127 |
| Average balance outstanding for the period | 69,770 | 6,063 | 2,168 |
| Maximum balance outstanding at any month end during period | 117,361 | 7,358 | 2,669 |
| Weighted average interest rate for the period | 5.33% | 4.09% | 7.54% |
| Weighted average interest rate for balances outstanding at September 30 | 5.11% | 3.61% | 7.25% |

Long-term borrowings: Our long-term borrowings of \$414,427,000, \$315,738,000 and \$263,679,000 at September 30, 2008, December 31, 2007, and September 30, 2007 respectively, consisted primarily of advances from the Federal Home Loan Bank (“FHLB”). Included in the September 2008 total is also \$10 million of subordinated debt issued to an unrelated institution, which bears a variable interest rate of 1 month LIBOR plus 275 basis points, a term of 7.5 years, and it is not prepayable by us within the first two and one half years.

Our long term borrowings bear both fixed and variable rates and mature in varying amounts through the year 2019.

The average interest rate paid on long-term borrowings for the nine month period ended September 30, 2008 was 4.61% compared to 5.16% for the first nine months of 2007.

Subordinated Debentures Owed to Unconsolidated Subsidiary Trusts: We have three statutory business trusts that were formed for the purpose of issuing mandatorily redeemable securities (the “capital securities”) for which we are

obligated to third party investors and investing the proceeds from the sale of the capital securities in our junior subordinated debentures (the “debentures”). The debentures held by the trusts are their sole assets. Our subordinated debentures totaled \$19,589,000 at September 30, 2008, December 31, 2007, and September 30, 2007.

In October 2002, we sponsored SFG Capital Trust I, in March 2004, we sponsored SFG Capital Trust II, and in December 2005, we sponsored SFG Capital Trust III, of which 100% of the common equity of each trust is owned by us. SFG Capital Trust I issued \$3,500,000 in capital securities and \$109,000 in common securities and invested the proceeds in \$3,609,000 of debentures. SFG Capital Trust II issued \$7,500,000 in capital securities and \$232,000 in common securities and invested the proceeds in \$7,732,000 of debentures. SFG Capital Trust III issued \$8,000,000

Summit Financial Group, Inc. and Subsidiaries
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in capital securities and \$248,000 in common securities and invested the proceeds in \$8,248,000 of debentures. Distributions on the capital securities issued by the trusts are payable quarterly at a variable interest rate equal to 3 month LIBOR plus 345 basis points for SFG Capital Trust I, 3 month LIBOR plus 280 basis points for SFG Capital Trust II, and 3 month LIBOR plus 145 basis points for SFG Capital Trust III, and equals the interest rate earned on the debentures held by the trusts, and is recorded as interest expense by us. The capital securities are subject to mandatory redemption in whole or in part, upon repayment of the debentures. We have entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of the guarantee. The debentures of SFG Capital Trust I are redeemable by us quarterly, and the debentures of SFG Capital Trust II, and SFG Capital Trust III are first redeemable by us in March 2009 and March 2011, respectively.

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

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

| Dollars in thousands | |
|----------------------|------------|
| Year Ending | Amount |
| December 31, | |
| 2008 | \$ 21,679 |
| 2009 | 83,911 |
| 2010 | 76,481 |
| 2011 | 32,466 |
| 2012 | 116,909 |
| Thereafter | 102,570 |
| | \$ 434,016 |

Note 12. Stock Option Plan

On January 1, 2006, we adopted SFAS No. 123R, Share-Based Payment (Revised 2004), which is a revision of SFAS No. 123, Accounting for Stock Issued for Employees. SFAS No. 123R establishes accounting requirements for share-based compensation to employees and carries forward prior guidance on accounting for awards to non-employees. Prior to the adoption of SFAS No. 123R, we reported employee compensation expense under stock option plans only if options were granted below market prices at grant date in accordance with the intrinsic value method of Accounting Principles Board Opinion (“APB”) No. 25, Accounting for Stock Issued to Employees, and related interpretations. In accordance with APB No. 25, we reported no compensation expense on options granted as the exercise price of the options granted always equaled the market price of the underlying stock on the date of grant. SFAS No. 123R eliminates the ability to account for stock-based compensation using APB No. 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which is generally the date of the grant.

We transitioned to SFAS No. 123R using the modified prospective application method ("modified prospective application"). As permitted under modified prospective application, SFAS No. 123R applies to new awards and to awards modified, repurchased, or cancelled after January 1, 2006. Additionally, compensation cost for non-vested awards that were outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered during the period of and/or the periods after the adoption of SFAS No. 123R, adjusted for estimated forfeitures. The recognition of compensation cost for those earlier awards is based on the same method and on the same grant-date fair values previously determined for the pro forma disclosures reported by us for periods prior to January 1, 2006.

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The Officer Stock Option Plan, which provides for the granting of stock options for up to 960,000 shares of common stock to our key officers, was adopted in 1998 and expired in 2008. Each option granted under the plan vests according to a schedule designated at the grant date and shall have a term of no more than 10 years following the vesting date. Also, the option price per share shall not be less than the fair market value of our common stock on the date of grant.

The fair value of our employee stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options at the time of grant. There were no option grants during the first nine months of 2008 or 2007.

During the first nine months of 2008, we recognized \$9,000 of compensation expense for share-based payment arrangements in our income statement, with a deferred tax asset of \$3,000, compared to \$24,000 compensation expense for the first nine months of 2007 with a deferred tax asset of \$9,000. At September 30, 2008, we had approximately \$3,000 total compensation cost related to nonvested awards not yet recognized and we expect to recognize it over the remainder of this year.

A summary of activity in our Officer Stock Option Plan during the first nine months of 2008 and 2007 is as follows:

| | For the Nine Months Ended | | | |
|---------------------------|---------------------------|---------------------------------|--------------------|---------------------------------|
| | September 30, 2008 | | September 30, 2007 | |
| | Options | Weighted-Average Exercise Price | Options | Weighted-Average Exercise Price |
| Outstanding, January 1 | 337,580 | \$ 18.28 | 349,080 | \$ 17.83 |
| Granted | - | - | - | - |
| Exercised | (1,850) | 4.81 | - | - |
| Forfeited | - | - | - | - |
| Outstanding, September 30 | 335,730 | \$ 18.36 | 349,080 | \$ 17.83 |

Other information regarding options outstanding and exercisable at September 30, 2008 is as follows:

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| Range of exercise price | # of shares | Options Outstanding | | | Options Exercisable | | |
|-------------------------|-------------|---------------------|---|--|---------------------|---------|--|
| | | WAEP | Wted. Avg. Remaining Contractual Life (yrs) | Aggregate Intrinsic Value (in thousands) | # of shares | WAEP | Aggregate Intrinsic Value (in thousands) |
| 4.63 - \$ 6.00 | 69,750 | \$ 5.37 | 4.31 | \$ 445 | 69,750 | \$ 5.37 | \$ 445 |
| 6.01 - 10.00 | 31,680 | 9.49 | 7.26 | 72 | 31,680 | 9.49 | 72 |
| 10.01 - 17.50 | 3,500 | 17.43 | 5.42 | - | 3,500 | 17.43 | - |
| 17.51 - 20.00 | 52,300 | 17.79 | 8.25 | - | 41,400 | 17.79 | - |
| 20.01 - 25.93 | 178,500 | 25.19 | 6.82 | - | 178,500 | 25.19 | - |
| | 335,730 | 18.36 | | \$ 517 | 324,830 | 18.37 | \$ 517 |

Note 13. 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:

| | |
|-------------------------------|-----------|
| | September |
| | 30, |
| | 2008 |
| Dollars in thousands | |
| Commitments to extend credit: | |

| | | |
|---------------------------|----|---------|
| Revolving home equity | | |
| and | | |
| credit card lines | \$ | 43,839 |
| Construction loans | | 71,417 |
| Other loans | | 50,780 |
| Standby letters of credit | | 11,293 |
| Total | \$ | 177,329 |

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.

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

Note 14. Restrictions on Capital

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 September 30, 2008, 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.

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

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| Dollars in thousands | Actual | | Minimum Required Regulatory Capital | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|--|------------|-------|--|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of September 30, 2008 | | | | | | |
| Total Capital (to risk weighted assets) | | | | | | |
| Summit | \$ 121,960 | 10.3% | \$ 94,412 | 8.0% | \$ 118,015 | 10.0% |
| Summit Community | 120,339 | 10.3% | 93,859 | 8.0% | 117,324 | 10.0% |
| Tier I Capital (to risk weighted assets) | | | | | | |
| Summit | \$ 97,126 | 8.2% | 47,206 | 4.0% | 70,809 | 6.0% |
| Summit Community | 105,588 | 9.0% | 46,929 | 4.0% | 70,394 | 6.0% |
| Tier I Capital (to average assets) | | | | | | |
| Summit | \$ 97,126 | 6.3% | 46,072 | 3.0% | 76,787 | 5.0% |
| Summit Community | 105,588 | 6.9% | 45,630 | 3.0% | 76,050 | 5.0% |
| As of December 31, 2007 | | | | | | |
| Total Capital (to risk weighted assets) | | | | | | |
| Summit | \$ 108,167 | 10.0% | 86,162 | 8.0% | 107,703 | 10.0% |
| Summit Community | 109,697 | 10.3% | 85,488 | 8.0% | 106,860 | 10.0% |
| Tier I Capital (to risk weighted assets) | | | | | | |
| Summit | 98,975 | 9.2% | 43,081 | 4.0% | 64,622 | 6.0% |
| Summit Community | 100,505 | 9.4% | 42,744 | 4.0% | 64,116 | 6.0% |
| Tier I Capital (to average assets) | | | | | | |
| Summit | 98,975 | 7.3% | 40,897 | 3.0% | 68,161 | 5.0% |
| Summit Community | 100,505 | 7.4% | 40,520 | 3.0% | 67,533 | 5.0% |

Note 15. Pending Acquisition

As announced on April 9, 2008, we exercised our right to terminate the Agreement and Plan of Reorganization (the "Agreement") by and between Summit and Greater Atlantic Financial Corp. ("Greater Atlantic") (Pink Sheets: GAFC.PK) dated April 12, 2007 under the terms of which Summit was to acquire Greater Atlantic. The Agreement permitted either party to terminate the Agreement if the transaction was not completed by March 31, 2008.

Also, as announced on June 10, 2008, we entered into a new agreement to acquire Greater Atlantic. The merger is expected to be completed in the fourth quarter of 2008, subject to regulatory and shareholder approvals. Following the transaction, Summit intends to merge Greater Atlantic Bank into Summit Community Bank.

Under the terms of the Agreement, each holder of a share of Greater Atlantic common stock is entitled to receive, subject to the limitations and adjustments set forth in the Agreement, the number of shares of Summit common stock equal to \$4.00 divided by the average closing price of Summit's common stock as reported on the NASDAQ Capital Market for the twenty (20) trading days before the closing of the merger. In no event will each share of Greater Atlantic common stock be exchanged for more than 0.328625 of a share of Summit common stock. If, at closing, Greater Atlantic's shareholders' equity, adjusted to exclude accumulated other comprehensive income or loss and the effect of removing the benefit of net operating loss carryforwards from the net deferred tax assets, is less than \$4,214,000 (which equals Greater Atlantic's shareholders' equity at March 31, 2008), then the aggregate value of the merger consideration will be reduced one dollar for each dollar that Greater Atlantic's adjusted shareholders' equity is less than \$4,214,000. For purposes of determining Greater Atlantic's adjusted shareholders' equity at closing,

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Greater Atlantic's shareholders' equity at closing shall be increased by the actual monthly operating losses, up to \$250,000 per month, incurred by Greater Atlantic after March 31, 2008 and before September 1, 2008, the fees accrued or paid to Greater Atlantic's financial advisor, and the fees accrued or paid to Greater Atlantic's legal counsel up to \$150,000.

The acquisition is also conditioned upon the following at close of the transaction: (a) Greater Atlantic and GAB having minimum regulatory capital ratios of: Tier 1 (core) capital equal to 4.0%, Tier 1 risk-based capital equal to 4.0% and total risk-based capital equal to 8.0%; (b) GAB's ratio of the sum of non-performing loans, other real estate owned and net loans charged off after March 31, 2008, to total consolidated assets not exceeding 2.78%; and (c) Greater Atlantic's allowance for loan losses being adequate in accordance with generally accepted accounting principles and applicable regulatory guidance, as determined by Summit with the concurrence of Greater Atlantic's independent auditors.

Consummation of the merger is subject to approval of the shareholders of Greater Atlantic and the receipt of all required regulatory approvals, as well as other customary conditions. This acquisition is expected to close during fourth quarter of this year.

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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 units, Summit Community Bank ("Summit Community"), and Summit Insurance Services, LLC for the periods indicated. This discussion and analysis should be read in conjunction with our 2007 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.

Growth in our interest earning assets coupled with the lower interest rate environment beneficially impacting our cost of funds resulted in an increase of 13.20%, or \$3,934,000 in our net interest earnings on a tax equivalent basis for the first nine months in 2008 compared to the same period of 2007.

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 Note 2 to the consolidated financial statements of our 2007 Annual Report on Form 10-K. These policies, along with the disclosures presented in the other 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 and the valuation of goodwill 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.

The allowance for loan losses represents our estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows

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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 2 to the consolidated financial statements of our 2007 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 2007 Annual Report on Form 10-K.

Goodwill is subject to impairment testing at least annually to determine whether write-downs of the recorded balances are necessary. A fair value is determined based on at least one of three various market valuation methodologies. If the fair value equals or exceeds the book value, no write-down of recorded goodwill is necessary. If the fair value is less than the book value, an expense may be required on our books to write down the goodwill to the proper carrying value. During the third quarter, we completed the required annual impairment test for 2008 and determined that no impairment charge was necessary. We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Notes 2 and 10 of the consolidated financial statements of our Annual Report on Form 10-K for further discussion of our intangible assets, which include goodwill.

RESULTS OF OPERATIONS

Earnings Summary

Income from continuing operations for the nine months ended September 30, 2008 declined 112.99% to a loss of \$1,256,000, or \$0.17 per diluted share as compared to income of \$9,669,000, or \$1.33 per diluted share for the nine months ended September 30, 2007. Included in the loss for 2008 were an other-than-temporary non-cash impairment charge of \$6.0 million pre-tax, equivalent to \$3.8 million after-tax, or \$0.51 per diluted share, and a \$14.75 million provision for loan losses. For the quarter ended September 30, 2008, income from continuing operations decreased 304.37% to a loss of \$7,674,000, or \$1.03 per diluted share as compared to income of \$3,755,000, or \$0.50 per diluted share for the same period of 2007. Included in earnings for the current quarter were an other-than-temporary non-cash impairment charge of \$4.5 million pre-tax, equivalent to \$2.8 million after-tax, or \$0.38 per diluted share and \$12 million provision for loan losses. The impairment charges relate to certain preferred stock issuances of the Fannie Mae and Freddie Mac which we continue to own and the increased provision for loan losses reflects the higher level of nonperforming loans at September 30, 2008. Consolidated net income for the three months and nine months ended September 30, 2007, which includes the results of discontinued operations, was \$3,624,000 and \$9,225,000, respectively. As of January 31, 2008, we no longer have any material operations related to discontinued operations. Consolidated returns on average equity and assets for the first nine months of 2008 were (1.82%) and (0.11%), respectively, compared with 14.41% and 0.97% for the same period of 2007.

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 consolidated net interest income on a fully tax-equivalent basis totaled \$33,736,000 for the nine month period ended September 30, 2008 compared to \$29,802,000 for the same period of 2007, representing an increase of \$3,934,000 or 13.20%. This increase resulted from growth in interest earning assets, primarily loans, and also a 91 basis points decrease in the cost of interest bearing liabilities. Average interest earning assets grew 16.99% from

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\$1,217,493,000 during the first nine months of 2007 to \$1,424,349,000 for the first nine months of 2008. Average interest bearing liabilities grew 18.34% from \$1,113,610,000 at September 30, 2007 to \$1,317,815,000 at September 30, 2008, at an average yield for the first nine months of 2008 of 3.76% compared to 4.67% for the same period of 2007.

Our consolidated net interest margin decreased to 3.16% for the nine month period ended September 30, 2008, compared to 3.27% for the same period in 2007. On a quarterly basis, our net interest margin decreased to 2.89% at September 30, 2008, from 3.28% for the quarter ended September 30, 2007. The decline in margin for both the nine months and quarter ended September 30, 2008 was affected by the reversal of approximately \$1.6 million of interest income on loans placed on nonaccrual status during third quarter 2008. In addition, our margin continues to be pressured by an extremely competitive environment, both for loans and deposits. Rate reductions by the Federal Reserve have served to positively impact our net interest margin due to our liability sensitive balance sheet. For the nine months ended September 30, 2008 compared to September 30, 2007, the yields on earning assets decreased 89 basis points, while the cost of our interest bearing funds decreased 91 basis points.

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 modest growth in the volume of interest earning assets coupled with an expected relatively stable net interest margin over the same period. If market interest rates significantly rise over the next 12 to 18 months, the spread between interest earning assets and interest bearing liabilities could narrow such that its impact could not be offset by growth in earning assets. Conversely, if market interest rates were to decline over the next 12 to 18 months, the spread between interest earning assets and interest bearing liabilities would be expected to widen, thus increasing net interest income. 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.

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Table I - Average Balance Sheet and Net Interest Income Analysis
Dollars in thousands

| | For the Nine Months Ended | | | | | |
|---|---------------------------|----------------------|----------------|--------------------|----------------------|----------------|
| | September 30, 2008 | | | September 30, 2007 | | |
| | Average Balance | Earnings/ Expense | Yield/ Rate | Average Balance | Earnings/ Expense | Yield/ Rate |
| Interest earning assets | | | | | | |
| Loans, net of unearned income | | | | | | |
| Taxable | \$ 1,107,474 | \$ 57,824 | 6.97% | \$ 945,496 | \$ 57,435 | 8.12% |
| Tax-exempt (1) | 8,647 | 529 | 8.17% | 9,274 | 550 | 7.93% |
| Securities | | | | | | |
| Taxable | 256,914 | 9,921 | 5.16% | 214,602 | 8,216 | 5.12% |
| Tax-exempt (1) | 50,923 | 2,594 | 6.80% | 46,931 | 2,419 | 6.89% |
| Federal funds sold and interest bearing deposits with other banks | | | | | | |
| | 391 | 7 | 2.39% | 1,190 | 43 | 4.83% |
| Total interest earning assets | 1,424,349 | 70,875 | 6.65% | 1,217,493 | 68,663 | 7.54% |
| Noninterest earning assets | | | | | | |
| Cash & due from banks | 18,118 | | | 14,003 | | |
| Premises and equipment | 22,058 | | | 22,207 | | |
| Other assets | 37,579 | | | 29,132 | | |
| Allowance for loan losses | (10,176) | | | (8,564) | | |
| Total assets | \$ 1,491,928 | | | \$ 1,274,271 | | |
| Interest bearing liabilities | | | | | | |
| Interest bearing demand deposits | | | | | | |
| | \$ 198,246 | \$ 2,134 | 1.44% | \$ 227,461 | \$ 6,120 | 3.60% |
| Savings deposits | 54,583 | 668 | 1.63% | 43,449 | 561 | 1.73% |
| Time deposits | 536,493 | 17,461 | 4.35% | 536,784 | 19,856 | 4.95% |
| Short-term borrowings | 110,228 | 2,161 | 2.62% | 78,002 | 3,098 | 5.31% |
| Long-term borrowings and capital trust securities | 418,265 | 14,715 | 4.70% | 227,914 | 9,226 | 5.41% |
| Total interest bearing liabilities | 1,317,815 | 37,139 | 3.76% | 1,113,610 | 38,861 | 4.67% |
| Noninterest bearing liabilities and shareholders' equity | | | | | | |
| Demand deposits | 74,153 | | | 64,028 | | |
| Other liabilities | 8,085 | | | 11,297 | | |
| Shareholders' equity | 91,875 | | | 85,336 | | |
| Total liabilities and | | | | | | |

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| | | | | |
|--------------------------------------|--------------|-------|--------------|-------|
| shareholders' equity | \$ 1,491,928 | | \$ 1,274,271 | |
| Net interest earnings | \$ 33,736 | | \$ 29,802 | |
| Net yield on interest earning assets | | 3.16% | | 3.27% |

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

The tax equivalent adjustment resulted in an increase in interest income of \$1,039,000 and \$990,000 for the periods ended

September 30, 2008 and September 30 2007, respectively.

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

| Dollars in thousands | For the Nine Months Ended | | |
|---|--|------------|----------|
| | September 30, 2008 versus September 30, 2007 | | |
| | Increase (Decrease) Due to Change in: | | |
| | Volume | Rate | Net |
| Interest earned on: | | | |
| Loans | | | |
| Taxable | \$ 9,106 | \$ (8,717) | \$ 389 |
| Tax-exempt | (37) | 16 | (21) |
| Securities | | | |
| Taxable | 1,641 | 64 | 1,705 |
| Tax-exempt | 206 | (31) | 175 |
| Federal funds sold and interest bearing deposits with other banks | | | |
| | (21) | (15) | (36) |
| Total interest earned on interest earning assets | | | |
| | 10,895 | (8,683) | 2,212 |
| Interest paid on: | | | |
| Interest bearing demand deposits | | | |
| | (702) | (3,284) | (3,986) |
| Savings deposits | 138 | (31) | 107 |
| Time deposits | (11) | (2,384) | (2,395) |
| Short-term borrowings | 990 | (1,927) | (937) |
| Long-term borrowings and capital trust securities | | | |
| | 6,840 | (1,351) | 5,489 |
| Total interest paid on interest bearing liabilities | | | |
| | 7,255 | (8,977) | (1,722) |
| Net interest income | | | |
| | \$ 3,640 | \$ 294 | \$ 3,934 |

Noninterest Income

Total noninterest income from continuing operations decreased to \$1,801,000 for the nine months ended September 30, 2008, compared to \$4,659,000 for the same period of 2007. Further detail regarding noninterest income is reflected in the following table.

| Dollars in thousands | Noninterest Income | | | |
|------------------------------|-----------------------|----------|---------------------------|----------|
| | For the Quarter Ended | | For the Nine Months Ended | |
| | September 30, | | September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Insurance commissions | \$ 1,337 | \$ 1,303 | \$ 3,939 | \$ 1,719 |
| Service fees | 828 | 788 | 2,395 | 2,141 |
| Realized securities (losses) | (6) | - | (6) | - |
| | (4,495) | - | (6,036) | - |

Other-than-temporary impairment of securities

| | | | | |
|---|------------|----------|----------|----------|
| Net cash settlement on interest rate swaps | - | (181) | (171) | (544) |
| Change in fair value of interest rate swaps | - | 742 | 705 | 695 |
| Gain (loss) on sale of assets | (99) | 1 | 137 | (31) |
| Other | 260 | 253 | 838 | 679 |
| Total | \$ (2,175) | \$ 2,906 | \$ 1,801 | \$ 4,659 |

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Insurance commissions: Both 2008 periods include commissions derived from the Kelly Agencies, which were acquired in third quarter 2007.

Other-than-temporary impairment of securities: During third quarter 2008, we recorded a non-cash other-than temporary impairment charge of \$4,495,000 related to certain preferred stock issuances of the Fannie Mae and Freddie Mac which we continue to own. The impairment charge on these stocks was \$6,036,000 for the nine months ended September 30, 2008.

Change in fair value of derivative instruments: The \$705,000 change reflected in the nine months ended September 30, 2008 period includes the gain realized upon termination of these interest rate swaps that did not qualify for hedge accounting.

Noninterest Expense

Total noninterest expense for continuing operations increased approximately 6.8% for the quarter ended September 30, 2008 and 18.3% for the nine months ended September 30, 2008 as compared to the same periods in 2007. Salaries and employee benefits expense represented the largest category of expense growth. Table III below shows the breakdown of these increases.

Table III -
Noninterest Expense

| Dollars in thousands | For the Quarter Ended September 30, | | | | For the Nine Months Ended September 30, | | | |
|--------------------------------|-------------------------------------|--------|--------|----------|---|----------|--------|-----------|
| | 2008 | | Change | | 2008 | | Change | |
| | \$ | % | 2007 | | \$ | % | 2007 | |
| Salaries and employee benefits | \$ 4,113 | \$ 59 | 1.5% | \$ 4,054 | \$ 12,695 | \$ 2,177 | 20.7% | \$ 10,518 |
| Net occupancy expense | 489 | 23 | 4.9% | 466 | 1,407 | 115 | 8.9% | 1,292 |
| Equipment expense | 538 | 42 | 8.5% | 496 | 1,606 | 170 | 11.8% | 1,436 |
| Supplies | 236 | (47) | -16.6% | 283 | 671 | 19 | 2.9% | 652 |
| Professional fees | 173 | (3) | -1.7% | 176 | 473 | (70) | -12.9% | 543 |
| Amortization of intangibles | 88 | 1 | 1.1% | 87 | 263 | 100 | 61.3% | 163 |
| Other | 1,648 | 390 | 31.0% | 1,258 | 4,407 | 823 | 23.0% | 3,584 |
| Total | \$ 7,285 | \$ 465 | 6.8% | \$ 6,820 | \$ 21,522 | \$ 3,334 | 18.3% | \$ 18,188 |

Salaries and employee benefits: Growth in salaries and employee benefits for the nine months ended September 30, 2008 was primarily due to the additional staff of the Kelly Agencies, which were acquired in third quarter 2007, and general merit raises. For the quarter ended September 30, 2008, additional salaries and benefit costs associated with the Kelly Agencies was generally offset by reductions in performance-based incentive payments throughout the Company during this same period.

Amortization of intangibles: Amortization of intangible assets increased 61.3% during 2008 compared to 2007 due to the amortization of the identifiable customer intangible related to the acquisition in 2007 of the Kelly Agencies.

Other: The largest increases in other expenses for both the quarter and the nine months were FDIC premium, up \$135,000 for the quarter and \$373,000 for the nine months ended September 30, 2008, reflecting higher assessment rates in 2008; telephone expense, up \$51,000 for the quarter and \$122,000 for the nine months; and foreclosure and repossession expense, up \$54,000 for the quarter and \$96,000 for the nine months ended September 30, 2008 compared to the same periods of 2007.

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Credit Experience

The provision for loan losses represents charges to earnings necessary to maintain an adequate allowance for potential future loan losses. 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 a \$14,750,000 provision for loan losses for the first nine months of 2008, compared to \$1,305,000 for the same period in 2007. This increase is primarily the result of the significant rise in nonperforming loans during the 2008 third quarter. Net loan charge offs for the first nine months of 2008 were \$2,509,000, as compared to \$781,000 over the same period of 2007. At September 30, 2008, the allowance for loan losses totaled \$21,433,000 or 1.83% of loans, net of unearned income, compared to \$9,192,000 or 0.86% of loans, net of unearned income at December 31, 2007.

As illustrated in Table IV below, our non-performing assets and loans past due 90 days or more and still accruing interest have increased during the past 12 months.

Table IV - Summary of
Non-Performing Assets
Dollars in thousands

| | September 30, 2008 | September 30, 2007 | December 31, 2007 |
|--|-----------------------|-----------------------|-------------------------|
| Accruing loans past due 90 days or more | \$ 5,612 | \$ 5,279 | \$ 7,416 |
| Nonperforming assets: | | | |
| Nonaccrual loans | 54,233 | 1,637 | 2,917 |
| Foreclosed properties | 2,232 | 810 | 2,058 |
| Reposessed assets | 52 | 5 | - |
| Total | \$ 62,129 | \$ 7,731 | \$ 12,391 |
| Total nonperforming loans as a percentage of total loans | 5.13% | 0.69% | 0.97% |
| Total nonperforming assets as a percentage of total assets | 3.96% | 0.58% | 0.86% |

Due to current declining economic conditions, borrowers have in many cases been unable to refinance their loans due to a range of factors including declining property values. As a result, we have experienced higher delinquencies and nonperforming assets, particularly in our residential real estate loan portfolios and in commercial construction loans to residential real estate developers. It is not known when the housing market will stabilize. While management anticipates loan delinquencies will remain higher than historical levels for the foreseeable future, we anticipate that nonperforming assets will begin to moderate.

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The following table presents a summary of our 30 to 89 days past due performing loans.

Loans Past Due 30-89 Days

| Dollars in thousands | For the Quarter Ended | | | | |
|------------------------------|-----------------------|-----------|-----------|------------|-----------|
| | 9/30/2008 | 6/30/2008 | 3/31/2008 | 12/31/2007 | 9/30/2007 |
| Commercial | \$ 706 | \$ 1,089 | \$ 321 | \$ 264 | \$ 87 |
| Commercial real estate | 1,407 | 24,606 | 1,249 | 1,604 | 2,278 |
| Construction and development | 1,996 | 9,919 | 1,059 | 997 | 817 |
| Residential real estate | 8,537 | 2,962 | 3,792 | 4,485 | 3,303 |
| Consumer | 1,140 | 979 | 946 | 1,335 | 984 |
| Total | \$ 13,786 | \$ 39,555 | \$ 7,367 | \$ 8,685 | \$ 7,469 |

The following table shows our nonperforming loans by category as of September 30, 2008 and 2007 and December 31, 2007.

Nonperforming Loans by
Type

| Dollars in thousands | September 30, | | December |
|------------------------------|---------------|----------|-------------|
| | 2008 | 2007 | 31, 2007 |
| Commercial | \$ 140 | \$ 712 | \$ 716 |
| Commercial real estate | 27,347 | 582 | 4,346 |
| Construction and development | 29,127 | 2,557 | 2,016 |
| Residential real estate | 2,799 | 2,871 | 3,012 |
| Consumer | 432 | 194 | 243 |
| Total | \$ 59,845 | \$ 6,916 | \$ 10,333 |

Commercial real estate nonperforming: One borrower -- a hotel, conference and golf course facility near Front Royal, Virginia -- comprises 87% of the balance of nonperforming commercial real estate loans at September 30, 2008. Another credit with a balance of \$1.9 million is secured by a commercial office building located in Charleston, West Virginia.

Construction and land development nonperforming: Approximately 90% of our nonperforming land development and construction loans are comprised of six credits related to residential development projects, as follows:

| Description | Location | Balance (in millions) |
|-------------------------------------|----------------------|--------------------------|
| Residential subdivision | Jefferson County, WV | \$ 1.8 |
| 4 Residential lots and 2 spec-homes | Winchester, VA | 1.5 |
| Residential lots | Front Royal, VA | 1.6 |
| Residential subdivision and acreage | Berkeley County, WV | 3.5 |
| Residential subdivision | Berkeley County, WV | 9.5 |
| Residential subdivision | Frederick County, VA | 8.5 |

Residential real estate nonperforming: Nonperforming residential real estate loans remained steady during the first nine months of 2008. Many borrowers have been unable to make their payments due to a range of factors stemming from current declining economic conditions.

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All nonperforming loans are individually reviewed and adequate reserves are in place. The majority of nonperforming loans are secured by real property with values supported by appraisals. As a result of our internal loan review process, the ratio of internally classified loans to total loans increased from 6.21% at December 31, 2007 to 8.52% at September 30, 2008. Our internal loan review process includes a watch list of loans that have been specifically identified through the use of various sources, including past due loan reports, previous internal and external loan evaluations, classified loans identified as part of regulatory agency loan reviews and reviews of new loans representative of current lending practices. Once this watch list is reviewed to ensure it is complete, we review the specific loans for collectibility, performance and collateral protection. In addition, a grade is assigned to the individual loans utilizing internal grading criteria, which is somewhat similar to the criteria utilized by our subsidiary bank's primary regulatory agency. Refer to the Asset Quality section of the financial review of the 2007 Annual Report on Form 10-K for further discussion of the processes related to internally classified loans.

FINANCIAL CONDITION

Our total assets were \$1,567,325,000 at September 30, 2008, compared to \$1,435,536,000 at December 31, 2007, representing a 9.2% increase. Table V below serves to illustrate significant changes in our financial position between December 31, 2007 and September 30, 2008.

Table V - Summary of Significant Changes in Financial Position
Dollars in thousands

| | Balance December 31, 2007 | Increase (Decrease) Amount Percentage | | Balance September 30, 2008 |
|--|------------------------------------|---|--------|-------------------------------------|
| Assets | | | | |
| Securities available for sale | \$ 283,015 | 22,947 | 8.1% | \$ 305,962 |
| Loans, net of unearned interest | 1,061,681 | 105,358 | 9.9% | 1,167,039 |
| Liabilities | | | | |
| Deposits | \$ 828,687 | \$ 116,537 | 14.1% | \$ 945,224 |
| Short-term borrowings | 172,055 | (73,739) | -42.9% | 98,316 |
| Long-term borrowings and subordinated debentures | 335,327 | 98,689 | 29.4% | 434,016 |

Loan growth during the first nine months of 2008, occurring principally in the commercial real estate and residential real estate portfolios, was funded primarily by both borrowings from the FHLB and brokered deposits.

Deposits increased approximately \$117 million during the first nine months of 2008. Retail deposits increased approximately \$11.3 million while brokered deposits increased approximately \$105.3 million since December 31, 2007.

Long term borrowings and subordinated debentures increased primarily due to our replacement of a portion of our FHLB overnight borrowings with longer term FHLB advances and also the issuance of \$10 million in subordinated debt.

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Refer to Notes 6, 7, 8, 10, and 11 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 September 30, 2008 and December 31, 2007.

LIQUIDITY

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, Federal funds sold, non-pledged securities, and available lines of credit with the FHLB, the total of which approximated \$180 million, or 11.5% of total assets at September 30, 2008 versus \$181 million, or 12.6% of total assets at December 31, 2007. Despite the recent tightened collateral policy of the FHLB whereby the "haircuts" applied to certain types of collateral were increased, therefore reducing our available line of credit, we were able to maintain our levels of liquidity comparative with that of the past in third quarter 2008 through purchases of additional qualifying collateral (primarily mortgage-backed securities) financed by the issuance of brokered deposits.

Our liquidity position is monitored continuously 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.

CAPITAL RESOURCES

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 September 30, 2008 totaled \$80,510,000 compared to \$89,420,000 at December 31, 2007.

During first quarter 2008, we issued \$10 million of subordinated debt which qualifies as Tier 2 capital. This debt has an interest rate of 1 month LIBOR plus 275 basis points, a term of 7.5 years, and is not prepayable by us within the first two and a half years.

During second quarter 2008, our Board of Directors declared and paid the first half 2008 cash dividend of \$0.18 per share compared to \$0.17 paid for the first half of 2007. The first half 2008 dividend totaled \$1,334,000, representing a 10.8% increase over the \$1,204,000 paid during the first half 2007.

Refer to Note 14 of the notes to the accompanying consolidated financial statements for information regarding regulatory restrictions on our capital as well as our subsidiaries' capital.

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CONTRACTUAL CASH OBLIGATIONS

During our normal course of business, we incur contractual cash obligations. The following table summarizes our contractual cash obligations at September 30, 2008.

| Dollars in thousands | Long Term Debt | Capital Trust Securities | Operating Leases |
|----------------------|----------------------|--------------------------------|---------------------|
| 2008 | \$ 21,679 | \$ - | \$ 268 |
| 2009 | 83,911 | - | 606 |
| 2010 | 76,481 | - | 201 |
| 2011 | 32,466 | - | 121 |
| 2012 | 116,909 | - | 121 |
| Thereafter | 82,981 | 19,589 | 127 |
| Total | \$ 414,427 | \$ 19,589 | \$ 1,444 |

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 September 30, 2008 are presented in the following table.

| Dollars in thousands | September 30, 2008 |
|--|--------------------------|
| Commitments to extend credit: | |
| Revolving home equity and credit card lines | \$ 43,839 |
| Construction loans | 71,417 |
| Other loans | 50,780 |
| Standby letters of credit | 11,293 |
| Total | \$ 177,329 |

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 fairly well-matched in the near term. The nature of our lending and funding activities tends to drive our interest rate risk position to being liability sensitive in the intermediate term. That is, absent any changes in the volumes of our interest earning assets or interest

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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. 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 shows our projected earnings sensitivity as of September 30, 2008 which is well within our ALCO policy limit of a 10% reduction in net interest income over the ensuing twelve month period.

| Change in Interest Rates (basis points) | Estimated % Change in Net Interest Income Over: | |
|---|---|------------------|
| | 0 - 12 Months | 0 - 24 Months |
| Down 100 (1) | 1.24% | 1.52% |
| Down 100, steepening yield curve (2) | 2.01% | 5.16% |
| Up 100 (1) | 0.11% | -0.18% |
| Up 200 (1) | -0.12% | -3.41% |

(1) assumes a parallel shift in the yield curve
 (2) assumes steepening curve whereby short term rates decline by 100 basis points, while long term rates remain unchanged

CONTROLS AND PROCEDURES

Our management, including the Chief Executive Officer and Chief Financial Officer, has conducted as of September 30, 2008, 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 September 30, 2008 were effective. There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2007, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

SIGNATURES

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

SUMMIT FINANCIAL GROUP, INC.
(registrant)

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

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

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

Date: November 10, 2008

