ENNIS, INC.
Form 10-Q
July 02, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended May 31, 2013

OR

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Transition Period from to

Commission File Number 1-5807

ENNIS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Texas	**75-0256410**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
2441 Presidential Pkwy., Midlothian, Texas	**76065**
(Address of Principal Executive Offices)	**(Zip code)**

(972) 775-9801

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Date File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated Filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of June 28, 2013, there were 26,216,476 shares of the Registrant s common stock outstanding.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

FORM 10-Q

FOR THE PERIOD ENDED MAY 31, 2013

TABLE OF CONTENTS

PART I: FINANCIAL INFORMATION	
Item 1. Financial Statements	3
Consolidated Balance Sheets at May 31, 2013 (unaudited) and February 28, 2013	3
Unaudited Consolidated Statements of Earnings for the three months ended May 31, 2013 and May 31, 2012	5
Unaudited Consolidated Statements of Comprehensive Income for the three months ended May 31, 2013 and May 31, 2012	6
Unaudited Consolidated Statements of Cash Flows for the three months ended May 31, 2013 and May 31, 2012	7
Notes to Consolidated Financial Statements	8
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3. Quantitative and Qualitative Disclosures About Market Risk	28
Item 4. Controls and Procedures	29
PART II: OTHER INFORMATION	
Item 1. Legal Proceedings	29
Item 1A. Risk Factors	29
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 3. Defaults Upon Senior Securities	30
Item 4. Mine Safety Disclosures	30
Item 5. Other Information	30
Item 6. Exhibits	30
SIGNATURES	31

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

ENNIS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	May 31, 2013	February 28, 2013
	(unaudited)	
Assets		
Current assets		
Cash	$ 14,396	$ 6,232
Accounts receivable, net of allowance for doubtful receivables of $2,707 at May 31, 2013 and $3,952 at February 28, 2013	63,784	60,071
Prepaid expenses	6,819	7,425
Prepaid income taxes	775	4,170
Inventories	97,975	109,698
Deferred income taxes	5,820	5,820
Assets held for sale	710	
Total current assets	190,279	193,416
Property, plant and equipment, at cost		
Plant, machinery and equipment	154,718	155,093
Land and buildings	79,903	80,438
Other	23,234	23,252
Total property, plant and equipment	257,855	258,783
Less accumulated depreciation	167,812	166,870
Net property, plant and equipment	90,043	91,913
Goodwill	121,809	121,809
Trademarks and trade names, net	63,378	63,378
Customer lists, net	19,371	20,134
Deferred finance charges, net	485	522
Other assets	4,052	4,120
Total assets	$ 489,417	$ 495,292

See accompanying notes to consolidated financial statements.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except for par value and share amounts)

	May 31, 2013 *(unaudited)*	February 28, 2013
Liabilities and Shareholders Equity		
Current liabilities		
Accounts payable	$ 20,966	$ 22,256
Accrued expenses		
Employee compensation and benefits	14,081	17,003
Taxes other than income	798	582
Income taxes payable	1,693	621
Other	2,446	2,577
Total current liabilities	39,984	43,039
Long-term debt	45,000	57,500
Liability for pension benefits	9,861	9,341
Deferred income taxes	23,276	23,184
Other liabilities	1,020	1,012
Total liabilities	119,141	134,076
Commitments and contingencies		
Shareholders equity		
Preferred stock $10 par value, authorized 1,000,000 shares; none issued		
Common stock $2.50 par value, authorized 40,000,000 shares; issued 30,053,443 shares at May 31 and February 28, 2013	75,134	75,134
Additional paid-in capital	121,599	122,186
Retained earnings	260,219	251,713
Accumulated other comprehensive income (loss):		
Foreign currency translation, net of taxes	721	571
Minimum pension liability, net of taxes	(15,474)	(15,474)
Total accumulated other comprehensive income (loss)	(14,753)	(14,903)
Treasury stock	(71,923)	(72,914)
Total shareholders equity	370,276	361,216
Total liabilities and shareholders equity	$ 489,417	$ 495,292

See accompanying notes to consolidated financial statements.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(*Dollars in thousands, except share and per share amounts*)

(Unaudited)

	Three months ended May 31, 2013	Three months ended May 31, 2012
Net sales	$ 138,466	$ 142,528
Cost of goods sold	102,671	114,279
Gross profit margin	35,795	28,249
Selling, general and administrative	22,205	22,026
Gain from disposal of assets	(7)	(4)
Income from operations	13,597	6,227
Other income (expense)		
Interest expense	(251)	(469)
Other, net	157	350
	(94)	(119)
Earnings before income taxes	13,503	6,108
Provision for income taxes	4,997	2,229
Net earnings	$ 8,506	$ 3,879
Weighted average common shares outstanding		
Basic	26,038,068	25,963,369
Diluted	26,055,869	25,983,907
Per share amounts		
Net earnings basic	$ 0.33	$ 0.15
Net earnings diluted	$ 0.33	$ 0.15
Cash dividends per share	$	$ 0.175

See accompanying notes to consolidated financial statements.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(*Dollars in thousands*)

(Unaudited)

	Three months ended May 31,	
	2013	**2012**
Net earnings	$ 8,506	$ 3,879
Foreign currency translation adjustment, net of deferred taxes	150	(2,107)
Comprehensive income	$ 8,656	$ 1,772

See accompanying notes to consolidated financial statements.

6

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Three months ended May 31, 2013	Three months ended May 31, 2012
Cash flows from operating activities:		
Net earnings	$ 8,506	$ 3,879
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	2,387	2,572
Amortization of deferred finance charges	37	37
Amortization of trade names, customer lists, and patent	795	832
Gain from disposal of assets	(7)	(4)
Bad debt expense	1,099	287
Stock based compensation	405	316
Deferred income taxes	(1)	2
Changes in operating assets and liabilities:		
Accounts receivable	(4,850)	(300)
Prepaid expenses	4,100	1,913
Inventories	11,683	14,876
Other assets	36	3
Accounts payable and accrued expenses	(3,167)	(9,873)
Other liabilities	8	(313)
Liability for pension benefits	520	539
Net cash provided by operating activities	21,551	14,766
Cash flows from investing activities:		
Capital expenditures	(669)	(133)
Proceeds from disposal of plant and property	7	7
Net cash used in investing activities	(662)	(126)
Cash flows from financing activities:		
Repayment of debt	(12,500)	(5,000)
Dividends		(4,560)
Purchase of treasury stock	(1)	(1)
Net cash used in financing activities	(12,501)	(9,561)
Effect of exchange rate changes on cash	(224)	(522)
Net change in cash	8,164	4,557
Cash at beginning of period	6,232	10,410
Cash at end of period	$ 14,396	$ 14,967

See accompanying notes to consolidated financial statements.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

1. Significant Accounting Policies and General Matters

Basis of Presentation

These unaudited consolidated financial statements of Ennis, Inc. and its subsidiaries (collectively referred to as the Company, Registrant, Ennis, or we, us, or our) for the quarter ended May 31, 2013 have been prepared in accordance with generally accepted accounting principles for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended February 28, 2013, from which the accompanying consolidated balance sheet at February 28, 2013 was derived. All significant intercompany balances and transactions have been eliminated in consolidation. In the opinion of management, all adjustments considered necessary for a fair presentation of the interim financial information have been included and are of a normal recurring nature. In preparing the financial statements, the Company is required to make estimates and assumptions that affect the disclosure and reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company evaluates these estimates and judgments on an ongoing basis, including those related to bad debts, inventory valuations, property, plant and equipment, intangible assets, pension plan, accrued liabilities, and income taxes. The Company bases estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. The results of operations for any interim period are not necessarily indicative of the results of operations for a full year.

2. Accounts Receivable and Allowance for Doubtful Receivables

Accounts receivable are reduced by an allowance for an estimate of amounts that are uncollectible. Substantially all of the Company s receivables are due from customers in North America. The Company extends credit to its customers based upon its evaluation of the following factors: (i) the customer s financial condition, (ii) the amount of credit the customer requests, and (iii) the customer s actual payment history (which includes disputed invoice resolution). The Company does not typically require its customers to post a deposit or supply collateral. The Company s allowance for doubtful receivables is based on an analysis that estimates the amount of its total customer receivable balance that is not collectible. This analysis includes assessing a default probability to customers receivable balances, which is influenced by several factors including (i) current market conditions, (ii) periodic review of customer credit worthiness, and (iii) review of customer receivable aging and payment trends.

The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance in the period the payment is received. Credit losses from continuing operations have consistently been within management s expectations.

The following table presents the activity in the Company s allowance for doubtful receivables for the three months ended May 31, 2013 and May 31, 2012 (in thousands):

	Three months ended May 31,	
	2013	**2012**
Balance at beginning of period	$ 3,952	$ 4,403
Bad debt expense	1,099	287
Recoveries	5	6
Accounts written off	(2,349)	(217)
Balance at end of period	$ 2,707	$ 4,479

3. Inventories

The Company uses the lower of last-in, first-out (LIFO) cost or market to value certain of its business forms inventories and the lower of first-in, first-out (FIFO) cost or market to value its remaining forms and apparel inventories. The Company regularly reviews inventories on hand, using specific aging categories, and writes down

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

3. Inventories -continued

the carrying value of its inventories for excess and potentially obsolete inventories based on historical usage and estimated future usage. In assessing the ultimate realization of its inventories, the Company is required to make judgments as to future demand requirements. As actual future demand or market conditions may vary from those projected by the Company, adjustments to inventories may be required.

The following table summarizes the components of inventories at the different stages of production as of the dates indicated (in thousands):

	May 31, 2013	February 28, 2013
Raw material	$ 14,481	$ 14,470
Work-in-process	6,233	11,238
Finished goods	77,261	83,990
	$ 97,975	$ 109,698

4. Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets of acquired businesses and is not amortized. Goodwill and indefinite-lived intangibles are evaluated for impairment on an annual basis, or more frequently if impairment indicators arise, using a fair-value-based test that compares the fair value of the asset to its carrying value. Fair values of reporting units are typically calculated using a factor of expected earnings before interest, taxes, depreciation, and amortization. The Company must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets in assessing the recoverability of its goodwill and other intangibles. If these estimates or the related assumptions change, the Company may be required to record impairment charges for these assets in the future.

The cost of intangible assets is based on fair values at the date of acquisition. Intangible assets with determinable lives are amortized on a straight-line basis over their estimated useful life (between 1 and 10 years). Trademarks with indefinite lives are evaluated for impairment on an annual basis, or more frequently if impairment indicators arise. The Company assesses the recoverability of its definite-lived intangible assets primarily based on its current and anticipated future undiscounted cash flows.

The carrying amount and accumulated amortization of the Company s intangible assets at each balance sheet date are as follows (in thousands):

As of May 31, 2013	Weighted Average Remaining Life *(in years)*	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets				
Trade names		$ 1,234	$ 1,234	$
Customer lists	6.1	37,887	18,516	19,371

Noncompete		500	500	
Patent	4.8	773	166	607
Total	6.0	$ 40,394	$ 20,416	$ 19,978

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

4. Goodwill and Other Intangible Assets -continued

As of February 28, 2013	Weighted Average Remaining Life *(in years)*	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets				
Trade names		$ 1,234	$ 1,234	$
Customer lists	6.4	37,887	17,753	20,134
Noncompete		500	500	
Patent	5.0	773	134	639
Total	6.2	$ 40,394	$ 19,621	$ 20,773

	May 31, 2013	February 28, 2013
Non-amortizing intangible assets		
Trademarks	$ 63,378	$ 63,378

Aggregate amortization expense for the three months ended May 31, 2013 and May 31, 2012 was $0.8 million.

The Company s estimated amortization expense for the current and next five fiscal years ending in February of the stated year is as follows (in thousands):

2014	$ 3,180
2015	3,063
2016	3,004
2017	3,004
2018	2,765
2019	2,302

Changes in the net carrying amount of goodwill as of the dates indicated are as follows (in thousands):

	Print Segment Total	Apparel Segment Total	Total
Balance as of February 29, 2012	$ 47,085	$ 74,549	$ 121,634
Goodwill acquired adjustment	175		175
Goodwill impairment			

Balance as of February 28, 2013	47,260	74,549	121,809
Goodwill acquired			
Goodwill impairment			
Balance as of May 31, 2013	$ 47,260	$ 74,549	$ 121,809

During the fiscal year ended February 28, 2013, an adjustment of $0.2 million reflects a revised estimate in accounts receivable, inventories, accrued expenses, and property, plant and equipment, net of adjustment to the purchase price, related to the acquisition of PrintXcel and Printegra assets from Cenveo Corporation (Cenveo) and its subsidiaries.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

5. Other Accrued Expenses

The following table summarizes the components of other accrued expenses as of the dates indicated (in thousands):

	May 31, 2013	February 28, 2013
Accrued taxes	$ 352	$ 361
Accrued legal and professional fees	620	777
Accrued interest	104	120
Accrued utilities	66	96
Accrued phantom stock obligation	499	467
Accrued acquisition related obligations	159	163
Other accrued expenses	646	593
	$ 2,446	$ 2,577

6. Long-Term Debt

Long-term debt consisted of the following as of the dates indicated (in thousands):

	May 31, 2013	February 28, 2013
Revolving credit facility	$ 45,000	$ 57,500

On February 22, 2012, the Company entered into the Second Amendment to Second Amended and Restated Credit Agreement (the Facility) with a group of lenders led by Bank of America, N.A. (the Lenders). The Facility provides the Company access to $150.0 million in revolving credit, which the Company may increase to $200.0 million in certain circumstances, and matures on August 16, 2016. The Facility bears interest at the London Interbank Offered Rate (LIBOR) plus a spread ranging from 1.0% to 2.25% (LIBOR + 1.5% or 1.69% at May 31, 2013 and 1.74% at May 31, 2012), depending on the Company s ratio of total funded debt to the sum of net earnings plus interest, tax, depreciation and amortization (EBITDA). As of May 31, 2013, the Company had $45.0 million of borrowings under the revolving credit line and $4.1 million outstanding under standby letters of credit arrangements, leaving the Company availability of approximately $100.9 million. The Facility contains financial covenants, restrictions on capital expenditures, acquisitions, asset dispositions, and additional debt, as well as other customary covenants, such as a minimum tangible equity level and the total funded debt to EBITDA ratio. The Company was in compliance with these covenants as of May 31, 2013. The Facility is secured by substantially all of the Company s domestic assets as well as all capital securities of each of the Company s U.S. subsidiaries and 65% of all capital securities of each of the Company s direct foreign subsidiaries.

7. Shareholders Equity

Changes in shareholders equity accounts for the three months ended May 31, 2013 are as follows (in thousands, except share amounts):

Common Stock	Additional Paid-in	Retained	Accumulated Other	Treasury Stock

	Shares	Amount	Capital	Earnings	Comprehensive Income (Loss)	Shares	Amount	Total
Balance February 28, 2013	30,053,443	$ 75,134	$ 122,186	$ 251,713	$ (14,903)	(4,084,765)	$ (72,914)	$ 361,216
Net earnings				8,506				8,506
Foreign currency translation, net of deferred tax of $93					150			150
Stock based compensation			405					405
Exercise of stock options and restricted stock grants			(992)			55,530	992	
Stock repurchases						(49)	(1)	(1)
Balance May 31, 2013	30,053,443	$ 75,134	$ 121,599	$ 260,219	$ (14,753)	(4,029,284)	$ (71,923)	$ 370,276

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

7. Shareholders Equity -continued

On October 20, 2008, the Board of Directors authorized the repurchase of up to $5.0 million of the common stock through a stock repurchase program. Under the board-approved repurchase program, share purchases may be made from time to time in the open market or through privately negotiated transactions depending on market conditions, share price, trading volume and other factors, and such purchases, if any, will be made in accordance with applicable insider trading and other securities laws and regulations. These repurchases may be commenced or suspended at any time or from time to time without prior notice. While no shares have been repurchased during the last three fiscal years or during the current fiscal year under the program, there have been a total of 96,000 shares of common stock that have been purchased under the repurchase program since its inception at an average price per share of $10.45. On April 20, 2012, the Board increased the authorized amount available to repurchase our shares by an additional $5.0 million, bringing the total available to repurchase the Company s common stock to approximately $9.0 million. Unrelated to the stock repurchase program, the Company purchased 49 shares of common stock during the three months ended May 31, 2013.

8. Stock Option Plan and Stock Based Compensation

The Company grants stock options and restricted stock to key executives and managerial employees and non-employee directors. At May 31, 2013, the Company had one stock option plan, the 2004 Long-Term Incentive Plan of Ennis, Inc., as amended and restated as of June 30, 2011, formerly the 1998 Option and Restricted Stock Plan amended and restated as of May 14, 2008 (the Plan). The Company has 858,742 shares of unissued common stock reserved under the Plan for issuance. The exercise price of each stock option granted under the Plan equals a referenced price of the Company s common stock as reported on the New York Stock Exchange on the date of grant, and an option s maximum term is ten years. Stock options and restricted stock may be granted at different times during the year and vest ratably over various periods, from grant date up to five years. The Company uses treasury stock to satisfy option exercises and restricted stock awards.

The Company recognizes compensation expense for stock options and restricted stock grants on a straight-line basis over the requisite service period. For the three months ended May 31, 2013 and May 31, 2012, the Company included in selling, general and administrative expenses, compensation expense related to share based compensation of $0.4 million ($0.3 million net of tax), and $0.3 million ($0.2 million net of tax), respectively.

Stock Options

The Company had the following stock option activity for the three months ended May 31, 2013:

	Number of Shares *(exact quantity)*	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life *(in years)*	Aggregate Intrinsic Value(a) *(in thousands)*
Outstanding at February 28, 2013	363,000	$ 15.79	6.4	$ 421
Granted	36,155	14.05		
Terminated	(3,750)	11.67		
Exercised				
Outstanding at May 31, 2013	395,405	$ 15.67	6.5	$ 762

Exercisable at May 31, 2013	283,194	$ 15.73	5.5	$ 572

(a) Intrinsic value is measured as the excess fair market value of the Company s common stock as reported on the New York Stock Exchange over the applicable exercise price.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

8. Stock Option Plan and Stock Based Compensation -continued

The following is a summary of the assumptions used and the weighted average grant-date fair value of the stock options granted during the three months ended May 31, 2013 and May 31, 2012:

	May 31,	
	2013	2012
Expected volatility	30.41%	37.02%
Expected term (years)	3	3
Risk free interest rate	0.35%	0.43%
Dividend yield	4.63%	4.42%
Weighted average grant-date fair value	$ 1.96	$ 2.83

There were no stock options exercised or tax benefits realized from stock based compensation during the three months ended May 31, 2013 and May 31, 2012.

A summary of the status of the Company s unvested stock options at February 28, 2013, and changes during the three months ended May 31, 2013 is presented below:

	Number of Options	Weighted Average Grant Date Fair Value
Unvested at February 28, 2013	169,954	$ 3.20
New grants	36,155	1.96
Vested	(93,898)	3.08
Forfeited		
Unvested at May 31, 2013	112,211	$ 2.89

As of May 31, 2013, there was $0.3 million of unrecognized compensation cost related to unvested stock options granted under the Plan. The weighted average remaining requisite service period of the unvested stock options was 2.0 years. The total fair value of shares underlying the options vested during the three months ended May 31, 2013 was $1.6 million.

Restricted Stock

The Company had the following restricted stock grant activity for the three months ended May 31, 2013:

	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at February 28, 2013	187,048	$ 16.49
Granted	55,607	14.05
Terminated		
Vested	(55,530)	16.55
Outstanding at May 31, 2013	187,125	$ 15.74

As of May 31, 2013, the total remaining unrecognized compensation cost related to unvested restricted stock granted under the Plan was approximately $2.1 million. The weighted average remaining requisite service period of the unvested restricted stock awards was 1.8 years. As of May 31, 2013, the Company s outstanding restricted stock had an underlying fair value at date of grant of $2.9 million.

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

9. Pension Plan

The Company and certain subsidiaries have a noncontributory defined benefit retirement plan (the Pension Plan), covering approximately 9% of aggregate employees. Benefits are based on years of service and the employee s average compensation for the highest five compensation years preceding retirement or termination. The Company s funding policy is to contribute annually an amount in accordance with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA).

Pension expense is composed of the following components included in cost of goods sold and selling, general and administrative expenses in the Company s consolidated statements of earnings (in thousands):

	Three months ended May 31,	
	2013	2012
Components of net periodic benefit cost		
Service cost	$ 315	$ 321
Interest cost	601	600
Expected return on plan assets	(872)	(802)
Amortization of:		
Prior service cost	(36)	(36)
Unrecognized net loss	512	456
Net periodic benefit cost	$ 520	$ 539

The Company is required to make contributions to the Pension Plan. These contributions are required under the minimum funding requirements of ERISA. Due to the recent enactment of the Moving Ahead for Progress in the 21st Century (MAP-21) in July 2012, plan sponsors can calculate the discount rate used to measure the Pension Plan liability using a 25-year average of interest rates plus or minus a corridor. Prior to MAP-21, the discount rate used in measuring the pension liability was based on the 24-month average of interest rates. As a result of the enactment, which effectively raises the discount rates mandated for determining the value of a pension plan s benefit liability and annual cost of accruals, the Company s minimum required contribution to the Pension Plan is zero for the Pension Plan year ending February 28, 2014. However, the Company expects to make a cash contribution to the Pension Plan of between $2.0 million and $3.0 million during fiscal year 2014. The Company contributed $3.0 million to the Pension Plan during fiscal year 2013.

10. Earnings Per Share

Basic earnings per share have been computed by dividing net earnings by the weighted average number of common shares outstanding during the applicable period. Diluted earnings per share reflect the potential dilution that could occur if stock options or other contracts to issue common shares were exercised or converted into common stock.

For the three months ended May 31, 2013 and May 31, 2012, shares related to stock options of 333,405 and 301,150, respectively, were not included in the diluted earnings per share computation because their exercise price exceeded the average fair market value of the Company s stock. The following table sets forth the computation for basic and diluted earnings per share for the periods indicated:

14

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

10. Earnings Per Share -continued

	Three months ended May 31,	
	2013	2012
Basic weighted average common shares outstanding	26,038,068	25,963,369
Effect of dilutive options	17,801	20,538
Diluted weighted average common shares outstanding	26,055,869	25,983,907
Per share amounts:		
Net earnings basic	$ 0.33	$ 0.15
Net earnings diluted	$ 0.33	$ 0.15
Cash dividends	$	$ 0.175

11. Segment Information and Geographic Information

The Company operates in two segments the Print Segment and the Apparel Segment.

The Print Segment, which represented 59% of the Company s consolidated net sales for the three months ended May 31, 2013, is in the business of manufacturing, designing, and selling business forms and other printed business products primarily to distributors located in the United States. The Print Segment operates 47 manufacturing locations throughout the United States in 19 strategically located states. Approximately 97% of the business products manufactured by the Print Segment are custom and semi-custom products, constructed in a wide variety of sizes, colors, number of parts and quantities on an individual job basis depending upon the customers specifications.

The products sold include snap sets, continuous forms, laser cut sheets, tags, labels, envelopes, integrated products, jumbo rolls and pressure sensitive products in short, medium and long runs under the following labels: Ennis®, Royal Business Forms®, Block Graphics®, Specialized Printed Forms®, 360º Custom Labels℠, Enfusion®, Uncompromised Check Solutions®, VersaSeal®, Witt Printing®, B&D Litho®, Genforms®, PrintGraphics℠, Calibrated Forms®, PrintXcel and Printegra®. The Print Segment also sells the Adams-McClure® brand (which provides Point of Purchase advertising for large franchise and fast food chains as well as kitting and fulfillment); the Admore® brand (which provides presentation folders and document folders); Ennis Tag & Label℠ (which provides tags and labels, promotional products and advertising concept products); Atlas Tag & Label® (which provides tags and labels); Trade Envelopes® and Block Graphics® (which provide custom and imprinted envelopes) and Northstar® and General Financial Supply® (which provide financial and security documents).

The Print Segment sells predominantly through private printers and independent distributors. Northstar also sells direct to a small number of customers. Northstar has continued its focus with large banking organizations on a direct basis (where a distributor is not acceptable or available to the end-user) and has acquired several of the top 25 banks in the United States as customers and is actively working on other large banks within the top 25 tier of banks in the United States. Adams-McClure sales are generally provided through advertising agencies.

The Apparel Segment, which accounted for 41% of the Company s consolidated net sales for the three months ended May 31, 2013, consists of Alstyle Apparel. This group is primarily engaged in the production and sale of activewear including t-shirts, fleece goods, and other wearables. Alstyle sales are seasonal, with sales in the first and second quarters generally being the highest. Substantially all of the Apparel Segment sales

are to customers in the United States.

Corporate information is included to reconcile segment data to the consolidated financial statements and includes assets and expenses related to the Company s corporate headquarters and other administrative costs.

Table of Contents

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

11. Segment Information and Geographic Information-continued

Segment data for the three months ended May 31, 2013 and May 31, 2012 were as follows (in thousands):

	Print Segment	Apparel Segment	Corporate	Consolidated Totals
Three months ended May 31, 2013:				
Net sales	$ 81,439	$ 57,027	$	$ 138,466
Depreciation	1,377	970	40	2,387
Amortization of identifiable intangibles	428	367		795
Segment earnings (loss) before income tax	13,447	4,368	(4,312)	13,503
Segment assets	161,672	307,420	20,325	489,417
Capital expenditures	479	150	40	669
Three months ended May 31, 2012:				
Net sales	$ 87,299	$ 55,229	$	$ 142,528
Depreciation	1,544	955	73	2,572
Amortization of identifiable intangibles	465	367		832
Segment earnings (loss) before income tax	12,614	(2,821)	(3,685)	6,108
Segment assets	173,150	317,813	21,918	512,881
Capital expenditures	118		15	133

Identifiable long-lived assets by country include property, plant, and equipment, net of accumulated depreciation. The Company attributes revenues from external customers to individual geographic areas based on the country where the sale originated. Information about the Company s operations in different geographic areas as of and for the three months ended is as follows (in thousands):

	United States	Canada	Mexico	Total
Three months ended May 31, 2013:				
Net sales to unaffiliated customers				
Print Segment	$ 81,439	$	$	$ 81,439
Apparel Segment	51,702	5,262	63	57,027
	$ 133,141	$ 5,262	$ 63	$ 138,466
Identifiable long-lived assets				
Print Segment	$ 39,499	$	$	$ 39,499
Apparel Segment	215	48	46,978	47,241
Corporate	3,303			3,303
	$ 43,017	$ 48	$ 46,978	$ 90,043
Three months ended May 31, 2012:				
Net sales to unaffiliated customers				

Print Segment	$	87,299	$		$		$	87,299
Apparel Segment		49,281		5,674		274		55,229
	$	136,580	$	5,674	$	274	$	142,528
Identifiable long-lived assets								
Print Segment	$	43,484	$		$		$	43,484
Apparel Segment		168		28		47,687		47,883
Corporate		3,459						3,459
	$	47,111	$	28	$	47,687	$	94,826

ENNIS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED MAY 31, 2013

12. Supplemental Cash Flow Information

Net cash flows from operating activities reflect cash payments for interest and income taxes as follows (in thousands):

	Three months ended May 31,	
	2013	2012
Interest paid	$ 267	$ 248
Income taxes paid	$ 546	$ 625

13. Concentrations of Risk

Financial instruments that potentially subject the Company to a concentration of credit risk principally consist of cash and trade receivables. Cash is placed with high-credit quality financial institutions. The Company believes its credit risk with respect to trade receivables is limited due to industry and geographic diversification. As disclosed on the Consolidated Balance Sheets, the Company maintains an allowance for doubtful receivables to cover the Company s estimate of credit losses associated with accounts receivable.

The Company, for quality and pricing reasons, purchases its paper, cotton and yarn products from a limited number of suppliers. To maintain its high standard of color control associated with its apparel products, the Company purchases its dyeing chemicals from limited sources. While other sources may be available to the Company to purchase these products, they may not be available at the cost or at the quality the Company has come to expect.

For the purposes of the Consolidated Statements of Cash Flows, the Company considers cash to include cash on hand and in bank accounts. The Federal Deposit Insurance Corporation (FDIC) insures accounts up to $250,000. At May 31, 2013, cash balances included $12.4 million that was not federally insured because it represented amounts in individual accounts above the federally insured limit for each such account. This at-risk amount is subject to fluctuation on a daily basis. While management does not believe there is significant risk with respect to such deposits, we cannot be assured that we will not experience losses on our deposits. At May 31, 2013, the Company had $0.6 million in Canadian and $0.8 million in Mexican bank accounts.

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Ennis, Inc. (formerly Ennis Business Forms, Inc.) was organized under the laws of Texas in 1909. Ennis, Inc. and its subsidiaries print and manufacture a broad line of business forms and other business products (the Print Segment) and also manufacture a line of activewear (the Apparel Segment) for distribution throughout North America. The Print Segment distributes business products and forms throughout the United States primarily through independent dealers. This distributor channel encompasses print distributors, stationers, quick printers, computer software developers, and advertising agencies, among others. The Apparel Segment produces and sells activewear, including t-shirts, fleece goods and other wearables. Distribution of our activewear throughout the United States, Canada and Mexico is primarily through sales representatives. The distributor channel encompasses activewear wholesalers and screen printers. We offer a great selection of high-quality activewear apparel and hats with a wide variety of styles and colors in sizes ranging from toddler to 6XL. The apparel line features a wide variety of tees, fleece and shorts.

Business Segment Overview

We are one of the largest providers of business forms to independent distributors in the United States and are also one of the largest providers of blank t-shirts in North America to the activewear market. We operate in two reportable segments: Print and Apparel. For additional financial information concerning segment reporting, please see Note 11 of the Notes to the Consotyle="TEXT-ALIGN: right">- ---

December 1, 2013 - December 31, 2013
17,000 9.40--

(a) Shares purchased under the Employee Stock Ownership Plan.

Item 6. Selected Financial Data

The following consolidated selected financial data is derived from our audited financial statements as of and for the five (5) years ended December 31, 2013. The selected financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes contained elsewhere in this report.

	For the Year Ended (unless otherwise noted)				
Dollars in thousands, except per share amounts	2013	2012	2011	2010	2009
Summary of Operations					
Interest income	$ 57,280	$ 63,884	$ 71,047	$ 79,672	$ 89,536
Interest expense	18,477	24,064	31,203	39,520	45,994
Net interest income	38,803	39,820	39,844	40,152	43,542
Provision for loan losses	4,500	8,500	10,000	21,350	20,325
Net interest income after provision for loan losses	34,303	31,320	29,844	18,802	23,217
Noninterest income	11,209	12,879	11,906	10,998	6,389
Noninterest expense	34,756	37,267	36,641	34,730	32,487
Income (loss) before income taxes	10,756	6,932	5,109	(4,930)	(2,881)
Income tax expense (benefit)	2,688	1,219	1,035	(2,955)	(2,165)
Net income (loss)	8,068	5,713	4,074	(1,975)	(716)
Dividends on preferred shares	775	777	371	297	74
Net income (loss) applicable to common shares	$ 7,293	$ 4,936	$ 3,703	$ (2,272)	$ (790)
Balance Sheet Data (at year end)					
Assets	$ 1,386,227	$ 1,387,104	$ 1,450,121	$ 1,477,570	$ 1,584,625
Securities available for sale	288,780	281,539	286,599	271,730	271,654
Loans	937,070	937,168	965,516	995,319	1,137,336
Deposits	1,003,812	1,027,125	1,016,500	1,036,939	1,017,338
Short-term borrowings	62,769	3,958	15,956	1,582	49,739
Long-term borrowings	163,516	203,268	270,254	304,109	381,492
Shareholders' equity	111,072	108,555	102,566	89,821	90,660
Credit Quality					
Net loan charge-offs	$ 9,774	$ 8,279	$ 9,512	$ 21,126	$ 20,258
Nonperforming assets	72,346	93,954	116,641	92,235	107,504
Allowance for loan losses	12,659	17,933	17,712	17,224	17,000
Per Share Data					
Earnings per share					
Basic earnings	$ 0.98	$ 0.66	$ 0.50	$ (0.31)	$ (0.11)
Diluted earnings	0.84	0.60	0.49	(0.31)	(0.11)
Book value per common share (at year end) (A)	11.55	11.31	10.68	11.01	11.19
Tangible book value per common share (at year end) (A)	10.72	10.44	9.78	9.90	10.04
Cash dividends	-	-	-	-	0.06
Performance Ratios					
Return on average equity	7.38 %	5.36 %	4.32 %	-2.60 %	-0.90%
Return on average assets	0.58 %	0.40 %	0.28 %	-0.15 %	-0.05%

Equity to assets	8.0	%	7.8	%	7.1	%	6.1	%	5.7%

(A) - Assumes conversion of convertible preferred stock

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

FORWARD LOOKING STATEMENTS

This annual report contains comments or information that constitute forward looking statements (within the meaning of the Private Securities Litigation Act of 1995) that are based on current expectations that involve a number of risks and uncertainties. Words such as “expects”, “anticipates”, “believes”, “estimates” and other similar expressions or future or conditional verbs such as “will”, “should”, “would” and “could” are intende identify such forward-looking statements. 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. 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.

Although we believe the expectations reflected in such forward looking statements are reasonable, actual results may differ materially. Factors that might cause such a difference include changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking laws and regulations; changes in tax laws; the impact of technological advances; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; and changes in the national and local economy.

DESCRIPTION OF BUSINESS

We are a $1.39 billion community-based financial services company providing a full range of banking and other financial services to individuals and businesses through our two operating segments: community banking and insurance. Our community bank, Summit Community Bank, has a total of 15 banking offices located in West Virginia and Virginia. In addition, we also operate an insurance agency, Summit Insurance Services, LLC with an office in Moorefield, West Virginia which offers both commercial and personal lines of insurance and two offices in Leesburg, Virginia, primarily specializing in group health, life and disability benefit plans. See Note 17 of the accompanying consolidated financial statements for our segment information. Summit Financial Group, Inc. employs approximately 224 full time equivalent employees.

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.

Key Items in 2013

- Net income for 2013 totaled $7.29 million compared to $4.94 million in 2012. Net income grew despite charges related to the writedowns of Other Real Estate Owned (“OREO” properties) to fair value.

- Other than temporary impairment of securities declined to $118,000 in 2013 compared to $451,000 in 2012 and $2.6 million in 2011.

- Our allowance for loan losses totaled 1.33% of total loans at December 31, 2013, compared to 1.88% at December 31, 2012, with our provision for loan losses totaling $4.5 million in 2013 compared to $8.5 million during 2012.

- In 2013, nonperforming assets decreased each quarter, reaching $72.3 million at year end, their lowest levels since 2008. We continue to manage our problem assets through a combination of asset sales, loan workouts and charge-offs. However, disposition of foreclosed real estate remains difficult to achieve as the return of our real estate markets to normal activity levels has been slow.

- The impact of foregone net interest income from nonaccruing loans continues to negatively impact the margin.

- We remained well capitalized by regulatory capital guidelines at December 31, 2013, with our leverage ratio at its highest level in seven years and our total risk-based capital ratio at its highest level in thirteen years.

OUTLOOK

In the years following the 2008 financial crisis, Summit's focus has been to weather its impact by limiting growth, strengthening capital and liquidity, while maintaining marginal profitability as economic conditions improved. Looking forward, while the Company will continue to be somewhat negatively impacted by its elevated levels of nonperforming assets, management anticipates positive trends in earnings, while levels of problem assets will trend downward.

CRITICAL ACCOUNTING POLICIES

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

Our most significant accounting policies are presented in the notes to the accompanying consolidated financial statements. 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, the valuation of goodwill, fair value measurements, and deferred income tax assets to be the accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

Allowance for loan losses: The allowance for loan losses represents our estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on our consolidated balance sheet. To the extent actual outcomes differ from our estimates, additional provisions for loan losses may be required that would negatively impact earnings in future periods. Note 7 to the accompanying consolidated financial statements 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 this financial review.

Goodwill: Goodwill is subject to an analysis by reporting unit at least annually to determine whether write-downs of the recorded balances are necessary. Initially, an assessment of qualitative factors (Step 0) is performed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test is unnecessary. However, if we conclude otherwise, then we are required to perform the first step (Step 1) of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the fair value is less than the carrying value, an expense may be required on our books to write down the goodwill to the proper carrying value. Step 2 of impairment testing, which is necessary only if the reporting unit does not pass Step 1, compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination.

Community Banking – During third quarter 2013, we performed the Step 0 assessment of our goodwill of our community banking reporting unit and determined that it was not more likely than not that the fair value was less than its carrying value. In performing the qualitative Step 0 assessments, we considered certain events and circumstances such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the fair value is less than its carrying amount. No indicators of impairment were noted as of September 30, 2013.

Insurance Services – During third quarter 2013, we performed the Step 0 assessment of our goodwill of our insurance services reporting unit. We considered certain events and circumstances specific to the reporting unit, such as macroeconomic conditions, industry and market considerations, overall financial performance and cost factors when evaluating whether it is more likely than not that the fair value of our insurance services reporting unit is less than its carrying value and deemed it necessary to perform the further 2-step impairment test. We performed an internal valuation utilizing the income approach to determine the fair value of our insurance services reporting unit. This methodology consisted of discounting the expected future cash flows of this unit based upon a forecast of its operations considering long-term key business drivers such as anticipated commission revenue growth. The long term growth rate used in determining the terminal value was estimated at 2%, and a discount rate of 10.0% was applied to the insurance services unit's estimated future cash flows. We did not fail this Step 1 test as of September 30, 2013, therefore Step 2 testing was not necessary.

We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Note 11 of the consolidated financial statements of our Annual Report on Form 10-K for further discussion of our intangible assets, which include goodwill.

Fair Value Measurements: ASC Topic 820 Fair Value Measurements provides a definition of fair value, establishes a framework for measuring fair value, and requires expanded disclosures about fair value measurements. Fair value is the price that could be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Based on the observability of the inputs used in the valuation techniques, we classify our financial assets and liabilities measured and disclosed at fair value in accordance with the three-level hierarchy (e.g., Level 1, Level 2 and Level 3) established under ASC Topic 820. Fair value determination in accordance with ASC Topic 820 requires that we make a number of significant judgments. In determining the fair value of financial instruments, we use market prices of the same or similar instruments whenever such prices are available. We do not use prices involving distressed sellers in determining fair value. If observable market prices are unavailable or impracticable to obtain, then fair value is estimated using modeling techniques such as discounted cash flow analyses. These modeling techniques incorporate our assessments regarding assumptions that market participants would use in pricing the asset or the liability, including assumptions about the risks inherent in a particular valuation technique and the risk of nonperformance.

Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Additionally, fair value is used on a non-recurring basis to evaluate assets or liabilities for impairment or for disclosure purposes in accordance with ASC Topic 825, Financial Instruments.

Deferred Income Tax Assets: At December 31, 2013, we had net deferred tax assets of $12.6 million. Based on our ability to offset the net deferred tax asset against expected future taxable income in carryforward years, there was no impairment of the deferred tax assets at December 31, 2013. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. However, our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryback/carryforward periods available under applicable law is not sufficient to cover the amount of net deferred tax assets, such assets may become impaired.

BUSINESS SEGMENT RESULTS

We are organized and managed along two major business segments, as described in Note 17 of the accompanying consolidated financial statements. The results of each business segment are intended to reflect each segment as if it were a stand-alone business. Net income by segment follows:

Dollars in thousands	2013	2012	2011
Community banking	$ 9,606	$ 7,022	$ 4,715
Insurance	120	273	232
Parent and other	(2,433)	(2,359)	(1,244)
Consolidated net income	$ 7,293	$ 4,936	$ 3,703

Table of Contents

RESULTS OF OPERATIONS

Earnings Summary

Net income applicable to common shares increased 47.8% during 2013 reaching $7.29 million, compared to $4.94 million in 2012, which was 33.3% greater than 2011's $3.70 million. On a per share basis, the income applicable to common shares was $0.84, $0.60 and $0.49 per diluted share in 2013, 2012 and 2011, respectively, representing 40.0% and 22.4% increases in 2013 and 2012, respectively. Return on average equity was 7.38% in 2013 compared to 5.36% in 2012 and 4.32% in 2011. Return on average assets for the year ended December 31, 2013 was 0.58% compared to 0.40% in 2012 and 0.28% in 2011. Included in 2013's net income was $3.7 million of write-downs of OREO properties to fair value. A summary of the significant factors influencing our results of operations and related ratios is included in the following discussion.

Net Interest Income

The major component of our net earnings is net interest income, which is the excess of interest earned on earning assets over the interest expense incurred on interest bearing sources of funds. Net interest income is affected by changes in volume, resulting from growth and alterations of the balance sheet's composition, fluctuations in interest rates and maturities of sources and uses of funds. We seek to maximize net interest income through management of our balance sheet components. This is accomplished by determining the optimal product mix with respect to yields on assets and costs of funds in light of projected economic conditions, while maintaining portfolio risk at an acceptable level.

Net interest income on a fully tax equivalent basis, average balance sheet amounts, and corresponding average yields on interest earning assets and costs of interest bearing liabilities for the years 2013, 2012 and 2011 are presented in Table I. Table II presents, for the periods indicated, the changes in interest income and expense attributable to (a) changes in volume (changes in volume multiplied by prior period rate) and (b) changes in rate (change in rate multiplied by prior period volume). Changes in interest income and expense attributable to both rate and volume have been allocated between the factors in proportion to the relationship of the absolute dollar amounts of the change in each.

Net interest income on a fully tax equivalent basis totaled $40.2 million, $41.3 million, and $41.4 million for the years ended December 31, 2013, 2012, and 2011, respectively, representing a decrease of 2.7% in 2013 and 0.1% in 2012. During 2013 and 2012, the volumes of both interest earning assets and interest bearing liabilities declined. While our earnings on interest earning assets decreased $6.7 million in 2013, this decline was partially offset by a reduction in the volume of interest bearing liabilities and a reduction in the cost of interest bearing liabilities. During 2012, these reductions were nearly offset by lower yields on both interest earning assets and interest bearing liabilities while during 2011, these reductions were more than offset by lower yields on both interest earnings assets and interest bearing liabilities. Total average earning assets decreased 3.7% to $1.25 billion at December 31, 2013 from $1.30 billion at December 31, 2012.   Total average interest bearing liabilities decreased 3.5% to $1.17 billion at December 31, 2013, compared to $1.21 billion at December 31, 2012. As identified in Table II, tax equivalent net interest income decreased $1.1 million in 2013 and $49,000 during 2012.

Our net interest margin was 3.22% for 2013 compared to 3.19% and 3.08% for 2012 and 2011, respectively. Our net interest margin increased 3 basis points in 2013 and 11 basis points in 2012. The continuing low interest rate environment throughout 2013 and 2012 has served to positively impact our net interest margin due to our liability sensitive balance sheet. The cost of interest bearing liabilities decreased 41 and 44 basis points for 2013 and 2012, respectively, which more than offset the 35 basis point decrease in each 2013 and 2012 in the yield on interest earning assets. See Tables I and II for further details regarding changes in volumes and rates of average assets and liabilities and how those changes affect our net interest income.

Assuming no significant change in market interest rates, we anticipate a relatively stable net interest margin in the near term as we do not expect interest rates to rise in the near future, we do not expect significant growth in our interest earning assets, nor do we expect our nonperforming asset balances to decline significantly in the near future. We continue to monitor the net interest margin through net interest income simulation to minimize the potential for any significant negative impact. See the "Market Risk Management" section for further discussion of the impact changes in market interest rates could have on us. Further analysis of our yields on interest earning assets and interest bearing liabilities are presented in Tables I and II below.

Table I - Average Balances - Assets, Liabilities and Shareholders' Equity,
Interest Earnings & Expenses, and Average Yields/Rates

	Average Balances				
Dollars in thousands	2013	2012	2011	2010	2009
ASSETS					
Interest earning assets					
Loans, net of unearned interest (1)					
Taxable	$ 949,616	$ 963,209	$ 987,315	$ 1,082,537	$ 1,184,571
Tax-exempt (2)	5,440	6,628	5,105	5,965	8,045
Securities					
Taxable	208,588	233,560	252,901	253,529	271,820
Tax-exempt (2)	75,707	71,937	63,894	40,048	46,740
Federal Funds sold and interest bearing deposits with other banks	7,821	19,731	33,690	16,373	1,335
	1,247,172	1,295,065	1,342,905	1,398,452	1,512,511
Noninterest earning assets					
Cash and due from banks	4,381	4,188	4,022	4,267	18,282
Premises and equipment	20,926	21,578	22,620	23,742	23,646
Other assets	125,629	118,427	118,408	104,907	60,656
Allowance for loan losses	(15,152)	(18,157)	(18,161)	(19,226)	(18,293)
Total assets	$ 1,382,956	$ 1,421,101	$ 1,469,794	$ 1,512,142	$ 1,596,802
LIABILITIES AND SHAREHOLDERS' EQUITY					
Liabilities					
Interest bearing liabilities					
Interest bearing demand deposits	$ 181,413	$ 170,698	$ 152,552	$ 147,513	$ 154,233
Savings deposits	195,398	203,908	207,226	188,233	112,712
Time deposits	556,644	548,044	601,925	605,663	632,988
Short-term borrowings	34,098	13,248	4,238	16,172	99,497
Long-term borrowings and subordinated debentures	202,237	276,092	315,900	380,235	429,481
	1,169,790	1,211,990	1,281,841	1,337,816	1,428,911
Noninterest bearing liabilities					
Demand deposits	94,943	94,243	85,247	73,971	71,281
Other liabilities	8,951	8,256	8,474	9,597	8,666
Total liabilities	1,273,684	1,314,489	1,375,562	1,421,384	1,508,858
Shareholders' equity - preferred	9,313	9,326	4,738	3,519	3,519
Shareholders' equity - common	99,959	97,286	89,494	87,239	84,425
Total liabilities and shareholders' equity	$ 1,382,956	$ 1,421,101	$ 1,469,794	$ 1,512,142	$ 1,596,802

(1) For purposes of this table, nonaccrual loans are included in average loan balances. Included in interest and fees on loans are loan fees of $689,000,
$720,000, and $573,000 for the years ended December 31, 2013, 2012 and
2011 respectively.

(2) For purposes of this table, interest income on tax-exempt securities and loans has been adjusted assuming an effective combined Federal and state tax
rate of 34% for all years presented. The tax equivalent adjustment results in an increase in interest income of $1,396,000, $1,500,000, and $1,525,000
for the years ended December 31, 2013, 2012 and
2011, respectively.

Table of Contents

Table I - Average Balances - Assets, Liabilities and Shareholders' Equity,
Interest Earnings & Expenses, and Average Yields/Rates (continued)

	Interest Earnings/Expense					Average Yield/Rate				
Dollars in thousands	2013	2012	2011	2010	2009	2013	2012	2011	2010	2009
ASSETS										
Interest earning assets										
Loans, net of unearned interest (1)										
Taxable	$ 50,505	$ 55,248	$ 58,911	$ 65,643	$ 71,405	5.32 %	5.74 %	5.97 %	6.06 %	6.03%
Tax-exempt (2)	388	483	402	476	665	7.13 %	7.29 %	7.87 %	7.98 %	8.27%
Securities										
Taxable	4,131	5,689	9,106	11,922	15,602	1.98 %	2.44 %	3.60 %	4.70 %	5.74%
Tax-exempt (2)	3,647	3,929	4,080	2,670	3,150	4.82 %	5.46 %	6.39 %	6.67 %	6.74%
Federal Funds sold and interest bearing deposits with other banks	5	35	72	31	13	0.06 %	0.18 %	0.21 %	0.19 %	0.97%
	$ 58,676	$ 65,384	$ 72,571	$ 80,742	$ 90,835	4.70 %	5.05 %	5.40 %	5.77 %	6.01%
LIABILITIES AND SHAREHOLDERS' EQUITY										
Liabilities										
Interest bearing liabilities										
Interest bearing demand deposits	$ 255	$ 325	$ 391	$ 583	$ 784	0.14 %	0.19 %	0.26 %	0.40 %	0.51%
Savings deposits	1,152	1,361	1,899	2,323	1,774	0.59 %	0.67 %	0.92 %	1.23 %	1.57%
Time deposits	8,985	11,472	15,983	18,131	22,407	1.61 %	2.09 %	2.66 %	2.99 %	3.54%
Short-term borrowings	95	31	8	80	573	0.28 %	0.23 %	0.19 %	0.49 %	0.58%
Long-term borrowings and subordinated debentures	7,991	10,875	12,921	18,403	20,457	3.95 %	3.94 %	4.09 %	4.84 %	4.76%
	$ 18,478	$ 24,064	$ 31,202	$ 39,520	$ 45,995	1.58 %	1.99 %	2.43 %	2.95 %	3.22%
Net Interest Earnings	$ 40,198	$ 41,320	$ 41,369	$ 41,222	$ 44,840					
Net Interest Margin						3.22 %	3.19 %	3.08 %	2.95 %	2.96%

(1) For purposes of this table, nonaccrual loans are included in average loan balances. Included in interest and fees on loans are loan fees of $689,000, $720,000, and $573,000 for the years ended December 31, 2013, 2012 and 2011 respectively.

(2) For purposes of this table, interest income on tax-exempt securities and loans has been adjusted assuming an effective combined Federal and state tax rate of 34% for all years presented. The tax equivalent adjustment results in an increase in interest income of $1,396,000, $1,500,000, and $1,525,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

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

	2013 Versus 2012 Increase (Decrease) Due to Change in:			2012 Versus 2011 Increase (Decrease) Due to Change in:		
Dollars in thousands	Volume	Rate	Net	Volume	Rate	Net
Interest earned on						
Loans						
Taxable	$ (771)	$ (3,972)	$ (4,743)	$ (1,417)	$ (2,246)	$ (3,663)
Tax-exempt	(85)	(10)	$ (95)	113	(32)	$ 81
Securities						
Taxable	(567)	(991)	$ (1,558)	(653)	(2,764)	$ (3,417)
Tax-exempt	199	(481)	$ (282)	481	(632)	$ (151)
Federal funds sold and interest bearing deposits with other banks	(14)	(16)	(30)	(26)	(11)	(37)
Total interest earned on interest earning assets	(1,238)	(5,470)	(6,708)	(1,502)	(5,685)	(7,187)
Interest paid on						
Interest bearing demand deposits	19	(89)	(70)	43	(109)	(66)
Savings deposits	(55)	(154)	(209)	(29)	(509)	(538)
Time deposits	177	(2,664)	(2,487)	(1,341)	(3,170)	(4,511)
Short-term borrowings	57	7	64	21	2	23
Long-term borrowings and subordinated debentures	(2,918)	34	(2,884)	(1,582)	(464)	(2,046)
Total interest paid on interest bearing liabilities	(2,720)	(2,866)	(5,586)	(2,888)	(4,250)	(7,138)
Net interest income	$ 1,482	$ (2,604)	$ (1,122)	$ 1,386	$ (1,435)	$ (49)

Noninterest Income

Noninterest income totaled 0.81%, 0.91%, and 0.81%, of average assets in 2013, 2012, and 2011, respectively. Noninterest income totaled $11.2 million in 2013 compared to $12.9 million in 2012, and $11.9 million in 2011, with insurance commissions, service fees from deposit accounts and realized securities gains being the primary positive components and other-than-temporary impairment of securities being the largest negative component. Further detail regarding noninterest income is reflected in the following table.

Table III - Noninterest Income

Dollars in thousands	2013	2012	2011
Insurance commissions	$ 4,429	$ 4,433	$ 4,461
Service fees related to deposit accounts	4,326	4,255	4,125
Mortgage origination revenue	244	207	208
Realized securities gains	240	2,348	4,006
Other-than-temporary impairment of securities	(118)	(451)	(2,646)
Bank owned life insurance income	994	1,109	846

Other		1,094		978		906
Total	$	11,209	$	12,879	$	11,906

Noninterest Expense

Noninterest expense was well controlled in both 2013 and 2012. These expenses totaled $34.8 million, $37.3 million, and $36.6 million, or 2.5%, 2.6%, and 2.5% of average assets for each of the years ended December 31, 2013, 2012, and 2011. Total noninterest expense decreased $2.5 million in 2013 compared to 2012 and increased $626,000 in 2012 compared to 2011. Our most notable change in noninterest expense during 2013 was the reduction in write-downs of foreclosed properties. Table IV below shows the breakdown of these changes.

Table IV - Noninterest Expense

Dollars in thousands	2013	Change $	Change %	2012	Change $	Change %	2011
Salaries, commissions, and employee benefits	$ 16,178	$ 646	4.2 %	$ 15,532	$ (301)	-1.9 %	$ 15,833
Net occupancy expense	1,853	(86)	-4.4 %	1,939	4	0.2 %	1,935
Equipment expense	2,303	(46)	-2.0 %	2,349	6	0.3 %	2,343
Supplies	318	(27)	-7.8 %	345	21	6.5 %	324
Professional fees	1,181	20	1.7 %	1,161	(212)	-15.4 %	1,373
Advertising	243	6	2.5 %	237	80	51.0 %	157
Amortization of intangibles	351	-	0.0 %	351	-	0.0 %	351
FDIC premiums	2,060	(7)	-0.3 %	2,067	(356)	-14.7 %	2,423
Foreclosed properties expense	1,045	(176)	-14.4 %	1,221	(237)	-16.3 %	1,458
Loss (gain) on sales of foreclosed properties	518	(159)	-23.5 %	677	972	-329.5 %	(295)
Write-downs of foreclosed properties	3,722	(3,140)	-45.8 %	6,862	211	3.2 %	6,651
Other	4,984	458	10.1 %	4,526	438	10.7 %	4,088
Total	$ 34,756	$ (2,511)	-6.7 %	$ 37,267	$ 626	1.7 %	$ 36,641

Write-downs of foreclosed properties: These write-downs declined in 2013 as the majority of our foreclosed properties had been written to fair value prior to 2013, and 2013 reappraisals did not result in as significant write-downs as in 2012 and 2011. Although management expects the decreasing trend to continue, we do not expect the trend to be at levels experienced in 2013.

Other: The increase in other expenses during 2013 is primarily attributable to four categories: 1) debit card expense increased $146,000 due to increased usage, and an increase in service provider charges, 2) internet banking expense increased $87,000 due to higher volume of users, 3) deferred director compensation plan expense increased $210,000 due to increase in market value of liabilities and 4) controllable write-offs increased $112,000 due to consumer loan fee refunds. The increase during 2012 of other expenses is primarily the result of a refund of Virginia business franchise taxes during 2011. This refund is a result of OREO property taxes paid in Virginia being an allowable offset to taxable capital for business franchise tax calculation purposes.

Income Tax Expense/Benefit

Income tax expense for the years ended December 31, 2013, 2012 and 2011 totaled $2.69 million, $1.22 million, and $1.04 million, respectively. Refer to Note 12 of the accompanying consolidated financial statements for further information and additional discussion of the significant components influencing our effective income tax rates.

CHANGES IN FINANCIAL POSITION

Our average assets decreased during 2013 to $1.38 billion, a decrease of 2.7% below 2012's average of $1.42 billion, and our year end December 31, 2013 assets were $877,000 less than December 31, 2012. Average assets decreased 3.3% in 2012, from $1.47 billion in 2011. Significant changes in the components of our balance sheet in 2013 and 2012 are discussed below.

Loan Portfolio

Table V depicts gross loan balances by type and the respective percentage of each to total loans at December 31, as follows:

Table V - Loans by Type

	2013		2012		2011		2010		2009	
Dollars in thousands	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Commercial	$88,405	9.3 %	$85,908	9.0 %	$99,101	10.1 %	$97,261	9.6 %	$122,508	10.6%

Commercial real estate	430,804	45.3	%	430,837	45.0	%	429,531	43.5	%	423,011	41.7	%	465,037	40.2%
Construction and development	86,712	9.1	%	83,155	8.7	%	96,013	9.8	%	112,840	11.1	%	162,080	14.1%
Residential mortgage	321,541	33.8	%	331,980	34.7	%	334,688	34.0	%	352,328	34.7	%	372,867	32.2%
Consumer	19,900	2.1	%	20,658	2.2	%	22,377	2.3	%	23,886	2.4	%	28,203	2.4%
Other	3,279	0.4	%	3,703	0.4	%	2,765	0.3	%	4,840	0.5	%	5,652	0.5%
Total loans	$950,641	100.0	%	$956,241	100.0	%	$984,475	100.0	%	$1,014,166	100.0	%	$1,156,347	100.0%

Table of Contents
37

Total net loans averaged $955.1 million in 2013, which represented 69% of total average assets compared to $969.8 million in 2012, or 68% of total average assets. We have slowed our loan growth due to the current weakened economic conditions in our market areas and limited availability of new capital resources.

Refer to Note 5 of the accompanying consolidated financial statements for our loan maturities and a discussion of our adjustable rate loans as of December 31, 2013.

In the normal course of business, we make various commitments and incur certain contingent liabilities, which are disclosed in Note 14 of the accompanying consolidated financial statements but not reflected in the accompanying consolidated financial statements. There have been no significant changes in these types of commitments and contingent liabilities and we do not anticipate any material losses as a result of these commitments.

Securities

Securities comprised approximately 20.8% of total assets at December 31, 2013 compared to 20.3% at December 31, 2012. Average securities approximated $284.3 million for 2013 or 6.9% less than 2012's average of $305.5 million. Refer to Note 4 of the accompanying consolidated financial statements for details of amortized cost, the estimated fair values, unrealized gains and losses as well as the security classifications by type.

All of our securities are classified as available for sale to provide us with flexibility to better manage our balance sheet structure and react to asset/liability management issues as they arise. Pursuant to ASC Topic 320 Investments—Debt and Equity Securities, anytime that we carry a security with an unrealized loss that has been determined to be “other-than-temporary”, we must recognize that loss in income. During 2013, 2012 and 2011, we took other-than-temporary non-cash impairment charges of $118,000, $451,000, and $2.6 million, respectively, related to certain nongovernment sponsored residential mortgage-backed securities.

At December 31, 2013, we did not own securities of any one issuer that were not issued by the U.S. Treasury or a U.S. Government agency that exceeded ten percent of shareholders’ equity. The maturity distribution of the securities portfolio at December 31, 2013, together with the weighted average yields for each range of maturity, is summarized in Table VI. The stated average yields are stated on a tax equivalent basis.

Table VI - Securities Maturity Analysis

(At amortized cost, dollars in thousands)	Within one year		After one but within five years		After five but within ten years		After ten years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
U. S. Government agencies and corporations	$ 94	4.0 %	$ 740	4.0 %	$ 8,652	3.1 %	$ 19,614	2.1%
Residential mortgage backed securities:								
Government sponsored agencies	53,155	2.7 %	92,498	2.8 %	5,586	3.2 %	4,031	3.4%
Nongovernment sponsored entities	5,027	5.0 %	4,879	4.1 %	1,005	3.6 %	608	4.6%
State and political subdivisions	3,217	6.3 %	4,047	3.8 %	18,715	3.5 %	63,696	4.4%
Corporate debt securities	-	-	974	1.9 %	2,999	2.0 %	-	-
Other	-	-	-	-	-	-	77	-
Total	$ 61,493	3.1 %	$ 103,138	2.9 %	$ 36,957	3.2 %	$ 88,026	3.8%

Deposits

Total deposits at December 31, 2013 decreased $23.3 million or 2.3% compared to December 31, 2012. We have strengthened our focus on growing core transaction accounts, which is reflected by their growth over the past five years, increasing 25.5% since 2009.

Table of Contents

Table VII - Deposits

Dollars in thousands	2013		2012		2011		2010		2009	
Noninterest bearing demand	$	92,837	$	100,592	$	88,655	$	74,604	$	74,119
Interest bearing demand		186,578		175,706		158,483		150,291		148,587
Savings		193,446		193,039		208,809		177,053		188,419
Time deposits		530,951		557,788		560,553		634,991		606,213
Total deposits	$	1,003,812	$	1,027,125	$	1,016,500	$	1,036,939	$	1,017,338

See Table I for average deposit balance and rate information by deposit type for 2013, 2012, 2011, 2010 and 2009, and Note 10 of the accompanying consolidated financial statements for a maturity distribution of time deposits as of December 31, 2013.

Borrowings

Lines of Credit: We have remaining available lines of credit from the Federal Home Loan Bank of Pittsburgh ("FHLB") totaling $330.8 million at December 31, 2013. We use these lines primarily to fund loans to customers. Funds acquired through this program are reflected on the consolidated balance sheet in short-term borrowings or long-term borrowings, depending on the repayment terms of the debt agreement. We also had $86.1 million available on a short term line of credit with the Federal Reserve Bank at December 31, 2013, which is primarily secured by consumer loans, construction loans, and commercial and industrial loans and a $6.0 million available line of credit with a correspondent bank.

Short-term Borrowings: Total short-term borrowings consisting primarily of advances from the FHLB having original maturities of 30 days or less increased $58.8 million from $4.0 million at December 31, 2012 to $62.8 million at December 31, 2012. See Note 11 of the accompanying consolidated financial statements for additional disclosures regarding our short-term borrowings.

Long-term Borrowings: Long-term borrowings historically have been used to fund our loan growth, however over the past four years long-term borrowings have been reduced significantly as our balance sheet contracted. Total long-term borrowings of $163.5 million at December 31, 2013 and $203.3 million at December 31, 2012 consisted primarily of funds borrowed on available lines of credit from the FHLB and structured reverse repurchase agreements with two unaffiliated institutions. Long-term borrowings from the FHLB totaled $82.6 million at December 31, 2013, compared to $122.7 million outstanding at December 31, 2012. At December 31, 2013, we had two term loans which are secured by the common stock of our subsidiary bank. $5.4 million bears a variable interest rate of prime minus 50 basis points with a final maturity of 2017, and $3.5 million bears a fixed rate of 8% with a final maturity of 2023. At December 31, 2012, we had one term loan secured by the common stock of our subsidiary bank, with an interest rate of prime minus 50 basis points, maturing in 2017, with an outstanding balance of $8.6 million. During 2007, we entered into $110 million of structured reverse repurchase agreements, with terms ranging from 5 to 10 years and call features ranging from 2 to 3.5 years in which they are callable by the purchaser. These structured reverse repurchase agreements totaled $72.0 million at December 31, 2013. Refer to Note 11 of the accompanying consolidated financial statements for additional information regarding our long-term borrowings.

Subordinated Debentures: We have subordinated debt totaling $16.8 million at December 31, 2013 and 2012. Subordinated debt qualifies as Tier 2 regulatory capital until the debt is within 5 years of maturity, at which time, the qualifying amount is decreased by 20 percent each year until maturity. During 2009, we issued $6.8 million in subordinated debt, of which $5.0 million was issued to an affiliate of a director of Summit. We also issued $1.0 million and $0.8 million to two unrelated parties. These three issuances bear an interest rate of 10 percent per annum, have a term of 10 years, and are not prepayable by us within the first five years. During 2008, $10.0 million of subordinated debt was issued to an unrelated institution, which bears a variable interest rate of 1 month LIBOR plus 275 basis points, and has a term of 7.5 years.

ASSET QUALITY

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

Table VIII presents a summary of non-performing assets at December 31, as follows:

Table VIII - Nonperforming Assets

Dollars in thousands	2013	2012	2011	2010	2009
Accruing loans past due 90 days or more					
Commercial	$ -	$ -	$ -	$ -	$ 23
Residential construction & development	-	-	344	-	-
Residential real estate	-	-	-	1,442	156
Consumer	-	-	-	-	20
Other	-	-	-	-	2
Total accruing loans 90+ days past due	-	-	344	1,442	201
Nonaccrual loans					
Commercial	1,224	5,002	3,260	1,318	408
Commercial real estate	2,318	2,556	7,163	2,686	35,217
Commercial construction & development	3,782	-	1,052	-	11,553
Residential construction & development	9,048	13,641	22,289	10,049	14,775
Residential real estate	2,446	16,522	18,187	6,075	4,407
Consumer	128	55	145	141	381
Total nonaccrual loans	18,946	37,776	52,096	20,269	66,741
Foreclosed properties					
Commercial	-	-	-	597	-
Commercial real estate	9,903	11,835	15,721	14,745	4,788
Commercial construction & development	11,125	17,597	17,101	17,021	2,028
Residential construction & development	20,485	23,074	27,877	34,377	30,230
Residential real estate	11,879	3,666	3,239	3,495	3,247
Total foreclosed properties	53,392	56,172	63,938	70,235	40,293
Repossessed assets	8	6	263	289	269
Total nonperforming assets	$ 72,346	$ 93,954	$ 116,641	$ 92,235	$ 107,504
Total nonperforming loans as a percentage of total loans	1.99 %	3.96 %	5.33 %	2.14 %	5.79%
Total nonperforming assets as a percentage of total assets	5.22 %	6.77 %	8.04 %	6.24 %	6.78%
Allowance for loan losses as a percentage of nonperforming loans	66.82 %	47.47 %	33.78 %	79.33 %	25.40%
Allowance for loan losses as a percentage of period end loans	1.33 %	1.88 %	1.80 %	1.70 %	1.47%

The following table details our most significant nonperforming loan relationships at December 31, 2013.

Table IX - Significant Nonperforming Loan Relationships
December 31, 2013
Dollars in thousands

Location	Underlying Collateral	Loan Origination	Loan Nonaccrual	Loan Balance	Method Used to	Most Recent Appraised		Amount Allocated to	Amount Previously

		Date	Date		Measure Impairment	Value			Allowance for Loan Losses	Charged-off
Eastern Panhandle WV	Commercial development & commercial real estate	Aug. 2006 & Apr. 2007	Aug. 2013	$5,171	Collateral Value	$8,464	(1	)	$-	$-
Eastern Panhandle WV	Residential development & undeveloped acreage	Mar. 2008 & June 2008	Jun. 2011	$5,936	Collateral value	$4,617	(1	)	$1,781	$2,477

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

Refer to Note 5 Loans, for information regarding our past due loans, impaired loans, nonaccrual loans, and troubled debt restructurings.

We monitor our concentrations in higher-risk lending areas in accordance with the Interagency Guidance for Concentrations in Commercial Real Estate Lending issued in 2006. This guidance establishes concentration guidelines of 100% of Tier 1 Capital plus the allowance for loan and lease loss for lending in construction, land development, and other land loans. It further establishes a guideline of 300% of Tier 1 Capital plus the allowance for loan and lease loss for lending in construction, land development and other land loans plus loans secured by non-owner occupied non-farm non-residential properties. As of December 31, 2013, Summit Community Bank was within the recommended limits of 100% and 300%, respectively.

We maintain the allowance for loan losses at a level considered adequate to provide for estimated probable credit losses inherent in the loan portfolio. The allowance is comprised of three distinct reserve components: (1) specific reserves related to loans individually evaluated, (2) quantitative reserves related to loans collectively evaluated, and (3) qualitative reserves related to loans collectively evaluated. A summary of the methodology we employ on a quarterly basis with respect to each of these components in order to evaluate the overall adequacy of our allowance for loan losses is as follows:

Specific Reserve for Loans Individually Evaluated

First, we identify loan relationships having aggregate balances in excess of $500,000 and that may also have credit weaknesses. Such loan relationships are identified primarily through our analysis of internal loan evaluations, past due loan reports, and loans adversely classified by regulatory authorities. Each loan so identified is then individually evaluated to determine whether it is impaired – that is, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the contractual terms of the underlying loan agreement. Substantially all of our impaired loans historically have been collateral dependent, meaning repayment of the loan is expected to be provided solely from the sale of the loan's underlying collateral. For such loans, we measure impairment based on the fair value of the loan's collateral, which is generally determined utilizing current appraisals. A specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over the fair value of its underlying collateral, less estimated costs to sell. Our policy is to re-evaluate the fair value of collateral dependent loans at least every twelve months unless there is a known deterioration in the collateral's value, in which case a new appraisal is obtained.

Quantitative Reserve for Loans Collectively Evaluated

Second, we stratify the loan portfolio into the following ten loan pools: land and land development, construction, commercial, commercial real estate -- owner-occupied, commercial real estate -- non-owner occupied, conventional residential mortgage, jumbo residential mortgage, home equity, consumer, and other. Loans within each pool are then further segmented between (1) loans which were individually evaluated for impairment and not deemed to be impaired, (2) larger-balance loan relationships exceeding $2 million which are assigned an internal risk rating in conjunction with our normal ongoing loan review procedures and (3) smaller-balance homogenous loans.

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

Qualitative Reserve for Loans Collectively Evaluated

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

Relationship between Allowance for Loan Losses, Net Charge-offs and Nonperforming Loans

In analyzing the relationship between the allowance for loan losses, net loan charge-offs and nonperforming loans, it is helpful to understand the process of how loans are treated as they deteriorate over time. Reserves for loans are established at origination through the quantitative and qualitative reserve process discussed above.

Charge-offs, if necessary, are typically recognized in a period after the reserves were established. If the previously established reserves exceed that needed to satisfactorily resolve the problem credit, a reduction in the overall level of the reserve could be recognized. In summary, if loan quality deteriorates, the typical credit sequence is periods of reserve building, followed by periods of higher net charge-offs.

Consumer loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), whichever is earlier. Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Commercial-related loans (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination includes many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity.

Substantially all of our nonperforming loans are secured by real estate. The majority of these loans were underwritten in accordance with our loan-to-value policy guidelines which range from 70-85% at the time of origination. The fair values of the underlying collateral value remains in excess of the recorded investment in many of our nonperforming loans, and therefore, no specific reserve allocation is required; as of December 31, 2013, approximately 68% of our impaired loans required no reserves or have been charged down to their fair value.

At December 31, 2013 and 2012, our allowance for loan losses totaled $12.7 million, or 1.33% of total loans and $17.9 million, or 1.88% of total loans, respectively, and is considered adequate to cover our estimate of probable credit losses inherent in our loan portfolio. The 2013 decline is a result of lower average loan losses experienced over the past twelve quarters. Lower losses cause our historical charge-off factor of the quantitative reserve calculation to decline, thus requiring fewer quantitative reserves. Table X presents an allocation of the allowance for loan losses by loan type at each respective year end date, as follows:

Table X - Allocation of the Allowance for Loan Losses

	2013		2012		2011		2010		2009	
Dollars in thousands	Amount	% of loans in each category to total loans	Amount	% of loans in each category to total loans	Amount	% of loans in each category to total loans	Amount	% of loans in each category to total loans	Amount	% of loans in each category to total loans
Commercial	$1,323	9.3 %	$782	9.0 %	$770	10.1 %	$323	9.6 %	$401	10.6%
Commercial real estate	1,610	45.3 %	4,656	45.1 %	4,618	43.6 %	4,049	41.7 %	3,938	40.2%
Construction and development	5,724	9.1 %	5,358	8.7 %	7,381	9.8 %	8,182	11.1 %	8,747	14.0%
Residential real estate	3,904	33.8 %	6,984	34.7 %	4,749	34.0 %	4,376	34.7 %	3,626	32.3%
Consumer	48	2.1 %	132	2.1 %	161	2.3 %	263	2.4 %	249	2.4%
Other	50	0.4 %	21	0.4 %	33	0.2 %	31	0.5 %	39	0.5%
Total	$12,659	100.0 %	$17,933	100.0 %	$17,712	100.0 %	$17,224	100.0 %	$17,000	100.0%

Table of Contents
42

A reconciliation of the activity in the allowance for loan losses follows:

Table XI - Allowance for Loan Losses

Dollars in thousands	2013	2012	2011	2010	2009
Balance, beginning of year	$ 17,933	$ 17,712	$ 17,224	$ 17,000	$ 16,933
Losses					
Commercial	723	1,273	506	601	479
Commercial real estate	1,040	1,442	586	9,239	469
Construction and development	3,596	3,757	3,568	7,937	16,946
Residential real estate	5,359	2,114	5,035	3,836	3,921
Consumer	79	136	162	279	214
Other	162	95	86	233	231
Total	10,959	8,817	9,943	22,125	22,260
Recoveries					
Commercial	12	13	35	38	129
Commercial real estate	682	64	92	273	23
Construction and development	187	61	43	331	1,615
Residential real estate	138	228	98	164	29
Consumer	79	95	112	87	90
Other	87	77	51	106	116
Total	1,185	538	431	999	2,002
Net losses	9,774	8,279	9,512	21,126	20,258
Provision for loan losses	4,500	8,500	10,000	21,350	20,325
Balance, end of year	$ 12,659	$ 17,933	$ 17,712	$ 17,224	$ 17,000

At December 31, 2013 and 2012, we had approximately $53.4 million and $56.2 million, respectively, in other real estate owned which was obtained as the result of foreclosure proceedings. Although foreclosed property is recorded at fair value less estimated costs to sell, the prices ultimately realized upon their sale may or may not result in us recognizing loss.

LIQUIDITY AND CAPITAL RESOURCES

Bank 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 excess funds at correspondent banks, non-pledged securities, and available lines of credit with the FHLB, Federal Reserve Bank of Richmond and correspondent banks, which totaled approximately $586.0 million or 42.27% of total consolidated assets at December 31, 2013.

Our liquidity strategy is to fund loan growth with deposits and other borrowed funds while maintaining an adequate level of short- and medium-term investments to meet normal daily loan and deposit activity. As a member of the FHLB, we have access to borrow approximately $467 million. At December 31, 2013, we had available borrowing capacity of $331 million on our FHLB line. We also maintain a credit line with the Federal Reserve Bank of Richmond as a contingency liquidity vehicle. The amount available on this line at December 31, 2013 was approximately $86 million, which is secured by a pledge of our consumer loans, construction loans, and commercial and industrial loan portfolios. We have a $6 million unsecured line of credit with a correspondent bank. Also, we classify all of our securities as available for sale to enable us to liquidate them if the need arises. During 2013, our loans decreased approximately $5.4 million, while total deposits decreased $23.3 million. This additional liquidity need was met primarily by FHLB short-term advances.

Liquidity risk represents the risk of loss due to the possibility that funds may not be available to satisfy current or future commitments based on external market issues, customer or creditor perception of financial strength, and events unrelated to Summit such as war, terrorism, or financial institution market specific issues. The Asset/Liability Management Committee (“ALCO”), comprised of members of senior management and certain members of the Board of Directors, oversees our liquidity risk management process. The ALCO develops and recommends policies and limits governing our liquidity to the Board of Directors for approval with the objective of ensuring that we can obtain cost-effective funding to meet current and future obligations, as well as maintain sufficient levels of on-hand liquidity, under both normal and “stressed” circumstances.

One aspect of our liquidity management process is establishing contingency liquidity funding plans under various scenarios in order to prepare for unexpected liquidity shortages or events. The following represents three “stressed” liquidity circumstances and our related contingency plans with respect to each.

Table of Contents

Scenario 1 – Summit Community's capital status becomes less than "well capitalized". Banks which are less than "well capitalized" in accordance with regulatory capital guidelines are prohibited from issuing new brokered deposits without first obtaining a waiver from the FDIC to do so. In the event Summit Community's capital status were to fall below well capitalized and was not successful in obtaining the FDIC's waiver to issue new brokered deposits, Summit Community:

- Would have limited amounts of maturing brokered deposits to replace in the short-term, as we have limited our brokered deposits maturing in any one quarter to no more than $50 million.
- Presently has $586 million in available sources of liquid funds which could be drawn upon to fund maturing brokered deposits until Summit Community had restored its capital to well capitalized status.
- Would first seek to restore its capital to well capitalized status through capital contributions from Summit, its parent holding company.
- Would generally have no more than $100 million in brokered deposits maturing in any one year time frame, which is well within its presently available sources of liquid funds, if in the event Summit does not have the capital resources to restore Summit Community's capital to well capitalized status. One year would give Summit Community ample time to raise alternative funds either through retail deposits or the sale of assets, and obtain capital resources to restore it to well capitalized status.

Scenario 2 – Summit Community's credit quality deteriorates such that the FHLB restricts further advances. If in the event that the Bank's credit quality deteriorated to the point that further advances under its line with the FHLB were restricted, Summit Community:

- Would severely curtail lending and other growth activities until such time as access to this line could be restored, thus eliminating the need for net new advances.
- Would still have available current liquid funding sources secured by unemcumbered loans and securities totaling $279 million aside from its FHLB line, which would result in a funding source of approximately $237 million.

Scenario 3 – A competitive financial institution offers a retail deposit program at interest rates significantly above current market rates in the Summit Community's market areas. If a competitive financial institution offered a retail deposit program at rates well in excess of current market rates in the Summit Community's market area, the Bank:

- Presently has $586 million in available sources of liquid funds which could be drawn upon immediately to fund any "net run off" of deposits from this activity.
- Would severely curtail lending and other growth activities so as to preserve the availability of as much contingency funds as possible.
- Would begin offering its own competitive deposit program when deemed prudent so as to restore the retail deposits lost to the competition.

We continuously monitor our liquidity position to ensure that day-to-day as well as anticipated funding needs are met. We are not aware of any trends, commitments, events or uncertainties that have resulted in or are reasonably likely to result in a material change to our liquidity.

Growth and Expansion: During 2013, we spent approximately $0.7 million on capital expenditures for premises and equipment. We expect our capital expenditures to approximate $0.5 million in 2014, primarily for equipment upgrades.

Management anticipates that the Company's near term level of assets will remain stable or even increase slightly in comparison with that of the prior year due to an expected continued slowly growing economy.

Capital Compliance: Our capital position has significantly improved. This is primarily attributable to an increase in retained earnings due to our return to profitability in 2011, a decline in total assets, and various capital raises over the past five years. Stated as a percentage of total assets, our equity ratio was 8.0% and 7.8% at December 31, 2013 and 2012, respectively. At December 31, 2013, we had Tier 1 risk-based, Total risk-based and Tier 1 leverage capital in excess of the minimum levels required to be considered "well capitalized" of $63.7 million, $44.7 million, and $54.0 million, respectively. Our subsidiary bank, Summit Community Bank, had Tier 1 risk-based, Total risk-based and Tier 1 leverage capital in excess of the minimum "well capitalized" levels of $84.3 million, $56.9 million, and $75.1 million, respectively. We intend to maintain both Summit's and its subsidiary bank's capital ratios at levels that would be considered to be "well capitalized" in accordance with regulatory capital guidelines. See Note 16 of the accompanying consolidated financial statements for further discussion of our regulatory capital.

During 2009, we issued $6.8 million in subordinated debentures, of which $5.0 million was issued to an affiliate of a director of Summit. We also issued $1.0 million and $0.8 million to two unrelated parties. These three issuances bear an interest rate of 10 percent per annum, have a term of 10 years, and are not prepayable by us within the first five years. During 2008, we issued $10.0 million of subordinated debentures. 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. These subordinated debentures qualify as Tier 2 capital until they are within 5 years of maturity, thereafter the amount qualifying as Tier 2 capital is reduced by 20 percent each year until maturity.

On September 30, 2009, we issued $3.7 million of 8% non-cumulative convertible preferred stock and during fourth quarter 2011, we issued an additional $5.8 million of 8% non-cumulative convertible preferred stock.

Dividends: There were no cash dividends paid on common shares in 2013 or 2012. Future cash dividends will depend on the earnings, and financial condition of our subsidiary bank and our capital adequacy as well as general economic conditions. As discussed below under Regulatory Matters, we are presently restricted from paying cash dividends on our common stock.

The primary source of funds for the dividends paid to our shareholders is dividends received from our subsidiary bank. Dividends paid by our subsidiary bank are subject to restrictions by banking law and regulations and require approval by the bank’s regulatory agency if dividends declared in any year exceed the bank’s current year's net income, as defined, plus its retained net profits of the two preceding years. Presently, as a result of the current bank MOU, the bank is required to give 30 days prior written notice of its intent to pay any cash dividends to its regulatory authorities to give regulatory authorities an opportunity to object. Summit Community received regulatory approval for and paid two upstream dividends to Summit totaling $2.0 million during 2013.

Regulatory Matters: Summit and the Bank have entered into informal Memoranda of Understanding (“MOU’s”) with their respective regulatory authorities. A memorandum of understanding is characterized by the regulatory authorities as an informal action that is not published or publicly available and that is used when circumstances warrant a milder form of action than a formal supervisory action, such as a formal written agreement or order.

See Risks Relating to Our Business beginning on page 15 of the Risk Factors section of this Annual Report on Form 10K for specific details of the MOUs.

Contractual Cash Obligations: During our normal course of business, we incur contractual cash obligations. The following table summarizes our contractual cash obligations at December 31, 2013.

Table XII - Contractual Cash Obligations

Dollars in thousands	Long Term Debt and Subordinated Debentures	Operating Leases
2014	$ 82,526	$ 204
2015	11,909	38
2016	28,911	-
2017	918	-
2018	45,017	-
Thereafter	30,624	-
Total	$ 199,905	$ 242

Off-Balance Sheet Arrangements: We are involved with some off-balance sheet arrangements that have or are reasonably likely to have an effect on our financial condition, liquidity, or capital. These arrangements at December 31, 2013 are presented in the following table. Refer to Note 14 of the accompanying consolidated financial statements for further discussion of our off-balance sheet arrangements.

Table XIII - Off-Balance Sheet Arrangements

Dollars in thousands
Commitments to extend credit
Revolving home equity and

credit card lines	$	51,621
Construction loans		28,549
Other loans		36,495
Standby letters of credit		1,711
Total	$	118,376

Table of Contents
45

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

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 embedded 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"). The ALCO is comprised of members of the Board of Directors and of members of senior management. 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. At December 31, 2013, our interest rate risk position was liability sensitive. That is, liabilities are likely to reprice faster than assets, resulting in a decrease in net interest income in a rising rate environment, while a falling interest rate environment would produce an increase in net interest income. Net interest income is also subject to changes in the shape of the yield curve. In general, a flat yield curve results 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 rates is assumed to gradually take place over a 12 month period, and then remain stable, except for the up 400 scenario, which assumes a gradual increase in rates over 24 months. Assumptions used to project yields and rates for new loans and deposits are derived from historical analysis. Securities portfolio maturities and prepayments are reinvested in like instruments. Mortgage loan prepayment assumptions are developed from industry estimates of prepayment speeds. Noncontractual deposit repricings are modeled on historical patterns.

The following table presents the estimated sensitivity of our net interest income to changes in interest rates, as measured by our earnings simulation model as of December 31, 2013. The sensitivity is measured as a percentage change in net interest income given the stated changes in interest rates (gradual change over 12 months, stable thereafter for the down 100 and the up 200 scenarios, and gradual change over 24 months for the up 400 scenario) compared to net interest income with rates unchanged in the same period. The estimated changes set forth below are dependent on the assumptions discussed above and are well within our ALCO policy limits shown below relative to reductions in net interest income over the ensuing twelve month period.

	Estimated % Change in Net Interest Income over:		
Change in Interest Rates	0 - 12 Months Policy	0 - 12 Months Actual	13 - 24 Months Actual
Down 100 basis points (1)	-7 %	-0.70 %	0.48%
Up 200 basis points (1)	-10 %	-4.88 %	-5.21%
Up 400 basis points (2)	-15 %	-4.25 %	-10.41%

(1) assumes a parallel shift in the yield curve over 12 months
(2) assumes a parallel shift in the yield curve over 24 months

Table of Contents
46

REPORT OF MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Summit Financial Group, Inc. is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements and notes included in this annual report have been prepared in conformity with United States generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

We, as management of Summit Financial Group, Inc., are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with United States generally accepted accounting principles and in conformity with the Federal Financial Institutions Examination Council instructions for consolidated Reports of Condition and Income (call report instructions). The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

The Audit Committee, consisting entirely of independent directors, meets regularly with management, internal auditors and the independent registered public accounting firm, and reviews audit plans and results, as well as management's actions taken in discharging responsibilities for accounting, financial reporting, and internal control. Arnett Foster Toothman, PLLC, independent registered public accounting firm, and the internal auditors have direct and confidential access to the Audit Committee at all times to discuss the results of their examinations.

Management assessed the Corporation's system of internal control over financial reporting as of December 31, 2013. In making this assessment, we used the criteria for effective internal control over financial reporting set forth in Internal Control-Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992. Based on this assessment, management concludes that, as of December 31, 2013, its system of internal control over financial reporting is effective and meets the criteria of the Internal Control-Integrated Framework. Arnett Foster Toothman, PLLC, independent registered public accounting firm, has issued an attestation report on management's assessment of the Corporation's internal control over financial reporting.

Management is also responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations.

H, Charles Maddy, III President and Chief Executive Officer	Robert S. Tissue Senior Vice President and Chief Financial Officer	Julie R. Cook Vice President and Chief Accounting Officer

Moorefield, West Virginia
February 28, 2014

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
ON EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors and Shareholders
Summit Financial Group, Inc.
Moorefield, West Virginia

We have audited Summit Financial Group, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. Summit Financial Group, Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Report of Management's Assessment of Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards established by the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Summit Financial Group, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based upon the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Summit Financial Group, Inc. and our report, dated March 7, 2014, expressed an unqualified opinion.

Charleston, West Virginia
March 7, 2014

Table of Contents

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Summit Financial Group, Inc.
Moorefield, West Virginia

We have audited the accompanying consolidated balance sheets of Summit Financial Group, Inc. and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Summit Financial Group, Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Summit Financial Group, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992, and our report dated March 7, 2014, expressed an unqualified opinion on the effectiveness of Summit Financial Group Inc's internal control over financial reporting.

Charleston, West Virginia
March 7, 2014

Table of Contents

Consolidated Balance Sheets

	December 31,	
Dollars in thousands	2013	2012
ASSETS		
Cash and due from banks	$ 3,442	$ 3,833
Interest bearing deposits with other banks	8,340	10,969
Cash and cash equivalents	11,782	14,802
Securities available for sale	288,780	281,539
Other investments	7,815	14,658
Loan held for sale	321	226
Loans, net	937,070	937,168
Property held for sale	53,392	56,172
Premises and equipment, net	20,623	21,129
Accrued interest receivable	5,669	5,621
Intangible assets	7,949	8,300
Cash surrender value of life insurance policies	35,611	29,553
Other assets	17,215	17,936
Total assets	$ 1,386,227	$ 1,387,104
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	$ 92,837	$ 100,592
Interest bearing	910,975	926,533
Total deposits	1,003,812	1,027,125
Short-term borrowings	62,769	3,958
Long-term borrowings	163,516	203,268
Subordinated debentures	16,800	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589
Other liabilities	8,669	7,809
Total liabilities	1,275,155	1,278,549
Commitments and Contingencies		
Shareholders' Equity		
Preferred stock and related surplus,		

authorized 250,000 shares:				
Series 2009, 8% Non-cumulative convertible preferred stock,				
par value $1.00; issued 3,710 shares		3,519		3,519
Series 2011, 8% Non-cumulative convertible preferred stock,				
par value $1.00; issued 2013 - 11,938 shares; 2012 - 12,000 shares		5,776		5,807
Common stock and related surplus, $2.50 par value; authorized 20,000,000				
shares; issued 2013 - 7,451,022 shares; 2012 - 7,425,472 shares		24,664		24,520
Retained earnings		77,134		69,841
Accumulated other comprehensive income		(21)		4,868
Total shareholders' equity		111,072		108,555
Total liabilities and shareholders' equity	$	1,386,227	$	1,387,104

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Dollars in thousands (except per share amounts)	For the Year Ended December 31, 2013	2012	2011
Interest income			
Interest and fees on loans			
Taxable	$ 50,485	$ 55,248	$ 58,910
Tax-exempt	256	319	265
Interest and dividends on securities			
Taxable	4,127	5,689	9,105
Tax-exempt	2,407	2,593	2,694
Interest on interest bearing deposits with other banks	5	35	72
Total interest income	57,280	63,884	71,046
Interest expense			
Interest on deposits	10,392	13,158	18,273
Interest on short-term borrowings	94	31	7
Interest on long-term borrowings and subordinated debentures	7,991	10,875	12,922
Total interest expense	18,477	24,064	31,202
Net interest income	38,803	39,820	39,844
Provision for loan losses	4,500	8,500	10,000
Net interest income after provision for loan losses	34,303	31,320	29,844
Noninterest income			
Insurance commissions	4,429	4,433	4,461
Service fees related to deposit accounts	4,326	4,255	4,125
Realized securities gains	240	2,348	4,006
Bank owned life insurance income	994	1,109	846
Other	1,338	1,185	1,114
Total other-than-temporary impairment loss on securities	(155)	(1,308)	(6,279)
Portion of loss recognized in other comprehensive income	37	857	3,633
Net impairment loss recognized in earnings	(118)	(451)	(2,646)
Total noninterest income	11,209	12,879	11,906
Noninterest expenses			

Salaries, commissions, and employee benefits	16,178	15,532	15,833
Net occupancy expense	1,853	1,939	1,935
Equipment expense	2,303	2,349	2,343
Professional fees	1,181	1,161	1,373
Amortization of intangibles	351	351	351
FDIC premiums	2,060	2,067	2,423
Foreclosed properties expense	1,045	1,221	1,458
Loss (gain) on sales of foreclosed properties	518	677	(295)
Write-downs of foreclosed properties	3,722	6,862	6,651
Other	5,545	5,108	4,569
Total noninterest expenses	34,756	37,267	36,641
Income before income tax expense	10,756	6,932	5,109
Income tax expense	2,688	1,219	1,035
Net income	8,068	5,713	4,074
Dividends on preferred shares	775	777	371
Net income applicable to common shares	$ 7,293	$ 4,936	$ 3,703
Basic earnings per common share	$ 0.98	$ 0.66	$ 0.50
Diluted earnings per common share	$ 0.84	$ 0.60	$ 0.49

See Notes to Consolidated Financial Statements

Consolidated Statements of Comprehensive Income
For the Years Ended December 31, 2013, 2012 and 2011

Dollars in thousands	2013	2012	2011
Net income	$ 8,068	$ 5,713	$ 4,074
Other comprehensive income (loss):			
Net unrealized gain on cashflow hedge of $803, net of deferred taxes of $297	506	-	-
Non-credit related other-than-temporary impairment on available for sale debt securities - 2013 - $37, net of deferred taxes of $14; 2012 - $857, net of deferred taxes of $326; 2011 - $3,633, net of deferred taxes of $1,381	(23)	(531)	(2,252)
Net unrealized gain (loss) on available for sale debt securities of: 2013 - ($8,527) net of deferred taxes of ($3,155) and reclassification adjustment for net realized gains included in net income of $240; 2012 - $2,550, net of deferred taxes of $969 and reclassification adjustment for net realized gains included in net income of $2,348; 2011 - $8,834, net of deferred taxes of $3,357 and reclassification adjustment for net realized gains included in net income of $4,006;	(5,372)	1,581	5,477
Total comprehensive income	$ 3,179	$ 6,763	$ 7,299

See Notes to Consolidated Financial Statements

Consolidated Statements of Shareholders’ Equity
For the Years Ended December 31, 2013, 2012 and 2011

Dollars in thousands (except per share amounts)	Series 2009 Preferred Stock and Related Surplus	Series 2011 Preferred Stock and Related Surplus	Common Stock and Related Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2010	$ 3,519	$ -	$ 24,508	$ 61,201	$ 593	$ 89,821
Comprehensive income:						
Net income	-	-	-	4,074	-	4,074
Other comprehensive income					3,225	3,225
Total comprehensive income						7,299
Exercise of stock options	-	-	-	-	-	-
Stock compensation expense	-	-	10	-	-	10
Issuance of 12,000 shares Series 2011 Preferred Stock	-	5,807	-	-	-	5,807
Series 2009 Preferred Stock cash dividends declared ($80.00 per share)	-	-	-	(297)	-	(297)
Series 2011 Preferred Stock cash dividends declared ($10.00 per share)	-	-	-	(74)	-	(74)
Balance, December 31, 2011	3,519	5,807	24,518	64,904	3,818	102,566
Comprehensive income:						
Net income	-	-	-	5,713	-	5,713
Other comprehensive income					1,050	1,050
Total comprehensive income						6,763
Exercise of stock options	-	-	-	-	-	-
Stock compensation expense	-	-	2	-	-	2
Series 2009 Preferred Stock cash dividends declared ($80.00 per share)	-	-	-	(296)	-	(296)
Series 2011 Preferred Stock cash dividends declared ($40.00 per share)	-	-	-	(480)	-	(480)
Balance, December 31, 2012	3,519	5,807	24,520	69,841	4,868	108,555
Comprehensive income:						
Net income	-	-	-	8,068	-	8,068
Other comprehensive income					(4,889)	(4,889)
Total comprehensive income						3,179
Exercise of stock options	-	-	111	-	-	111
Stock compensation expense	-	-	2	-	-	2
Series 2009 Preferred Stock cash dividends declared ($80.00 per share)	-	-	-	(297)	-	(297)
Series 2011 Preferred Stock cash dividends declared ($40.00 per share)	-	-	-	(478)	-	(478)
Conversion of Series 2011 Preferred Stock to Common Stock	-	(31)	31	-	-	-
Balance, December 31, 2013	$ 3,519	$ 5,776	$ 24,664	$ 77,134	$ (21)	$ 111,072

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

	For the Year Ended December 31,		
Dollars in thousands	2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 8,068	$ 5,713	$ 4,074
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation	1,161	1,286	1,393
Provision for loan losses	4,500	8,500	10,000
Stock compensation expense	1	2	10
Deferred income tax expense (benefit)	1,786	(502)	(3,383)
Loans originated for sale	(8,754)	(8,258)	(9,427)
Proceeds from loans sold	8,660	8,032	9,770
Securities gains	(240)	(2,348)	(4,006)
Other-than-temporary impairment of securities	118	451	2,646
Loss (gain) on disposal of assets	501	677	(295)
Write-downs of foreclosed properties	3,722	6,862	6,651
Amortization of securities premiums (accretion of discounts), net	6,032	4,622	2,155
Amortization of goodwill and purchase accounting adjustments, net	363	363	363
Tax benefit of exercise of stock options	16	-	-
(Increase) decrease in accrued interest receivable	(48)	163	94
Increase in cash surrender value of bank owned life insurance	(1,058)	(269)	(825)
(Increase) decrease in other assets	2,478	(2,289)	(1,552)
Increase (decrease) in other liabilities	861	(1,259)	564
Net cash provided by operating activities	28,167	21,746	18,232
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from maturities and calls of securities available for sale	2,669	4,618	8,049
Proceeds from sales of securities available for sale	54,340	72,056	131,950
Principal payments received on securities available for sale	62,179	66,377	57,670
Purchases of securities available for sale	(137,755)	(141,297)	(214,130)
Purchases of other investments	(2,960)	-	(2,000)
Redemption of Federal Home Bank Loan Stock	6,531	4,763	3,796
Proceeds from maturities and calls of other investments	-	2,000	7,999
Net principal payments received from (loans made to) customers	(16,225)	11,906	7,238
Purchases of premises and equipment	(677)	(343)	(384)
Proceeds from disposal of premises and equipment	37	-	-
	10,654	9,373	13,334

Proceeds from sale of other repossessed assets & property held for sale			
Purchases of life insurance contracts	(5,000)	-	(15,000)
Net cash provided by (used in) investing activities	(26,207)	29,453	(1,478)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase in demand deposit, NOW and savings accounts	3,524	13,390	53,999
Net decrease in time deposits	(26,837)	(2,764)	(74,438)
Net increase (decrease) in short-term borrowings	58,810	(11,998)	14,373
Net proceeds from long-term borrowings	3,454	-	843
Repayment of long-term borrowings	(43,251)	(66,986)	(34,697)
Net proceeds from issuance of preferred stock	-	-	5,807
Exercise of stock options	96	-	-
Dividends paid on preferred stock	(776)	(731)	(297)
Net cash used in financing activities	(4,980)	(69,089)	(34,410)
Decrease in cash and cash equivalents	(3,020)	(17,890)	(17,656)
Cash and cash equivalents:			
Beginning	14,802	32,692	50,348
Ending	$ 11,782	$ 14,802	$ 32,692

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows-continued

	For the Year Ended December 31,		
Dollars in thousands	2013	2012	2011
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash payments for:			
Interest	$ 18,920	$ 24,745	$ 31,775
Income taxes	$ 1,118	$ 2,642	$ 3,250
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES			
Other assets acquired in settlement of loans	$ 11,823	$ 8,363	$ 12,564

See Notes to Consolidated Financial Statements

NOTE 1. BASIS OF PRESENTATION

We are a financial holding company headquartered in Moorefield, West Virginia. Our primary business is community banking. Our community bank subsidiary, Summit Community Bank ("Summit Community") provides commercial and retail banking services primarily in the Eastern Panhandle and South Central regions of West Virginia and the Northern region of Virginia. We also operate Summit Insurance Services, LLC in Moorefield, West Virginia and Leesburg, Virginia.

Our accounting and reporting policies conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry.

Use of estimates: We must make estimates and assumptions that affect the reported amounts and disclosures in preparing our financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

Principles of consolidation: The accompanying consolidated financial statements include the accounts of Summit and its subsidiaries. All significant accounts and transactions among these entities have been eliminated.

Variable interest entities: In accordance with ASC Topic 810, Consolidation, business enterprises that represent the primary beneficiary of another entity by retaining a controlling interest in that entity's assets, liabilities and results of operations must consolidate that entity in its financial statements. Prior to the issuance of ASC Topic 810, consolidation generally occurred when an enterprise controlled another entity through voting interests. If applicable, transition rules allow the restatement of financial statements or prospective application with a cumulative effect adjustment. We have determined that the provisions of ASC Topic 810 do not require consolidation of subsidiary trusts which issue guaranteed preferred beneficial interests in subordinated debentures (Trust Preferred Securities). The Trust Preferred Securities continue to qualify as Tier 1 capital for regulatory purposes. The banking regulatory agencies have not issued any guidance which would change the regulatory capital treatment for the Trust Preferred Securities based on the adoption of ASC Topic 810. The adoption of the provisions of ASC Topic 810 has had no material impact on our results of operations, financial condition, or liquidity. See Note 11 of our Notes to Consolidated Financial Statements for a discussion of our subordinated debentures owed to unconsolidated subsidiary trusts.

Cash and cash equivalents: Cash and cash equivalents includes cash on hand, amounts due from banks (including cash items in process of clearing), and federal funds sold.

Presentation of cash flows: For purposes of reporting cash flows, cash flows from demand deposits, NOW accounts, savings accounts and short-term borrowings are reported on a net basis, since their original maturities are less than three months. Cash flows from loans and certificates of deposit and other time deposits are reported net.

Advertising: Advertising costs are expensed as incurred.

Trust services: Assets held in an agency or fiduciary capacity are not our assets and are not included in the accompanying consolidated balance sheets. Trust services income is recognized on the cash basis in accordance with customary banking practice. Reporting such income on a cash basis rather than the accrual basis does not have a material effect on net income.

Reclassifications: Certain accounts in the consolidated financial statements for 2012 and 2011, as previously presented, have been reclassified to conform to current year classifications.

Significant accounting policies: The following table identifies our other significant accounting policies and the Note and page where a detailed description of each policy can be found.

Fair Value Measurements	Note 3	Page 58
Securities	Note 4	Page 63
Loans	Note 5	Page 68
Allowance for Loan Losses	Note 6	Page 75
Property Held for Sale	Note 7	Page 78
Premises and Equipment	Note 8	Page 78
Intangible Assets	Note 9	Page 78
Securities Sold Under Agreements to Repurchase	Note 11	Page 80
Income Taxes	Note 12	Page 82
Stock Based Compensation	Note 13	Page 83
Earnings Per Share	Note 18	Page 90
Derivative Financial Instruments	Note 19	Page 91

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU 2011-04, Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 was effective January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income amends Topic 220, Comprehensive Income, to require that all nonowner changes in shareholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in shareholders' equity was eliminated. ASU 2011-05 was effective January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment, amends Topic 350, Intangibles – Goodwill and Other, permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-than-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of impairment loss, if any. ASU 2011-08 was effective for annual and interim impairment tests beginning after December 15, 2011, and did not have a significant impact on our financial statements.

ASU 2011-12, Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05, defers changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on

the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 became effective for us on January 1, 2012 and did not have a significant impact on our financial statements.

ASU 2013-02, Comprehensive Income (Topic 220) - Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments were effective prospectively for reporting periods beginning after December 15, 2012 and did not have a material impact on our consolidated financial statements.

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

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

ASU 2014-04, Receivables (Topic 310) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure clarifies that an in substance repossession or foreclosure occurs upon either the creditor obtaining legal title to the residential real estate property or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. The amendments may be adopted using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted. Management does not believe the amendments will have a material impact on our consolidated financial statements.

NOTE 3. FAIR VALUE MEASUREMENTS

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

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

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

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

Accordingly, securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, and impaired loans held for investment. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-Sale Securities: Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities.

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

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

Loans: We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the original contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, Accounting by Creditors for Impairment of a Loan. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2013, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with ASC Topic 310, impaired loans where an allowance is established based on the fair value of collateral requires classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When a current appraised value is not available and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

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

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

A distribution of asset and liability fair values according to the fair value hierarchy at December 31, 2013 and 2012 is provided in the tables below.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

	Balance at December 31, 2013	Fair Value Measurements Using:		
Dollars in thousands		Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	$ 29,657	$ -	$ 29,657	$ -
Mortgage backed securities:				
Government sponsored agencies	155,716	-	155,716	-
Nongovernment sponsored entities	11,819	-	11,819	-
State and political subdivisions	15,870	-	15,870	-
Corporate debt securities	3,966	-	3,966	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	71,675	-	71,675	-
Total available for sale securities	$ 288,780	$ -	$ 288,780	$ -
Derivative financial instrument				
Interest rate swaps	$ 803	$ -	$ 803	

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

Tax-exempt mortgage backed securities		2,738		-		2,738		-
Total available for sale securities	$	281,539	$	-	$	281,539	$	-

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 tables below.

Dollars in thousands	Total at December 31, 2013	Fair Value Measurements Using: Level 1	Level 2	Level 3
Residential mortgage loans held for sale	$ 321	$ -	$ 321	$ -
Impaired loans				
Commercial	$ 1,616		$ 920	$ 696
Commercial real estate	17,902	-	4,879	13,023
Construction and development	22,083	-	17,590	4,493
Residential real estate	14,747	-	8,336	6,411
Consumer	34	-	3	31
Total impaired loans	$ 56,382	$ -	$ 31,728	$ 24,654
OREO				
Commercial	$ -	$ -	$ -	$ -
Commercial real estate	9,903	-	9,903	-
Construction and development	31,610	-	29,993	1,617
Residential real estate	11,879	-	11,847	32
Consumer	-	-		-
Total OREO	$ 53,392	$ -	$ 51,743	$ 1,649

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

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

ASC Topic 825, Financial Instruments, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The following summarizes the methods and significant assumptions we used in estimating our fair value disclosures for financial instruments.

Cash and cash equivalents: The carrying values of cash and cash equivalents approximate their estimated fair value.

Interest bearing deposits with other banks: The carrying values of interest bearing deposits with other banks approximate their estimated fair values.

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

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

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

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

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

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

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

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

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

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

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

Off-balance sheet instruments: The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit standing of the counter parties. The amounts of fees currently charged on commitments and standby letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values are not shown below.

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

	At December 31,			
	2013		2012	
Dollars in thousands	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	$ 11,782	$ 11,782	$ 14,802	$ 14,802
Securities available for sale	288,780	288,780	281,539	281,539
Other investments	7,815	7,815	14,658	14,658
Loans held for sale, net	321	321	226	226
Loans, net	937,070	952,592	937,168	965,454
Accrued interest receivable	5,669	5,669	5,621	5,621
Derivative financial assets	803	803	-	-
	$ 1,252,240	$ 1,267,762	$ 1,254,014	$ 1,282,300
Financial liabilities				
Deposits	$ 1,003,812	$ 1,029,606	$ 1,027,125	$ 1,064,957
Short-term borrowings	62,769	62,769	3,958	3,958
Long-term borrowings	163,516	173,863	203,268	220,175
Subordinated debentures	16,800	16,800	16,800	16,800
Subordinated debentures owed to				

unconsolidated subsidiary trusts		19,589		19,589		19,589	19,589
Accrued interest payable		1,433		1,433		1,877	1,877
	$	1,267,919	$	1,304,060	$	1,272,617	$ 1,327,356

Table of Contents

NOTE 4. SECURITIES

We classify debt and equity securities as “held to maturity”, “available for sale” or “trading” according to management’s intent. The appropriate classification is determined at the time of purchase of each security and re-evaluated at each reporting date.

Securities held to maturity – Certain debt securities for which we have the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts. There are no securities classified as held to maturity in the accompanying financial statements.

Securities available for sale - Securities not classified as "held to maturity" or as "trading" are classified as "available for sale." Securities classified as "available for sale" are those securities that we intend to hold for an indefinite period of time, but not necessarily to maturity. "Available for sale" securities are reported at estimated fair value net of unrealized gains or losses, which are adjusted for applicable income taxes, and reported as a separate component of shareholders' equity.

Trading securities - There are no securities classified as "trading" in the accompanying financial statements.

Impairment assessment: Impairment exists when the fair value of a security is less than its cost. Cost includes adjustments made to the cost basis of a security for accretion, amortization and previous other-than-temporary impairments. We perform a quarterly assessment of the debt and equity securities in our investment portfolio that have an unrealized loss to determine whether the decline in the fair value of these securities below their cost is other-than-temporary. This determination requires significant judgment. Impairment is considered other-than-temporary when it becomes probable that we will be unable to recover the cost of an investment. This assessment takes into consideration factors such as the length of time and the extent to which the market values have been less than cost, the financial condition and near term prospects of the issuer including events specific to the issuer or industry, defaults or deferrals of scheduled interest, principal or dividend payments, external credit ratings and recent downgrades, and our intent and ability to hold the security for a period of time sufficient to allow for a recovery in fair value. If a decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value which then becomes the new cost basis. The amount of the write down is included in other-than-temporary impairment of securities in the consolidated statements of income. The new cost basis is not adjusted for subsequent recoveries in fair value, if any.

Realized gains and losses on sales of securities are recognized on the specific identification method. Amortization of premiums and accretion of discounts are computed using the interest method.

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

	December 31, 2013			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
Available for Sale				
Taxable debt securities				
U. S. Government agencies				
and corporations	$ 29,100	$ 675	$ 118	$ 29,657
Residential mortgage-backed securities:				
Government-sponsored agencies	155,270	2,019	1,573	155,716
Nongovernment-sponsored entities	11,519	321	21	11,819
State and political subdivisions				
General obligations	9,317	-	475	8,842
Water and sewer revenues	3,229	-	114	3,115
Other revenues	4,051	4	142	3,913
Corporate debt securities	3,973	24	31	3,966
Total taxable debt securities	216,459	3,043	2,474	217,028
Tax-exempt debt securities				
State and political subdivisions				
General obligations	41,156	675	1,154	40,677
Water and sewer revenues	8,996	15	306	8,705
Lease revenues	7,956	-	391	7,565
Lottery/casino revenues	4,443	63	169	4,337
Other revenues	10,527	55	191	10,391
Residential mortgage-backed securities	-	-	-	-
Total tax-exempt debt securities	73,078	808	2,211	71,675
Equity securities	77	-	-	77
Total available for sale securities	$ 289,614	$ 3,851	$ 4,685	$ 288,780

		December 31, 2012		
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
Available for Sale				
Taxable debt securities				
U. S. Government agencies				
and corporations	$ 28,128	$ 892	$ -	$ 29,020
Residential mortgage-backed securities:				
Government-sponsored agencies	133,812	3,250	492	136,570
Nongovernment-sponsored entities	15,380	509	144	15,745

State and political subdivisions:				
General obligations	8,847	58	57	8,848
Water and sewer revenues	1,920	-	32	1,888
Other revenues	1,420	13	-	1,433
Corporate debt securities	1,959	29	38	1,950
Total taxable debt securities	191,466	4,751	763	195,454
Tax-exempt debt securities				
State and political subdivisions:				
General obligations	54,948	3,259	145	58,062
Water and sewer revenues	5,773	171	47	5,897
Lease revenues	6,910	159	13	7,056
Lottery/casino revenues	4,500	305	9	4,796
Other revenues	7,272	210	23	7,459
Residential mortgage-backed securities:				
Government-sponsored agencies	2,738	-	-	2,738
Total tax-exempt debt securities	82,141	4,104	237	86,008
Equity securities	77	-	-	77
Total available for sale securities	$ 273,684	$ 8,855	$ 1,000	$ 281,539

Table of Contents

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

	December 31, 2013			
	Amortized	Unrealized		Estimated
Dollars in thousands	Cost	Gains	Losses	Fair Value
West Virginia	$ 15,277	$ 78	$ 285	$ 15,070
California	9,177	86	249	9,014
Illinois	8,968	21	543	8,446
Texas	7,651	240	190	7,701
Washington	4,400	104	85	4,419

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

The proceeds from sales, calls and maturities of securities, including principal payments received on available for sale mortgage-backed obligations and the related gross gains and losses realized are as follows:

Dollars in thousands	Proceeds from			Gross realized	
		Calls and	Principal		
Years ended December 31,	Sales	Maturities	Payments	Gains	Losses
2013	$ 54,340	$ 2,669	$ 62,179	$ 674	$ 434
2012	$ 72,056	$ 4,618	$ 66,377	$ 3,253	$ 905
2011	$ 131,950	$ 8,049	$ 57,670	$ 4,450	$ 444

Residential mortgage-backed obligations having contractual maturities ranging from 1 to 50 years are reflected in the following maturity distribution schedules based on their anticipated average life to maturity, which ranges from 1 to 34 years. Accordingly, discounts are accreted and premiums are amortized over the anticipated average life to maturity of the specific obligation.

The maturities, amortized cost and estimated fair values of securities at December 31, 2013, are summarized as follows:

	Amortized	Estimated
Dollars in thousands	Cost	Fair Value
Due in one year or less	$ 61,493	$ 61,994
Due from one to five years	103,138	103,532
Due from five to ten years	36,957	36,599
	87,949	86,578

Due after ten years				
Equity securities		77		77
Total	$	289,614	$	288,780

At December 31, 2013 and 2012, securities with estimated fair values of $120.0 million and $122.1 million respectively, were pledged to secure public deposits, and for other purposes required or permitted by law.

Table of Contents
65

During 2013 and 2012 we recorded other-than-temporary impairment losses on residential mortgage-backed nongovernment sponsored entity securities as follows:

Dollars in thousands	2013	2012
Total other-than-temporary impairment losses	$ (155)	$ (1,308)
Portion of loss recognized in other comprehensive income	37	857
Net impairment losses recognized in earnings	$ (118)	$ (451)

Activity related to the credit component recognized on debt securities available for sale for which a portion of other-than-temporary impairment was recognized in other comprehensive income for the years ended December 31, 2013 and 2012 is as follows:

Dollars in thousands	2013	2012
Balance, January 1	$ (2,903)	$ (6,355)
Additions for the credit component on debt securities in which other-than-temporary impairment was not previously recognized	(118)	(451)
Securities sold or deemed worthless during the period	-	3,903
Balance, December 31	$ (3,021)	$ (2,903)

At December 31, 2013, our debt securities with other-than-temporary impairment in which only the amount of loss related to credit was recognized in earnings consisted solely of residential mortgage-backed securities issued by nongovernment-sponsored entities. We utilize third party vendors to estimate the portion of loss attributable to credit using discounted cash flow models. The vendors estimate cash flows of the underlying loan collateral of each mortgage-backed security using models that incorporate their best estimates of current key assumptions, such as default rates, loss severity and prepayment rates. Assumptions utilized could vary widely from security to security, and are influenced by such factors as loan interest rate, geographical location of underlying borrowers, collateral type and other borrower characteristics.

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

We held 134 available for sale securities having an unrealized loss at December 31, 2013. We do not intend to sell these securities, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized bases. We believe that this decline in value is primarily attributable to the lack of market liquidity and to changes in market interest rates and not due to credit quality. Accordingly, no additional other-than-temporary impairment charge to earnings is warranted at this time. Provided below is a summary of securities available for sale which were in an unrealized loss position at December 31, 2013 and 2012, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income.

2013

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

2012

Dollars in thousands	Less than 12 months Estimated Fair Value	Less than 12 months Unrealized Loss	12 months or more Estimated Fair Value	12 months or more Unrealized Loss	Total Estimated Fair Value	Total Unrealized Loss
Temporarily impaired securities						
Taxable debt securities						
U. S. Government agencies and corporations	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage-backed securities:						
Government-sponsored agencies	36,498	(414)	8,997	(78)	45,495	(492)
Nongovernment-sponsored entities	-	(4)	1,478	(14)	1,478	(18)
State and political subdivisions:						
General obligations	2,526	(57)	-	-	2,526	(57)
Water and sewer revenues	1,240	(28)	387	(4)	1,627	(32)
Other revenues	-	-	-	-	-	-
Corporate debt securities	-	-	962	(38)	962	(38)
Tax-exempt debt securities						

State and political subdivisions:												
General obligations		11,926		(145	)		-		-		11,926	(145)
Water and sewer revenues		2,534		(47	)		-		-		2,534	(47)
Lease revenues		1,013		(13	)		-		-		1,013	(13)
Lottery/casino revenues		1,777		(9	)		-		-		1,777	(9)
Other revenues		2,684		(23	)		-		-		2,684	(23)
Other equity securties		-		-			-		-		-	-
Total temporarily impaired securities		60,198		(740	)		11,824		(134	)	72,022	(874)
Other-than-temporarily impaired securities												
Taxable debt securities												
Residential mortgage-backed securities:												
Nongovernment-sponsored entities		265		(6	)		593		(120	)	858	(126)
Total other-than-temporarily impaired securities		265		(6	)		593		(120	)	858	(126)
Total	$	60,463	$	(746	)	$	12,417	$	(254	)	$ 72,880	$ (1,000)

Table of Contents

NOTE 5. LOANS

Loans are generally stated at the amount of unpaid principal, reduced by unearned discount and allowance for loan losses. Interest on loans is accrued daily on the outstanding balances. Loan origination fees and certain direct loan origination costs are deferred and amortized as adjustments of the related loan yield over its contractual life. We categorize residential real estate loans in excess of $600,000 as jumbo loans.

Generally, loans are placed on nonaccrual status when principal or interest is greater than 90 days past due based upon the loan's contractual terms. Interest is accrued daily on impaired loans unless the loan is placed on nonaccrual status. Impaired loans are placed on nonaccrual status when the payments of principal and interest are in default for a period of 90 days, unless the loan is both well-secured and in the process of collection. Interest on nonaccrual loans is recognized primarily using the cost-recovery method. Loans may be returned to accrual status when repayment is reasonably assured and there has been demonstrated performance under the terms of the loan or, if applicable, the terms of the restructured loans.

Commercial-related loans or portions thereof (which are risk-rated) are charged off to the allowance for loan losses when the loss has been confirmed. This determination includes many factors, including the prioritization of our claim in bankruptcy, expectations of the workout/restructuring of the loan and valuation of the borrower's equity. We deem a loss confirmed when a loan or a portion of a loan is classified "loss" in accordance with bank regulatory classification guidelines, which state, "Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted".

Consumer-related loans are generally charged off to the allowance for loan losses upon reaching specified stages of delinquency, in accordance with the Federal Financial Institutions Examination Council policy. For example, credit card loans are charged off by the end of the month in which the account becomes 180 days past due or within 60 days from receiving notification about a specified event (e.g., bankruptcy of the borrower), whichever is earlier. Residential mortgage loans are generally charged off to net realizable value no later than when the account becomes 180 days past due. Other consumer loans, if collateralized, are generally charged off to net realizable value at 120 days past due.

Loans are summarized as follows:

Dollars in thousands	2013	2012
Commercial	$ 88,352	$ 85,829
Commercial real estate		
Owner-occupied	149,618	154,252
Non-owner occupied	280,790	276,082
Construction and development		
Land and land development	71,453	79,335
Construction	15,155	3,772
Residential real estate		
Non-jumbo	212,946	216,714
Jumbo	53,406	61,567
Home equity	54,844	53,263
Consumer	19,889	20,586
Other	3,276	3,701
Total loans, net of unearned fees	949,729	955,101
Less allowance for loan losses	12,659	17,933
Loans, net	$ 937,070	$ 937,168

The following presents loan maturities at December 31, 2013:

Dollars in thousands	Within 1Year	After 1 but within 5 Years	After 5 Years
Commercial	$ 31,351	$ 37,753	$ 19,248
Commercial real estate	32,535	90,640	307,233
Construction and development	35,864	8,888	41,856
Residential real estate	11,376	18,772	291,048
Consumer	4,069	14,005	1,815
Other	497	1,032	1,747
	$ 115,692	$ 171,090	$ 662,947
Loans due after one year with:			
Variable rates		$ 100,298	
Fixed rates		733,739	
		$ 834,037	

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

	At December 31, 2013					
	Past Due					> 90 days and
Dollars in thousands	30-59 days	60-89 days	> 90 days	Total	Current	accruing
Commercial	$ 74	$ 34	$ 1,190	$ 1,298	$ 87,054	$ -
Commercial real estate						
Owner-occupied	328	459	487	1,274	148,344	-
Non-owner occupied	912	115	128	1,155	279,635	-
Construction and development						
Land and land development	1,627	-	8,638	10,265	61,188	-
Construction	-	-	-	-	15,155	-
Residential mortgage						
Non-jumbo	2,708	1,673	1,321	5,702	207,244	-
Jumbo	-	-	-	-	53,406	-
Home equity	588	87	-	675	54,169	-
Consumer	224	82	106	412	19,477	-
Other	-	-	-	-	3,276	-
Total	$ 6,461	$ 2,450	$ 11,870	$ 20,781	$ 928,948	$ -

	At December 31, 2012					
	Past Due					> 90 days and
Dollars in thousands	30-59 days	60-89 days	> 90 days	Total	Current	accruing
Commercial	$ 225	$ 5	$ 2,294	$ 2,524	$ 83,305	$ -
Commercial real estate						
Owner-occupied	57	-	1,023	1,080	153,172	-
Non-owner occupied	182	193	908	1,283	274,799	-
Construction and development						

Land and land development	-	-	11,795	11,795	67,540	-
Construction	-	-	153	153	3,619	-
Residential mortgage						
Non-jumbo	3,344	2,616	2,797	8,757	207,957	-
Jumbo	-	-	12,564	12,565	49,002	-
Home equity	337	448	179	964	52,299	-
Consumer	255	79	48	382	20,204	-
Other	-	-	-	-	3,701	-
Total	$ 4,400	$ 3,341	$ 31,761	$ 39,503	$ 915,598	$ -

Nonaccrual loans: The following table presents the nonaccrual loans included in the net balance of loans at December 31, 2013 and 2012.

Dollars in thousands	2013	2012
Commercial	$ 1,224	$ 5,002
Commercial real estate		
Owner-occupied	1,953	1,524
Non-owner occupied	365	1,032
Construction and development		
Land & land development	12,830	13,487
Construction	-	154
Residential mortgage		
Non-jumbo	2,446	3,518
Jumbo	-	12,564
Home equity	-	440
Consumer	128	55
Other	-	-
Total	$ 18,946	$ 37,776

Impaired loans: Impaired loans include the following:

§ Loans which we risk-rate (consisting of loan relationships having aggregate balances in excess of $2.0 million, or loans exceeding $500,000 and exhibiting credit weakness) through our normal loan review procedures and which, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement. Risk-rated loans with insignificant delays or insignificant short falls in the amount of payments expected to be collected are not considered to be impaired.

§ Loans that have been modified in a troubled debt restructuring.

Both commercial and consumer loans are deemed impaired upon being contractually modified in a troubled debt restructuring. Troubled debt restructurings typically result from our loss mitigation activities and occur when we grant a concession to a borrower who is experiencing financial difficulty in order to minimize our economic loss and to avoid foreclosure or repossession of collateral. Once restructured in a troubled debt restructuring, a loan is generally considered impaired until its maturity, regardless of whether the borrower performs under the modified terms. Although such a loan may be returned to accrual status if the criteria set forth in our accounting policy are met, the loan would continue to be evaluated for an asset-specific allowance for loan losses and we would continue to report the loan in the impaired loan table below.

The table below sets forth information about our impaired loans.

Method Used to Measure Impairment of Impaired Loans
Dollars in thousands

	December 31,		Method Used to measure impairment
Loan Category	2013	2012	
Commerical	$ 1,864	$ 10,776	Fair value of collateral
	158	165	Discounted cash flow
Commerical real estate			
Owner-occupied	10,067	14,028	Fair value of collateral
	2,483	2,686	Discounted cash flow
Non-owner occupied	5,832	9,468	Fair value of collateral

Construction and development					
Land & land development		24,625		29,307	Fair value of collateral
		644		656	Discounted cash flow
Residential mortgage					
Non-jumbo		5,516		5,626	Fair value of collateral
		566		692	Discounted cash flow
Jumbo		8,768		21,543	Fair value of collateral
Home equity		212		219	Fair value of collateral
Consumer		47		66	Discounted cash flow
Total	$	60,782	$	95,232	

The following tables present loans individually evaluated for impairment at December 31, 2013 and 2012.

	December 31, 2013				
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
Without a related allowance					
Commercial	$ 1,161	$ 1,167	$ -	$ 1,518	$ 98
Commercial real estate					
Owner-occupied	8,434	8,434	-	7,675	226
Non-owner occupied	5,075	5,077	-	5,110	253
Construction and development					
Land & land development	14,732	14,737	-	11,628	325
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,587	3,595	-	2,858	157
Jumbo	7,862	7,867	-	7,910	405
Home equity	186	186	-	186	11
Consumer	26	27	-	28	1
Total without a related allowance	$ 41,063	$ 41,090	$ -	$ 36,913	$ 1,476
With a related allowance					
Commercial	$ 855	$ 855	$ 406	$ 1,013	$ -
Commercial real estate					
Owner-occupied	4,116	4,116	305	3,945	184
Non-owner occupied	747	755	175	515	28
Construction and development					
Land & land development	10,532	10,532	3,186	11,310	147
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	2,485	2,487	256	2,292	107
Jumbo	900	901	37	906	45
Home equity	27	26	22	27	-
Consumer	20	20	13	9	-
Total with a related allowance	$ 19,682	$ 19,692	$ 4,400	$ 20,017	$ 511
Total					
Commercial	$ 45,652	$ 45,673	$ 4,072	$ 42,714	$ 1,261
Residential real estate	15,047	15,062	315	14,179	725
Consumer	46	47	13	37	1

Total	$	60,745	$	60,782	$	4,400	$	56,930	$	1,987

	December 31, 2012				
Dollars in thousands	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Balance	Interest Income Recognized while impaired
Without a related allowance					
Commercial	$ 10,518	$ 10,537	$ -	$ 3,131	$ 134
Commercial real estate					
Owner-occupied	9,992	9,996	-	8,528	368
Non-owner occupied	6,143	6,145	-	6,056	304
Construction and development					
Land & land development	11,596	11,596	-	11,093	367
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	3,497	3,505	-	3,040	125
Jumbo	7,347	7,349	-	5,399	272
Home equity	191	191	-	191	11
Consumer	38	38	-	32	1
Total without a related allowance	$ 49,322	$ 49,357	$ -	$ 37,470	$ 1,582
With a related allowance					
Commercial	$ 404	$ 404	$ 85	$ 515	$ 6
Commercial real estate					
Owner-occupied	6,719	6,718	461	4,442	187
Non-owner occupied	3,321	3,323	286	3,341	115
Construction and development					
Land & land development	18,367	18,367	2,611	17,633	344
Construction	-	-	-	-	-
Residential real estate					
Non-jumbo	2,812	2,813	394	2,378	77
Jumbo	14,189	14,194	3,216	13,585	59
Home equity	28	28	28	29	-
Consumer	28	28	16	2	-
Total with a related allowance	$ 45,868	$ 45,875	$ 7,097	$ 41,925	$ 788
Total					
Commercial	$ 67,060	$ 67,086	$ 3,443	$ 54,739	$ 1,825
Residential real estate	28,064	28,080	3,638	24,622	544
Consumer	66	66	16	34	1
Total	$ 95,190	$ 95,232	$ 7,097	$ 79,395	$ 2,370

The average recorded investment of impaired loans during 2011 was $55.5 million, and $1.1 million interest income was recognized on those loans while impaired.

A modification of a loan is considered a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession that we would not otherwise consider. This may include a transfer of real estate or other assets from the borrower, a modification of loan terms, or a combination of both. A loan continues to be classified as a TDR for the life of the loan. Included in impaired loans are TDRs of $34.5 million, of which $33.6 million were current with respect to restructured contractual payments at December 31, 2013, and $56.7 million, of which $42.3 million were current with respect to restructured contractual payments at December 31, 2012. There were no commitments to lend additional funds under these restructurings at either balance sheet date.

The following table presents by class the TDRs that were restructured during 2013 and 2012. Generally, the modifications were extensions of term, modifying the payment terms from principal and interest to interest only for an extended period, or reduction in interest rate. All TDRs are evaluated individually for allowance for loan loss purposes.

	2013			2012		
dollars in thousands	Number of Modifications	Pre-modification Recorded Investment	Post-modification Recorded Investment	Number of Modifications	Pre-modification Recorded Investment	Post-modification Recorded Investment
Commercial	2	$ 76	$ 79	9	$ 6,238	$ 5,681
Commercial real estate						
Owner-occupied	-	-	-	-	-	-
Non-owner occupied	1	244	244	3	4,063	3,685
Construction and development						
Land & land development	2	747	748	3	3,715	2,927
Construction	-	-	-	-	-	-
Residential real estate						
Non-jumbo	7	1,137	1,137	8	1,394	1,405
Jumbo	-	-	-	3	2,301	2,701
Home equity	-	-	-	-	-	-
Consumer	1	11	12	4	66	66
Total	13	$ 2,215	$ 2,220	30	$ 17,777	$ 16,465

The following table presents defaults during 2013 of TDRs that were restructured during 2013 and defaults during 2012 of TDRs that were restructured during 2012. For purposes of these tables, a default is considered as either the loan was past due 30 days or more at any time during the period, or the loan was fully or partially charged off during the period.

	2013		2012	
dollars in thousands	Number of Defaults	Recorded Investment at Default Date	Number of Defaults	Recorded Investment at Default Date
Commercial	-	$ -	3	$ 2,377
Commercial real estate				
Owner-occupied	-	-	-	-
Non-owner occupied	-	-	-	-
Construction and development				
Land & land development	1	698	-	-
Construction	-	-	-	-
Residential real estate				
Non-jumbo	2	347	3	382
Jumbo	-	-	1	1,300
Home equity	-	-	-	-
Consumer	-	-	3	58
Total	3	$ 1,045	10	$ 4,117

The following table details the activity regarding TDRs by loan type during 2013, and the related allowance on TDRs.

2013

Construction & Land Development

Dollars in thousands	Land & Land Develop-ment	Construc-tion	Commer-cial	Commercial Real Estate Owner Occupied	Commercial Real Estate Non-Owner Occupied	Residential Real Estate Non-jumbo	Residential Real Estate Jumbo	Home Equity	Con-sumer	Other	Total
Troubled debt restructurings											
Balance January 1, 2013	$ 9,570	$ -	$ 4,981	$ 10,692	$ 7,331	$ 5,089	$ 19,000	$ -	$ 65	$ -	$ 56,728
Additions	747	-	76	-	244	1,137	-	-	11	-	2,215
Charge-offs	(888)	-	(195)	(63)	-	(37)	(4,680)	-	(10)	-	(5,873)
Net (paydowns) advances	(3,265)	-	(3,620)	(412)	(140)	(458)	(42)	-	(20)	-	(7,957)
Transfer into OREO	-	-	-	(519)	-	(189)	(8,000)	-	-	-	(8,708)
Refinance out of TDR status	-	-	-	-	(1,891)	-	-	-	-	-	(1,891)
Balance December 31, 2013	$ 6,164	$ -	$ 1,242	$ 9,698	$ 5,544	$ 5,542	$ 6,278	$ -	$ 46	$ -	$ 34,514
Allowance related to troubled debt restructurings	$ 190	$ -	$ 16	$ 204	$ 175	$ 243	$ 37	$ -	$ 13	$ -	$ 878

Table of Contents
73

We categorize loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. We analyze loans individually by classifying the loans as to credit risk. We internally grade all commercial loans at the time of loan origination. In addition, we perform an annual loan review on all non-homogenous commercial loan relationships with an aggregate exposure exceeding $2 million, at which time these loans are re-graded. We use the following definitions for our risk grades:

Pass: Loans graded as Pass are loans to borrowers of acceptable credit quality and risk. They are higher quality loans that do not fit any of the other categories described below.

OLEM (Special Mention): Commercial loans categorized as OLEM are potentially weak. The credit risk may be relatively minor yet represent a risk given certain specific circumstances. If the potential weaknesses are not monitored or mitigated, the asset may weaken or inadequately protect our position in the future.

Substandard: Commercial loans categorized as Substandard are inadequately protected by the borrower's ability to repay, equity, and/or the collateral pledged to secure the loan. These loans have identified weaknesses that could hinder normal repayment or collection of the debt. These loans are characterized by the distinct possibility that we will sustain some loss if the identified weaknesses are not mitigated.

Doubtful: Commercial loans categorized as Doubtful have all the weaknesses inherent in those loans classified as Substandard, with the added elements that the full collection of the loan is improbable and the possibility of loss is high.

Loss: Loans classified as loss are considered to be non-collectible and of such little value that their continuance as a bankable asset is not warranted. This does not mean that the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future.

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

Loan Risk Profile by Internal Risk Rating

	Construction and Development						Commercial Real Estate			
	Land and land development		Construction		Commercial		Owner Occupied		Non-Owner Occupied	
Dollars in thousands	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
Pass	$41,662	$43,572	$15,022	$3,619	$82,323	$73,425	$143,982	$139,176	$268,967	$262,132
OLEM (Special Mention)	5,550	7,349	133	-	4,544	1,260	1,412	1,034	10,222	11,477
Substandard	24,131	28,414	-	153	1,485	11,144	4,224	14,042	1,601	2,473
Doubtful	110	-	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-	-	-
Total	$71,453	$79,335	$15,155	$3,772	$88,352	$85,829	$149,618	$154,252	$280,790	$276,082

The following table presents the recorded investment in consumer, residential real estate, and home equity loans, which are generally evaluated based on the aging status of the loans, which was previously presented, and payment activity.

	Performing		Nonperforming	
Dollars in thousands	2013	2012	2013	2012
Residential real estate				
Non-jumbo	$ 210,500	$ 213,196	$ 2,446	$ 3,518
Jumbo	53,406	49,003	-	12,564
Home Equity	54,844	52,823	-	440
Consumer	19,761	20,531	128	55
Other	3,276	3,701	-	-
Total	$ 341,787	$ 339,254	$ 2,574	$ 16,577

Table of Contents

74

Industry concentrations: At December 31, 2013 and 2012, we had no concentrations of loans to any single industry in excess of 10% of total loans.

Loans to related parties: We have had, and may be expected to have in the future, banking transactions in the ordinary course of business with our directors, principal officers, their immediate families and affiliated companies in which they are principal shareholders (commonly referred to as related parties). These transactions have been, in our opinion, on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others.

The following presents the activity with respect to related party loans aggregating $60,000 or more to any one related party (other changes represent additions to and changes in director and executive officer status):

Dollars in thousands	2013	2012
Balance, beginning	$ 18,973	$ 17,063
Additions	7,978	10,097
Amounts collected	(8,317)	(8,204)
Other changes, net	(57)	17
Balance, ending	$ 18,577	$ 18,973

Loan commitments: ASC Topic 815, Derivatives and Hedging, requires that commitments to make mortgage loans should be accounted for as derivatives if the loans are to be held for sale, because the commitment represents a written option and accordingly is recorded at the fair value of the option liability.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at a level considered adequate to provide for our estimate of probable credit losses inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Loans are charged against the allowance for loan losses when we believe that collectability is unlikely. While we use the best information available to make our evaluation, future adjustments may be necessary if there are significant changes in conditions.

The allowance is comprised of three distinct reserve components: (1) specific reserves related to loans individually evaluated, (2) quantitative reserves related to loans collectively evaluated, and (3) qualitative reserves related to loans collectively evaluated. A summary of the methodology we employ on a quarterly basis with respect to each of these components in order to evaluate the overall adequacy of our allowance for loan losses is as follows.

Specific Reserve for Loans Individually Evaluated

First, we identify loan relationships having aggregate balances in excess of $500,000 and that may also have credit weaknesses. Such loan relationships are identified primarily through our analysis of internal loan evaluations, past due loan reports, and loans adversely classified by regulatory authorities. Each loan so identified is then individually evaluated to determine whether it is impaired – that is, based on current information and events, it is probable that we will be unable to collect all amounts due in accordance with the contractual terms of the underlying loan agreement. Substantially all of our impaired loans historically have been collateral dependent, meaning repayment of the loan is expected to be provided solely from the sale of the loan's underlying collateral. For such loans, we measure impairment based on the fair value of the loan's collateral, which is generally determined utilizing current appraisals. A specific reserve is established in an amount equal to the excess, if any, of the recorded investment in each impaired loan over the fair value of its underlying collateral, less estimated costs to sell. Our policy is to re-evaluate the fair value of collateral dependent loans at least every twelve months unless there is a known deterioration in the collateral's value, in which case a new appraisal is obtained.

Quantitative Reserve for Loans Collectively Evaluated

Second, we stratify the loan portfolio into the following ten loan pools: land and land development, construction, commercial, commercial real estate -- owner-occupied, commercial real estate -- non-owner occupied, conventional residential mortgage, jumbo residential mortgage, home equity, consumer, and other. Loans within each pool are then further segmented between (1) loans which were individually evaluated for

impairment and not deemed to be impaired, (2) larger-balance loan relationships exceeding $2 million which are assigned an internal risk rating in conjunction with our normal ongoing loan review procedures and (3) smaller-balance homogenous loans.

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

Qualitative Reserve for Loans Collectively Evaluated

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

An analysis of the allowance for loan losses for the years ended December 31, 2013, 2012 and 2011 is as follows:

Dollars in thousands	2013	2012	2011
Balance, beginning of year	$ 17,933	$ 17,712	$ 17,224
Losses			
Commercial	723	1,273	506
Commercial real estate			
Owner occupied	1,031	636	508
Non-owner occupied	9	806	78
Construction and development			
Land and land development	3,596	3,390	3,568
Construction	-	367	-
Residential real estate			
Non-jumbo	541	1,372	3,178
Jumbo	4,741	737	1,511
Home equity	77	5	346
Consumer	79	136	162
Other	162	95	86
Total	10,959	8,817	9,943
Recoveries			
Commercial	12	13	35
Commercial real estate			
Owner occupied	8	33	37
Non-owner occupied	674	31	55
Construction and development			
Land and land development	187	61	43
Construction	-	-	-
Real estate - mortgage			
Non-jumbo	127	81	83
Jumbo	6	86	14
Home equity	5	61	1

Consumer		79		95		112
Other		87		77		51
Total		1,185		538		431
Net losses		9,774		8,279		9,512
Provision for loan losses		4,500		8,500		10,000
Balance, end of year	$	12,659	$	17,933	$	17,712

Table of Contents

Activity in the allowance for loan losses by loan class during 2013 and 2012 is as follows:

2013	Construction & Land Development			Commercial Real Estate		Residential Real Estate					
Dollars in thousands	Land & Land Develop-ment	Construc-tion	Commer-cial	Owner Occupied	Non-Owner Occupied	Non-jumbo	Jumbo	Home Equity	Con-sumer	Other	Total
Allowance for loan losses											
Beginning balance	$5,220	$ 138	$ 782	$1,387	$3,269	$2,617	$3,942	$425	$132	$21	$17,933
Charge-offs	3,596	-	723	1,031	9	541	4,741	77	79	162	10,959
Recoveries	187	-	12	8	674	127	6	5	79	87	1,185
Provision	3,644	131	1,252	605	(3,293)	(360)	2,681	(180)	(84)	104	4,500
Ending balance	$5,455	$ 269	$ 1,323	$969	$641	$1,843	$1,888	$173	$48	$50	$12,659
Allowance related to:											
Loans individually evaluated for impairment	$3,186	$ -	$ 406	$306	$175	$256	$37	$22	$13	$-	$4,401
Loans collectively evaluated for impairment	2,269	269	918	663	466	1,586	1,851	151	35	50	8,258
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	$5,455	$ 269	$ 1,324	$969	$641	$1,842	$1,888	$173	$48	$50	$12,659
Loans											
Loans individually evaluated for impairment	$25,269	$ -	$ 2,023	$12,550	$5,832	$6,082	$8,768	$212	$47	$-	$60,783
Loans collectively evaluated for impairment	46,184	15,155	86,329	137,068	274,958	206,864	44,638	54,632	19,842	3,276	888,946
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	$71,453	$ 15,155	$ 88,352	$149,618	$280,790	$212,946	$53,406	$54,844	$19,889	$3,276	$949,729

2012	Construction & Land Development			Commercial Real Estate		Residential Real Estate			
	Land & Land Develop-	Construc-	Commer-	Owner	Non-Owner	Non-		Home	Con-

Dollars in thousands	ment	tion	cial	Occupied	Occupied	jumbo	Jumbo	Equity	sumer	Other	Total
Allowance for loan losses											
Beginning balance	$7,262	$ 120	$ 770	$1,335	$3,283	$2,587	$1,331	$830	$161	$33	$17,712
Charge-offs	3,390	367	1,273	636	806	1,372	737	5	136	95	8,817
Recoveries	61	-	13	33	31	81	86	61	95	77	538
Provision	1,287	385	1,272	655	761	1,321	3,262	(461)	12	6	8,500
Ending balance	$5,220	$ 138	$ 782	$1,387	$3,269	$2,617	$3,942	$425	$132	$21	$17,933
Allowance related to:											
Loans individually evaluated for impairment	$2,611	$ -	$ 85	$461	$286	$394	$3,216	$28	$16	$-	$7,097
Loans collectively evaluated for impairment	2,609	138	697	926	2,983	2,223	726	397	116	21	10,836
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	$5,220	$ 138	$ 782	$1,387	$3,269	$2,617	$3,942	$425	$132	$21	$17,933
Loans											
Loans individually evaluated for impairment	$29,963	$ -	$ 10,941	$16,714	$9,468	$6,318	$21,543	$219	$66	$-	$95,232
Loans collectively evaluated for impairment	49,372	3,772	74,888	137,538	266,614	210,396	40,024	53,044	20,520	3,701	859,869
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-	-	-	-
Total	$79,335	$ 3,772	$ 85,829	$154,252	$276,082	$216,714	$61,567	$53,263	$20,586	$3,701	$955,101

Table of Contents

NOTE 7. PROPERTY HELD FOR SALE

Property held for sale consists of premises qualifying as held for sale under ASC Topic 360 Property, Plant, and Equipment, and of real estate acquired through foreclosure on loans secured by such real estate. Qualifying premises are transferred to property held for sale at the lower of carrying value or estimated fair value less anticipated selling costs. Foreclosed property is recorded at the estimated fair value less anticipated selling costs based upon the property's appraised value at the date of foreclosure, with any difference between the fair value of foreclosed property and the carrying value of the related loan charged to the allowance for loan losses. We perform periodic valuations of property held for sale subsequent to transfer. Changes in value subsequent to transfer are recorded in noninterest expense. Gains or losses not previously recognized resulting from the sale of property held for sale is recognized on the date of sale and is included
in
expense. Depreciation is not recorded on property held for sale. Expenses incurred in connection with operating foreclosed properties are charged to noninterest expense.

The following table presents the activity of property held for sale during 2013 and 2012.

Dollars in thousands	2013	2012
Beginning balance	$ 56,172	$ 63,938
Acquisitions	11,805	8,352
Capitalized improvements	276	942
Dispositions	(11,139)	(9,777)
Valuation adjustments	(3,722)	(6,862)
Reclassification of covered loans	-	(421)
Balance at year end	$ 53,392	$ 56,172

NOTE 8. PREMISES AND EQUIPMENT

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily by the straight-line method for premises and equipment over the estimated useful lives of the assets. The estimated useful lives employed are on average 30 years for premises and 3 to 10 years for furniture and equipment. Repairs and maintenance expenditures are charged to operating expenses as incurred. Major improvements and additions to premises and equipment, including construction period interest costs, are capitalized. No interest was capitalized during 2013, 2012, or 2011.

The major categories of premises and equipment and accumulated depreciation at December 31, 2013 and 2012 are summarized as follows:

Dollars in thousands	2013	2012
Land	$ 6,308	$ 6,308
Buildings and improvements	20,165	20,110
Furniture and equipment	12,777	12,648
	39,250	39,066
Less accumulated depreciation	18,627	17,937
Total premises and equipment, net	$ 20,623	$ 21,129

Depreciation expense for the years ended December 31, 2013, 2012 and 2011 approximated $1.16 million, $1.29 million, and $1.39 million, respectively.

NOTE 9. INTANGIBLE ASSETS

Goodwill and certain other intangible assets with indefinite useful lives are not amortized into net income over an estimated life, but rather are tested at least annually for impairment. Intangible assets determined to have definite useful lives are amortized over their estimated useful lives and also are subject to impairment testing.

In accordance with ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment, which amends Topic 350, Intangibles – Goodwill and Other, entities are permitted to first assess qualitative factors (Step 0) to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-than-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if the entity concludes otherwise, then it is required to perform the first step (Step 1) of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. 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. The second step (Step 2) of impairment testing is necessary only if the reporting unit does not pass Step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination.

During the third quarter, we completed Step 1 of the required annual impairment test for our insurance services reporting unit for 2013 and determined that no impairment write-offs were necessary. We performed the Step 0 qualitative assessment of the goodwill relative to our community banking reporting unit, and determined that it was not more likely than not that the fair value was less than its carrying value and noted no indicators of impairment.

In addition, at December 31, 2013 and December 31, 2012, we had $50,000 and $202,000, respectively, in unamortized acquired intangible assets consisting entirely of unidentifiable intangible assets recorded in accordance with ASC Topic 805, Business Combinations, and $1.70 million and $1.90 million in unamortized identifiable customer intangible assets at December 31, 2013 and 2012, respectively.

	Goodwill Activity		
Dollars in thousands	Community Banking	Insurance Services	Total
Balance, January 1, 2013	$ 1,488	$ 4,710	$ 6,198
Acquired goodwill, net	-	-	-
Balance, December 31, 2013	$ 1,488	$ 4,710	$ 6,198

	Other Intangible Assets					
	December 31, 2013			December 31, 2012		
Dollars in thousands	Community Banking	Insurance Services	Total	Community Banking	Insurance Services	Total
Unidentifiable intangible assets						
Gross carrying amount	$ 2,267	$ -	$ 2,267	$ 2,267	$ -	$ 2,267
Less: accumulated amortization	2,216	-	2,216	2,065	-	2,065
Net carrying amount	$ 51	$ -	$ 51	$ 202	$ -	$ 202
Identifiable intangible assets						
Gross carrying amount	$ -	$ 3,000	$ 3,000	$ -	$ 3,000	$ 3,000
Less: accumulated amortization	-	1,300	1,300	-	1,100	1,100
Net carrying amount	$ -	$ 1,700	$ 1,700	$ -	$ 1,900	$ 1,900

We recorded amortization expense of $351,000 for the year ended December 31, 2013 relative to our other intangible assets. Annual amortization is expected to be approximately $251,000 in 2014, and $200,000 for each of the years ending 2015 through 2018. The remaining amortization period is 9.5 years.

NOTE 10. DEPOSITS

The following is a summary of interest bearing deposits by type as of December 31, 2013 and 2012:

Dollars in thousands	2013	2012
	$ 186,578	$ 175,706

Demand deposits, interest bearing				
Savings deposits		193,446		193,039
Time deposits		530,951		557,788
Total	$	910,975	$	926,533

Table of Contents
79

Included in time deposits are deposits acquired through a third party ("brokered deposits") totaling $143.3 million and $190.4 million at December 31, 2013 and 2012, respectively.

A summary of the scheduled maturities for all time deposits as of December 31, 2013, follows:

Dollars in thousands	Amount
2014	$ 203,906
2015	82,956
2016	100,006
2017	35,314
2018	42,899
Thereafter	65,870
Total	$ 530,951

Time certificates of deposit in denominations of $100,000 or more totaled $391.8 million and $397.2 million at December 31, 2013 and 2012, respectively. The following is a summary of the maturity distribution of these deposits as of December 31, 2013:

Dollars in thousands	Amount	Percent
Three months or less	$ 29,746	7.6%
Three through six months	46,436	11.9%
Six through twelve months	60,887	15.5%
Over twelve months	254,693	65.0%
Total	$ 391,762	100.0%

At December 31, 2013 and 2012, our deposits of related parties including directors, executive officers, and their related interests approximated $13.6 million and $17.5 million, respectively.

NOTE 11. BORROWED FUNDS

Our subsidiary bank is a member of the Federal Home Loan Bank ("FHLB"). Membership in the FHLB makes available short-term and long-term advances under collateralized borrowing arrangements with each subsidiary bank. All FHLB advances are collateralized primarily by similar amounts of residential mortgage loans, certain commercial loans, mortgage backed securities and securities of U. S. Government agencies and corporations. We had $86.1 million available on a short term line of credit with the Federal Reserve Bank at December 31, 2013, which is primarily secured by commercial and industrial loans and consumer loans. We also had $6.0 million available on an unsecured line of credit with a correspondent bank.

At December 31, 2013, our subsidiary banks had combined additional borrowings availability of $330.8 million from the FHLB. Short-term FHLB advances are granted for terms of 1 to 365 days and bear interest at a fixed or variable rate set at the time of the funding request.

Short-term borrowings: At December 31, 2013, we had $92.1 million borrowing availability through credit lines and Federal funds purchased agreements. A summary of short-term borrowings is presented below.

2013	2012

Dollars in thousands	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit	Short-term FHLB Advances	Federal Funds Purchased and Lines of Credit
Balance at December 31	$ 53,800	$ 8,969	$ 3,000	$ 958
Average balance outstanding for the year	29,786	4,313	12,291	957
Maximum balance outstanding at any month end	55,300	8,969	20,000	958
Weighted average interest rate for the year	0.28 %	0.25 %	0.24 %	0.25%
Weighted average interest rate for balances outstanding at December 31	0.26 %	0.25 %	0.25 %	0.25%

Federal funds purchased and repurchase agreements mature the next business day. The securities underlying the repurchase agreements are under our control and secure the total outstanding daily balances. We generally account for securities sold under agreements to repurchase as collateralized financing transactions and record them at the amounts at which the securities were sold, plus accrued interest. Securities, generally U.S. government and Federal agency securities, pledged as collateral under these financing arrangements cannot be sold or repledged by the secured party. The fair value of collateral provided is continually monitored and additional collateral is provided as needed.

Long-term borrowings: Our long-term borrowings of $163.5 million and $203.3 million as of December 31, 2013 and 2012, respectively, consisted primarily of advances from the FHLB and structured reverse repurchase agreements with two unaffiliated institutions.

	Balance at December 31,	
Dollars in thousands	2013	2012
Long-term FHLB advances	$ 82,600	$ 122,693
Long-term reverse repurchase agreements	72,000	72,000
Term loans	8,916	8,575
Total	$ 163,516	$ 203,268

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

Long-term borrowings bear both fixed and variable interest rates and mature in varying amounts through the year 2026. The average interest rate paid on long-term borrowings during 2013 and 2012 approximated 3.90% and 3.89%, respectively.

Subordinated debentures: We have subordinated debt totaling $16.8 million at December 31, 2013 and 2012. The subordinated debt qualifies as Tier 2 capital under Federal Reserve Board guidelines, until the debt is within 5 years of its maturity; thereafter the amount qualifying as Tier 2 capital is reduced by 20 percent each year until maturity. During 2009, we issued $6.8 million in subordinated debt, of which $5.0 million was issued to an affiliate of a director of Summit. We also issued $1.0 million and $0.8 million to two unrelated parties. These three issuances bear an interest rate of 10 percent per annum, a term of 10 years, and are not prepayable by us within the first five years. During 2008, we issued $10.0 million of subordinated debt to an unrelated institution, which bears a variable interest rate of 1 month LIBOR plus 275 basis points and a term of 7.5 years.

Subordinated debentures owed to unconsolidated subsidiary trusts: We have three statutory business trusts that were formed for the purpose of issuing mandatorily redeemable securities (the “capital securities”) for which we are obligated to third party investors and investing the proceeds from the sale of the capital securities in our junior subordinated debentures (the “debentures”). The debentures held by the trusts are their sole assets. Our subordinated debentures totaled $19.6 million at December 31, 2013 and 2012.

In October 2002, we sponsored SFG Capital Trust I, in March 2004, we sponsored SFG Capital Trust II, and in December 2005, we sponsored SFG Capital Trust III, of which 100% of the common equity of each trust is owned by us. SFG Capital Trust I issued $3.5 million in capital securities and $109,000 in common securities and invested the proceeds in $3.61 million of debentures. SFG Capital Trust II issued $7.5 million in capital securities and $232,000 in common securities and invested the proceeds in $7.73 million of debentures. SFG Capital Trust III issued $8.0 million in capital securities and $248,000 in common securities and invested the proceeds in $8.25 million of debentures. Distributions on the capital securities issued by the trusts are payable quarterly at a variable interest rate equal to 3 month LIBOR plus 345 basis points for SFG Capital Trust I, 3 month LIBOR plus 280 basis points for SFG Capital Trust II, and 3 month LIBOR plus 145 basis points for SFG Capital Trust III, and equals the interest rate earned on the debentures held by the trusts, and is recorded as interest expense by us. The capital securities are subject to mandatory redemption in whole or in part, upon repayment of the debentures. We have entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of the guarantee. The debentures of each Capital Trust are redeemable by us quarterly.

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

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

Dollars in thousands	Long-term borrowings	Subordinated debentures	Subordinated debentures owed to unconsolidated subsidiary trusts
2014	$ 82,526	$ -	$ -
2015	1,909	10,000	-
2016	28,911	-	-
2017	918	-	-
2018	45,017	-	-
Thereafter	4,235	6,800	19,589
Total	$ 163,516	$ 16,800	$ 19,589

NOTE 12. INCOME TAXES

The consolidated provision for income taxes includes Federal and state income taxes and is based on pretax net income reported in the consolidated financial statements, adjusted for transactions that may never enter into the computation of income taxes payable. Deferred tax assets and liabilities are determined based on the differences between the financial statement and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. Valuation allowances are established when deemed necessary to reduce deferred tax assets to the amount expected to be realized.

ASC Topic 740 Income Taxes clarifies the accounting and disclosure for uncertain tax positions, as defined. ASC Topic 740 requires that a tax position meet a "probable recognition threshold" for the benefit of the uncertain tax position to be recognized in the financial statements. A tax position that fails to meet the probable recognition threshold will result in either reduction of a current or deferred tax asset or receivable, or recording a current or deferred tax liability. ASC Topic 740 also provides guidance on measurement, derecognition of tax benefits, classification, interim period accounting disclosure, and transition requirements in accounting for uncertain tax positions.

The components of applicable income tax expense (benefit) for the years ended December 31, 2013, 2012 and 2011, are as follows:

Dollars in thousands	2013	2012	2011
Current			
Federal	$ 861	$ 1,716	$ 4,397
State	41	5	21
	902	1,721	4,418
Deferred			
Federal	1,587	(610)	(3,533)
State	199	108	150
	1,786	(502)	(3,383)
Total	$ 2,688	$ 1,219	$ 1,035

Reconciliation between the amount of reported income tax expense and the amount computed by multiplying the statutory income tax rates by book pretax income for the years ended December 31, 2013, 2012 and 2011 is as follows:

	2013		2012		2011	
Dollars in thousands	Amount	Percent	Amount	Percent	Amount	Percent
Computed tax at applicable statutory rate	$ 3,765	35	$ 2,426	35	$ 1,788	35
Increase (decrease) in taxes resulting from:						
Tax-exempt interest and dividends, net	(932)	(9)	(1,019)	(15)	(1,032)	(20)
State income taxes, net of Federal income tax benefit	156	1	74	1	112	2
Other, net	(301)	(3)	(262)	(4)	167	3
Applicable income taxes	$ 2,688	24	$ 1,219	17	$ 1,035	20

Deferred income taxes reflect the impact of "temporary differences" between amounts of assets and liabilities for financial reporting purposes and such amounts as measured for tax purposes. Deferred tax assets and liabilities represent the future tax return consequences of temporary differences, which will either be taxable or deductible when the related assets and liabilities are recovered or settled. Valuation allowances are established when deemed necessary to reduce deferred tax assets to the amount expected to be realized. Our WV net operating loss carryforward expires in 2028.

The tax effects of temporary differences, which give rise to our deferred tax assets and liabilities as of December 31, 2013 and 2012, are as follows:

Dollars in thousands	2013	2012
Deferred tax assets		
Allowance for loan losses	$ 4,681	$ 6,635
Depreciation	135	14
Foreclosed properties	4,928	5,063
Deferred compensation	2,006	1,646
Other deferred costs and accrued expenses	371	446
Other-than-temporarily impaired securities	931	1,331
Net unrealized loss on securities available for sale	308	-
NOL and tax credit carryforwards	404	178
Total	13,764	15,313
Deferred tax liabilities		
Accretion on tax-exempt securities	6	5
	-	2,985

Net unrealized gain on securities available for sale				
Net unrealized gain on interest rate swaps		297		-
Purchase accounting adjustments and goodwill		869		932
Total		1,172		3,922
Net deferred tax assets	$	12,592	$	11,391

In accordance with ASC Topic 740, we concluded that there were no significant uncertain tax positions requiring recognition in the consolidated financial statements. The evaluation was performed for the years ended 2010 through 2013, the tax years which remain subject to examination by major tax jurisdictions.

We may from time to time be assessed interest or penalties associated with tax liabilities by major tax jurisdictions, although any such assessments are estimated to be minimal and immaterial. To the extent we have received an assessment for interest and/or penalties; it has been classified in the consolidated statements of income as a component of other noninterest expense.

We are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2010 through 2012. Tax years 2009 through 2012 remain subject to West Virginia State examination.

Table of Contents

NOTE 13. EMPLOYEE BENEFITS

Retirement Plans: We have defined contribution profit-sharing plans with 401(k) provisions covering substantially all employees. Contributions to the plans are at the discretion of the Board of Directors. Contributions made to the plans and charged to expense were $354,000, $331,000, and $313,000 for the years ended December 31, 2013, 2012, and 2011, respectively.

Employee Stock Ownership Plan: We have an Employee Stock Ownership Plan (“ESOP”), which enables eligible employees to acquire shares of our common stock. The cost of the ESOP is borne by us through annual contributions to an Employee Stock Ownership Trust in amounts determined by the Board of Directors.

The expense recognized by us is based on cash contributed or committed to be contributed by us to the ESOP during the year. Contributions to the ESOP for the years ended December 31, 2013, 2012 and 2011 were $173,000, $100,000, and $69,000 respectively. Dividends paid by us to the ESOP are reported as a reduction to retained earnings. The ESOP owned 321,781 and 304,781 shares of our common stock at December 31, 2013 and 2012, respectively, all of which were purchased at the prevailing market price and are considered outstanding for earnings per share computations. The trustees of the Retirement Plans and ESOP are also members of our Board of Directors.

Supplemental Executive Retirement Plan: In May 1999, Summit Community Bank entered into a non-qualified Supplemental Executive Retirement Plan (“SERP”) with certain senior officers, which provides participating officers with an income benefit payable at retirement age or death. During 2000, Shenandoah Valley National Bank adopted a similar plan and during 2002, Summit Financial Group, Inc. adopted a similar plan. The liabilities accrued for the SERP’s at December 31, 2013 and 2012 were $3.41 million and $2.95 million, respectively, which are included in other liabilities. In addition, we purchased certain life insurance contracts to fund the liabilities arising under these plans. At December 31, 2013 and 2012, the cash surrender value of these insurance contracts was $35.2 million and $29.2 million, respectively, and is included in other assets in the accompanying consolidated balance sheets.

Stock Option Plan: The 2009 Officer Stock Option Plan was adopted by our shareholders in May 2009 and provides for the granting of stock options for up to 350,000 shares of common stock to our key officers.   Each option granted under the Plan vests according to a schedule designated at the grant date and has a term of no more than 10 years following the vesting date. Also, the option price per share was not to be less than the fair market value of our common stock on the date of grant. The 2009 Officer Stock Option Plan, which expires in May 2019, replaces the 1998 Officer Stock Option Plan (collectively the “Plans”) that expired in May 2008.

The fair value of our employee stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management’s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options at the time of grant. There were no options granted in 2013 or 2012.

We recognize compensation expense based on the estimated number of stock awards expected to actually vest, exclusive of the awards expected to be forfeited. During 2011, 2012, and 2013, our stock compensation expense and related deferred taxes were insignificant.

A summary of activity in our Officer Stock Option Plans during 2011, 2012 and 2013 is as follows:

	Options	Weighted-Average Exercise Price (WAEP)
Outstanding, December 31, 2010	317,180	$ 18.17
Granted	-	-
Exercised	-	-
Forfeited	-	-
Expired	-	-
Outstanding, December 31, 2011	317,180	$ 18.17
Granted	-	-
Exercised	-	-
Forfeited	(44,680)	-
Expired	(22,800)	-
Outstanding, December 31, 2012	249,700	$ 18.98
Granted	-	-
Exercised	(17,800)	5.37
Forfeited	(1,750)	19.69
Expired	(44,740)	21.83
Outstanding, December 31, 2013	185,410	$ 19.59
Exercisable Options:		
December 31, 2013	182,810	$ 19.82
December 31, 2012	245,500	$ 19.24
December 31, 2011	311,280	$ 18.44

Other information regarding options outstanding and exercisable at December 31, 2013 is as follows:

	Options Outstanding				Options Exercisable		
Range of exercise price	# of shares	WAEP	Wted. Avg. Remaining Contractual Life (yrs)	Aggregate Intrinsic Value (in thousands)	# of shares	WAEP	Aggregate Intrinsic Value (in thousands)
$ 2.54 - $6.00	16,950	$ 4.69	3.78	$ 88	14,950	$ 4.98	$ 74
6.01 - 10.00	23,160	9.07	3.23	20	22,560	9.14	17
10.01 - 17.50	2,300	17.43	0.16	-	2,300	17.43	-
17.51 - 20.00	38,500	17.80	3.00	-	38,500	8.00	-

20.01 - 25.93	104,500		25.04	2.74		-	104,500		25.04		-
	185,410	$	19.59		$	108	182,810	$	19.82	$	91

NOTE 14. COMMITMENTS AND CONTINGENCIES

Lending related financial instruments with off-balance sheet risk: We are a party to certain financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial position. The contract amounts of these instruments reflect the extent of involvement that we have in this class of financial instruments.

Many of our lending relationships contain both funded and unfunded elements. The funded portion is reflected on our balance sheet. The unfunded portion of these commitments is not recorded on our balance sheet until a draw is made under the loan facility. Since many of the commitments to extend credit may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash flow requirements.

A summary of the total unfunded, or off-balance sheet, credit extension commitments follows:

Dollars in thousands	December 31, 2013	2012
Commitments to extend credit:		
Revolving home equity and credit card lines	$ 51,621	$ 47,690
Construction loans	28,549	16,226
Other loans	36,495	35,401
Standby letters of credit	1,711	1,934
Total	$ 118,376	$ 101,251

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if we deem necessary upon extension of credit, is based on our credit evaluation. Collateral held varies but may include accounts receivable, inventory, equipment or real estate.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of the underlying contract with the third party.

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

Operating leases: We occupy certain facilities under long-term operating leases. The aggregate minimum annual rental commitments under those leases total approximately $204,000 in 2014 and $38,000 in 2015. Total net rent expense included in the accompanying consolidated financial statements was $278,000 in 2013, $298,000 in 2012, and $294,000 in 2011.

Litigation: We are involved in various legal actions arising in the ordinary course of business. To the best of our knowledge, no matters have been specifically identified to management that are reasonably possible to have a significant adverse effect on the consolidated financial statements.

Employment Agreements: We have various employment agreements with our chief executive officer and certain other executive officers. These agreements contain change in control provisions that would entitle the officers to receive compensation in the event there is a change in control in the Company (as defined) and a termination of their employment without cause (as defined).

NOTE 15. PREFERRED STOCK

On September 30, 2009, we sold in a private placement 3,710 shares, or $3.7 million, of 8% Non-Cumulative Convertible Preferred Stock, Series 2009, $1.00 par value, with a liquidation preference of $1,000 per share (the “Series 2009 Preferred Stock”), based on the private placement exemption under Section 4(2) of the Securities Act of 1933 (the “Securities Act”) and Rule 506 of Regulation D.

The terms of the Series 2009 Preferred Stock provide that it may be converted into common stock under three different scenarios. First, the Series 2009 Preferred Stock may be converted at the holder’s option, on any dividend payment date, at the option of the holder, into shares of common stock based on a conversion rate determined by dividing $1,000 by $5.50, plus cash in lieu of fractional shares and subject to anti-dilution adjustments (the “Series 2009 Conversion Rate”). Second, on or after June 1, 2012, Summit may, at its option, on any dividend payment date, convert some or all of the Series 2009 Preferred Stock into shares of Summit’s common stock at the applicable Series 2009 Conversion Rate. Summit may exercise this conversion right if, for 20 trading days within any period of 30 consecutive trading dates during the six months immediately preceding the conversion, the closing price of the common stock exceeds 135% of $5.50. Third, after ten years, on June

1, 2019, all remaining outstanding shares of the Series 2009 Preferred Stock will be converted at the applicable Series 2009 Conversion Rate. Adjustments to the Series 2009 Conversion Rate will be made in the event of a stock dividend, stock split, reclassification, reorganization, merger or other similar transaction.

Table of Contents
86

In late 2011, we sold pursuant to both subscription rights distributed to our common shareholders and to a supplemental public offering 12,000 shares, or $6.0 million, of 8% Non-Cumulative Convertible Preferred Stock, Series 2011, $1.00 par value, with a liquidation preference of $500 per share (the "Series 2011 Preferred Stock").

The terms of the Series 2011 Preferred Stock also provide that it may be converted into common stock under three different scenarios. First, the Series 2011 Preferred Stock may be converted at the holder's option, on any dividend payment date, at the option of the holder, into shares of common stock based on a conversion rate determined by dividing $500 by $4.00, plus cash in lieu of fractional shares and subject to anti-dilution adjustments (the "Series 2011 Conversion Rate"). Second, on or after June 1, 2014, Summit may, at its option, on any dividend payment date, convert some or all of the Series 2011 Preferred Stock into shares of Summit's common stock at the applicable Series 2011 Conversion Rate. Summit may exercise this conversion right if, for 20 trading days during the 30 consecutive trading days immediately preceding the date of notice of the conversion, the closing price of the common stock exceeds 135% of $4.00. Third, after ten years, on June 1, 2021, all remaining outstanding shares of the Series 2011 Preferred Stock will be converted at the applicable Series 2011 Conversion Rate. Adjustments to the Series 2011 Conversion Rate will be made in the event of a stock dividend, stock split, reclassification, reorganization, merger or other similar transaction.

Both the Series 2009 and Series 2011 Preferred Stock pay noncumulative dividends, if and when declared by the Board of Directors, at a rate of 8.0% per annum. Dividends declared are payable quarterly in arrears on the 1st day of March, June, September and December of each year. The Series 2009 and Series 2011 Preferred Stock qualify as Tier 1 capital for regulatory capital purposes.

NOTEREGULATORY MATTERS
16.

The primary source of funds for our dividends paid to our shareholders is dividends received from our subsidiaries. Dividends paid by the subsidiary bank are subject to restrictions by banking law and regulations and require approval by the bank's regulatory agency if dividends declared in any year exceed the bank's current year's net income, as defined, plus its retained net profits of the two preceding years. During 2014, the Bank will have $11.6 million plus net income for the interim periods through the date of declaration, available for dividends for distribution to us. Presently, as a result of the bank MOU, the bank is restricted from paying any cash dividends unless it has provided 30 days prior notice to its regulatory authorities, and its regulatory authorities did not object. Summit Community received regulatory approval for and paid two upstream dividends to Summit totaling $2.0 million during 2013.

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. Our 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. Failure to meet these minimum capital requirements can result in certain mandatory and possible additional discretionary actions by regulators that could have a material impact on our financial position and results of operations.

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 December 31, 2013, that we and each of our subsidiaries met all capital adequacy requirements to which we were subject.

The most recent notifications from the banking regulatory agencies categorized us and each of our subsidiary banks 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 subsidiary banks are required to maintain reserve balances with the Federal Reserve Bank. The required reserve balance was $508,000 at December 31, 2013.

Summit's and its subsidiary bank, Summit Community Bank's ("SCB") actual capital amounts and ratios are also presented in the following table.

Dollars in thousands	Actual Amount	Actual Ratio	Minimum Required Regulatory Capital Amount	Minimum Required Regulatory Capital Ratio	To be Well Capitalized under Prompt Corrective Action Provisions Amount	To be Well Capitalized under Prompt Corrective Action Provisions Ratio
As of December 31, 2013						
Total Capital (to risk-weighted assets)						
Summit	$ 144,202	14.5 %	$ 79,638	8.0 %	$ 99,547	10.0%
Summit Community	156,473	15.7 %	79,627	8.0 %	99,534	10.0%
Tier 1 Capital (to risk-weighted assets)						
Summit	122,918	12.4 %	39,499	4.0 %	59,248	6.0%
Summit Community	143,989	14.5 %	39,814	4.0 %	59,720	6.0%
Tier 1 Capital (to average assets)						
Summit	122,918	8.9 %	55,151	4.0 %	68,938	5.0%
Summit Community	143,989	10.4 %	55,150	4.0 %	68,938	5.0%
As of December 31, 2012						
Total Capital (to risk-weighted assets)						
Summit	$ 138,593	14.0 %	$ 79,391	8.0 %	$ 99,238	10.0%
Summit Community	148,803	15.0 %	79,484	8.0 %	99,354	10.0%
Tier 1 Capital (to risk-weighted assets)						
Summit	115,221	11.6 %	39,695	4.0 %	59,543	6.0%
Summit Community	136,231	13.7 %	39,742	4.0 %	59,613	6.0%
Tier 1 Capital (to average assets)						
Summit	115,221	8.3 %	55,591	4.0 %	69,489	5.0%
Summit Community	136,231	9.8 %	55,581	4.0 %	69,476	5.0%

Summit Financial Group, Inc. ("Summit") and its bank subsidiary, Summit Community Bank, Inc. (the "Bank"), have entered into informal Memoranda of Understanding ("MOU's") with their respective regulatory authorities. A memorandum of understanding is characterized by the regulatory authorities as an informal action that is not published or publicly available and that is used when circumstances warrant a milder form of action than a formal supervisory action, such as a formal written agreement or order.

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

§ Summit suspending all cash dividends on its common stock until further notice. Dividends on all preferred stock, as well as interest payments on subordinated notes underlying Summit's trust preferred securities, continue to be permissible; and,

§ Summit not incurring any additional debt, other than trade payables, without the prior written consent of the principal banking regulators.

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

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

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

§ maintaining a Board committee which monitors and promotes compliance with the provisions of the Bank MOU;

§ providing the Bank's regulatory authorities with updated reports of criticized assets and/or formal workout plans for all nonperforming borrower relationships with an aggregate outstanding balance exceeding $1 million;

§ developing and submitting to regulatory authorities a written plan to reduce the Bank's risk exposure in each adversely classified credit relationship in excess of $1 million and all OREO;

§ establishing procedures to report all loans with balances exceeding $500,000 that have credit weaknesses or that fall outside of the Bank's policy;

§ annually reviewing the organizational structure and operations of the Bank's loan department;

§ maintaining an adequate allowance for loan and lease losses through charges to current operating income;

§ reviewing overall liquidity objectives and developing and submitting to regulatory authorities plans and procedures aimed to improve liquidity and reduce reliance on volatile liabilities;

§ preparing comprehensive budgets and earnings forecasts for the Bank and submitting reports comparing actual performance to the budget plan;

§ maintaining a minimum Tier 1 Leverage Capital ratio of at least 8% and a Total Risk-based Capital ratio of at least 11%;

§ not paying any cash dividends without the prior written consent of the banking regulators; and,

§ providing quarterly progress reports to the Bank's regulatory authorities detailing steps taken to comply with the Bank MOU.

NOTE 17. SEGMENT INFORMATION

We operate two business segments: community banking and an insurance agency. These segments are primarily identified by the products or services offered. The community banking segment consists of our full service banks which offer customers traditional banking products and services through various delivery channels. The insurance agency segment consists of three insurance agency offices that sell insurance products. The accounting policies discussed throughout the notes to the consolidated financial statements apply to each of our business segments.

Intersegment revenue and expense consists of management fees allocated to the bank and Summit Insurance Services, LLC for overall direction in the areas of strategic planning, investment portfolio management, asset/liability management, financial reporting and other financial and administrative services. Information for each of our segments is included below:

	December 31, 2013				
Dollars in thousands	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	$ 40,725	$ -	$ (1,922)	$ -	$ 38,803
Provision for loan losses	4,500	-	-	-	4,500
Net interest income after provision for loan losses	36,225	-	(1,922)	-	34,303
Other income	6,666	4,543	1,087	(1,087)	11,209
Other expenses	29,795	4,331	1,717	(1,087)	34,756
Income (loss) before income taxes	13,096	212	(2,552)	-	10,756
Income tax expense (benefit)	3,490	92	(894)	-	2,688
Net income	9,606	120	(1,658)	-	8,068
Dividends on preferred shares	-	-	775	-	775
	$ 9,606	$ 120	$ (2,433)	$ -	$ 7,293

Net income applicable to common shares														
Intersegment revenue (expense)	$	(979	)	$	(108	)	$	1,087		$	-		$	-
Average assets	$	1,431,131		$	6,176		$	157,249		$	(211,600	)	$	1,382,956

Table of Contents
89

	December 31, 2012				
Dollars in thousands	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	$ 41,600	$ -	$ (1,780)	$ -	$ 39,820
Provision for loan losses	8,500	-	-	-	8,500
Net interest income after provision for loan losses	33,100	-	(1,780)	-	31,320
Other income	8,475	4,422	1,026	(1,044)	12,879
Other expenses	32,685	3,965	1,661	(1,044)	37,267
Income (loss) before income taxes	8,890	457	(2,415)	-	6,932
Income tax expense (benefit)	1,868	184	(833)	-	1,219
Net income	7,022	273	(1,582)	-	5,713
Dividends on preferred shares	-	-	777	-	777
Net income applicable to common shares	$ 7,022	$ 273	$ (2,359)	$ -	$ 4,936
Intersegment revenue (expense)	$ (942)	$ (102)	$ 1,044	$ -	$ -
Average assets	$ 1,477,636	$ 6,399	$ 154,506	$ (217,440)	$ 1,421,101

	December 31, 2011				
Dollars in thousands	Community Banking	Insurance Services	Parent	Eliminations	Total
Net interest income	$ 41,658	$ -	$ (1,814)	$ -	$ 39,844
Provision for loan losses	10,000	-	-	-	10,000
Net interest income after provision for loan losses	31,658	-	(1,814)	-	29,844
Other income	6,189	4,606	2,155	(1,044)	11,906
Other expenses	31,828	4,216	1,641	(1,044)	36,641
Income (loss) before income taxes	6,019	390	(1,300)	-	5,109
Income tax expense (benefit)	1,304	158	(427)	-	1,035
Net income	4,715	232	(873)	-	4,074
Dividends on preferred shares	-	-	371	-	371
Net income applicable to common shares	$ 4,715	$ 232	$ (1,244)	$ -	$ 3,703
Intersegment revenue (expense)	$ (942)	$ (102)	$ 1,044	$ -	$ -
Average assets	$ 1,532,600	$ 6,618	$ 143,379	$ (212,803)	$ 1,469,794

NOTE 18. EARNINGS PER SHARE

The computations of basic and diluted earnings per share (“EPS”) follow:

	For the Year Ended December 31,								
	2013			2012			2011		
Dollars in thousands, except per share amounts	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share	Income (Numerator)	Common Shares (Denominator)	Per Share

Net income	$	8,068			$	5,713			$	4,074		
Less preferred stock dividends		(775)				(777)				(371)		
Basic EPS	$	7,293	7,442,689	$ 0.98	$	4,936	7,425,472	$ 0.66	$	3,703	7,425,472	$ 0.50
Effect of dilutive securities:												
Stock options		-	7,532			-	1,152			-	-	
Series 2011 convertible preferred stock		478	1,496,738			480	1,500,000			74	238,182	
Series 2009 convertible preferred stock		297	674,545			297	674,545			297	674,545	
Diluted EPS	$	8,068	9,621,504	$ 0.84	$	5,713	9,601,169	$ 0.60	$	4,074	8,338,199	$ 0.49

Table of Contents
90

Stock option grants and the convertible preferred shares are disregarded in this computation if they are determined to be anti-dilutive. Our anti-dilutive stock options at December 31, 2013, 2012, and 2011, totaled 165,460 shares, 244,700 shares, and 312,180 shares, respectively.

NOTE 19. DERIVATIVE FINANCIAL INSTRUMENTS

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

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

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

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

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

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

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

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

A summary of our derivative financial instruments as of December 31, 2013 follows:

	December 31, 2013			
	Notional	Derivative Fair Value		Net Ineffective Hedge Gains
Dollars in thousands	Amount	Asset	Liability	(Losses)
CASH FLOW HEDGES				
Pay-fixed/receive-variable interest rate swaps				
Long term borrowings	$ 70,000	$ 803	$ -	$ -
	$ 70,000	$ 803	$ -	$ -

Table of Contents
91

NOTE 20. CONDENSED FINANCIAL STATEMENTS OF PARENT COMPANY

Our investment in our wholly-owned subsidiaries is presented on the equity method of accounting. Information relative to our balance sheets at December 31, 2013 and 2012, and the related statements of income and cash flows for the years ended December 31, 2013, 2012 and 2011, are presented as follows:

Balance Sheets

	December 31,	
Dollars in thousands	2013	2012
Assets		
Cash	$ 5,278	$ 5,495
Investment in subsidiaries, eliminated in consolidation	151,289	148,951
Securities available for sale	181	422
Premises and equipment	82	-
Accrued interest receivable	2	3
Cash surrender value of life insurance policies	48	44
Other assets	1,657	1,502
Total assets	$ 158,537	$ 156,417
Liabilities and Shareholders' Equity		
Short-term borrowings	$ -	$ -
Long-term borrowings	8,916	8,575
Subordinated debentures	16,800	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589
Other liabilities	2,160	2,898
Total liabilities	47,465	47,862
Preferred stock and related surplus, authorized 250,000 shares:		
Series 2009, 8% Non-cumulative convertible preferred stock,		
par value $1.00; issued 3,710 shares	3,519	3,519
Series 2011, 8% Non-cumulative convertible preferred stock,		
par value $1.00; issued 2013 - 11,938 shares; 2012 - 12,000 shares	5,776	5,807
Common stock and related surplus, $2.50 par value, authorized		
20,000,000 shares; issued 2013 - 7,451,022 shares; 2012 - 7,425,472 shares	24,664	24,520
Retained earnings	77,134	69,841

Accumulated other comprehensive income	(21)	4,868
Total shareholders' equity	111,072	108,555
Total liabilities and shareholders' equity	$ 158,537	$ 156,417

Statements of Income

	For the Year Ended December 31,		
Dollars in thousands	2013	2012	2011
Income			
Dividends from subsidiaries	$ 2,500	$ 500	$ 500
Other dividends and interest income	26	41	19
Realized securities gains (losses)	-	(18)	1,112
Management and service fees from subsidiaries	1,087	1,044	1,044
Total income	3,613	1,567	2,675
Expense			
Interest expense	1,948	1,821	1,833
Operating expenses	1,717	1,661	1,641
Total expenses	3,665	3,482	3,474
Income (loss) before income taxes and equity in undistributed income of subsidiaries	(52)	(1,915)	(799)
Income tax (benefit)	(894)	(833)	(426)
Income (loss) before equity in undistributed income of subsidiaries	842	(1,082)	(373)
Equity in (distributed) undistributed income of subsidiaries	7,226	6,795	4,447
Net income	8,068	5,713	4,074
Dividends on preferred shares	775	777	371
Net income applicable to common shares	$ 7,293	$ 4,936	$ 3,703

Statements of Cash Flows

Dollars in thousands	For the Year Ended December 31, 2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	$ 8,068	$ 5,713	$ 4,074
Adjustments to reconcile net earnings to			
net cash provided by operating activities:			
Equity in (undistributed) distributed net income of			
subsidiaries	(7,226)	(6,795)	(4,447)
Deferred tax (benefit)	(107)	(61)	(11)
Depreciation	2	12	21
Other-than-temporary impairment of securities	-	-	-
Realized securities (gains) losses	-	18	(1,112)
Tax benefit of exercise of stock options	16	-	-
Stock compensation expense	1	2	10
(Increase) decrease in cash surrender value of bank owned life insurance	(5)	(1)	5
(Increase) decrease in other assets	(1)	(11)	44
Increase (decrease) in other liabilities	(737)	599	439
Net cash provided by (used in) operating activities	11	(524)	(977)
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds sales of available for sale securities	-	648	1,130
Principal payments received on available for sale securities	440	662	-
Purchase of available for sale securities	(199)	(1,672)	-
Purchases of premises and equipment	(84)	-	-
Net cash provided by (used in) investing activities	157	(362)	1,130
CASH FLOWS FROM FINANCING ACTIVITIES			
Dividends paid on preferred stock	(776)	(731)	(297)
Exercise of stock options	96	-	-
Net proceeds from long-term borrowings	3,454	-	-
Repayment of long-term borrowings	(3,159)	(1,354)	(1,805)
Net proceeds from issuance of preferred stock	-	-	5,807
Net cash provided by (used in) financing activities	(385)	(2,085)	3,705
Increase (decrease) in cash	(217)	(2,971)	3,858
Cash:			

Beginning	5,495	8,466	4,608
Ending	$ 5,278	$ 5,495	$ 8,466
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash payments for:			
Interest	$ 1,942	$ 1,824	$ 1,832

Table of Contents
93

NOTE 21. QUARTERLY FINANCIAL DATA (Unaudited)

A summary of our unaudited selected quarterly financial data is as follows:

2013	First	Second	Third	Fourth
Dollars in thousands, except per share amounts	Quarter	Quarter	Quarter	Quarter
Interest income	$ 14,568	$ 14,308	$ 14,045	$ 14,359
Net interest income	9,758	9,504	9,538	10,003
Net income (loss)	1,792	1,216	2,272	2,788
Net income (loss) applicable to common shares	1,598	1,023	2,078	2,594
Basic earnings per share	$ 0.22	$ 0.14	$ 0.28	$ 0.35
Diluted earnings per share	$ 0.19	$ 0.13	$ 0.24	$ 0.29

2012	First	Second	Third	Fourth
Dollars in thousands, except per share amounts	Quarter	Quarter	Quarter	Quarter
Interest income	$ 16,797	$ 16,278	$ 15,589	$ 15,220
Net interest income	10,018	9,971	9,935	9,896
Net income (loss)	1,698	913	997	2,105
Net income (loss) applicable to common shares	1,504	719	803	1,910
Basic earnings per share	$ 0.20	$ 0.10	$ 0.11	$ 0.26
Diluted earnings per share	$ 0.18	$ 0.09	$ 0.10	$ 0.22

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures: Our management, including the Chief Executive Officer and Chief Financial Officer, have conducted as of December 31, 2013, 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 December 31, 2013 were effective.

Management's Report on Internal Control Over Financial Reporting: Information required by this item is set forth on page 47.

Attestation Report of the Registered Public Accounting Firm: Information required by this item is set forth on pages 48 and 49.

Changes in Internal Control Over Financial Reporting: There were no changes in our internal control over financial reporting during the quarter ended December 31, 2013, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

PART III.

Item 10. Directors, Executive Officers, and Corporate Governance

Information required by this item is set forth under the caption “Section 16(a) Beneficial Ownership Reporting Compliance”, under the headings “NOMINEES FOR DIRECTOR WHOSE TERMS EXPIRE IN 2017”, “DIRECTORS WHOSE TERMS EXPIRE IN 2016, “DIRECTORS WHOSE TERMS EXPIRE IN 2015”, and “EXECUTIVE OFFICERS” and under the captions “Family Relationships”, “Director Qualifications and Review of Director Nominees”, “Compensation and Nominating Committee” and “Audit and Compliance Committee” in our 2014 Proxy Statement, and is incorporated herein by reference.

We have adopted a Code of Ethics that applies to our chief executive officer, chief financial officer, chief accounting officer, and all directors, officers and employees. We have posted this Code of Ethics on our internet website at www.summitfgi.com under “Governance Documents”. Any amendments to or waivers from any provision of the Code of Ethics applicable to the chief executive officer, chief financial officer, or chief accounting officer will be disclosed by timely posting such information on our internet website.

There have been no material changes to the procedures by which shareholders may recommend nominees since the disclosure of the procedures in our 2013 proxy statement.

Item 11. Executive Compensation

Information required by this item is set forth under the heading “EXECUTIVE COMPENSATION” in our 2014 Proxy Statement, and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters

The following table provides information on our stock option plans as of December 31, 2013.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (#)	Weighted-average exercise price of outstanding options, warrants and rights ($)	Number of securities remaining available for future issuance under equity compensation plans (#)
Equity compensation plans approved by stockholders	185,410	$ 19.59	350,000
Equity compensation plans not approved by stockholders	-	-	-
Total	185,410	$ 19.59	350,000

The remaining information required by this item is set forth under the caption “Security Ownership of Directors and Officers” and under the headings “NOMINEES FOR DIRECTOR WHOSE TERMS EXPIRE IN 2017”, “DIRECTORS WHOSE TERMS EXPIRE IN 2016”, “DIRECTORS WHOSE TERMS EXPIRE IN 2015”, “PRINCIPAL SHAREHOLDER” and “EXECUTIVE OFFICERS” in our 2014 Proxy Statement, and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this item is set forth under the captions “Transactions with Related Persons” and “Independence of Directors and Nominees” in our 2014 Proxy Statement, and is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

Information required by this item is set forth under the caption “Fees to Arnett Foster Toothman, PLLC” in our 2014 Proxy Statement, and is incorporated herein by reference.

Table of Contents

PART IV.

Item 15. Exhibits, Financial Statement Schedules

All financial statements and financial statement schedules required to be filed by this Form or by Regulation S-X, which are applicable to the Registrant, have been presented in the financial statements and notes thereto in Item 8 in Management's Discussion and Analysis of Financial Condition and Results of Operation in Item 7 or elsewhere in this filing where appropriate. The listing of exhibits follows:

			Incorporated by Reference*		
Exhibit Number	Exhibit Description	Filed Herewith	Form	Exhibit	Filing Date
(3) Articles of Incorporation and By-Laws:					
(i)	Amended and Restated Articles of Incorporation of Summit Financial Group, Inc.		10-Q	3.i	3/31/2006
(ii)	Articles of Amendment 2009		8-K	3.1	9/30/2009
(iii)	Articles of Amendment 2011		8-K	3.1	11/03/2011
(iv)	Amended and Restated By-laws of Summit Financial Group, Inc.		10-Q	3.2	6/30/2006
(10) Material Contracts					
(i)	Amended and Restated Employment Agreement with H. Charles Maddy, III		10-K	10.1	12/31/2008
(ii)	First Amendment to Amended and Restated Employment Agreement with H. Charles Maddy, III		8-K	10.1	02/04/2010
(iii)	Second Amendment to Amended and Restated Employment Agreement with H. Charles Maddy, III		8-K	10.1	12/14/2010
(iv)	Third Amendment to Amended and Restated Employment Agreement with H. Charles Maddy, III		8-K	10.1	02/23/2012
(v)	Fourth Amendment to Amended and Restated Employment Agreement with H. Charles Maddy, III		8-K	10.1	02/21/2013
(vi)	Fifth Amendment to Amended and Restated Employment Agreement with H. Charles Maddy, III		8-K	10.1	
(vii)	Change in Control Agreement with H. Charles Maddy, III		10-K	10.2	12/31/2008
(viii)	Executive Salary Continuation Agreement with H. Charles Maddy, III		10-K	10.3	12/31/2008
(ix)	Form of Amended and Restated Employment Agreement entered into with Robert S. Tissue, Patrick N. Frye and Scott C. Jennings		10-K	10.4	12/31/2008
(x)	First Amendment to Amended and Restated Employment Agreement with Patrick N. Frye		10-K	10.8	12/31/2011
(xi)	Form of Executive Salary Continuation Agreement entered into with Robert S. Tissue, Patrick N. Frye and Scott C. Jennings		10-K	10.5	12/31/2008
(xii)	Amended and Restated Employment Agreement with Bradford E. Ritchie		10-K	10.12	12/31/2011
(xiii)	Executive Salary Continuation Agreement with Bradford E. Ritchie		10-K	10.13	12/31/2011

	Exhibit Number	Exhibit Description	Filed Herewith	Incorporated by Reference* Form	Exhibit	Filing Date
	(xiv)	Form of Indemnification Agreement between Summit and each Director of Summit		8-K	1.01	02/12/2009
	(xv)	1998 Officers Stock Option Plan		10-QSB	10	06/30/1998
	(xvi)	Board Attendance and Compensation Policy, as amended		10-K	10.13	12/31/2010
	(xvii)	Summit Financial Group, Inc. Directors Deferral Plan		10-K	10.10	12/31/2005
	(xviii)	Amendment No. 1 to Directors Deferral Plan		10-K	10.11	12/31/2005
	(xix)	Amendment No. 2 to Directors Deferral Plan		10-K	10.14	12/31/2008
	(xx)	Summit Community Bank, Inc. Amended and Restated Directors Deferral Plan		10-K	10.15	12/31/2008
	(xxi)	Rabbi Trust for The Summit Financial Group, Inc. Directors Deferral Plan		10-K	10.16	12/31/2008
	(xxii)	Amendment No. One to Rabbi Trust for Summit Financial Group, Inc. Directors Deferral Plan		10-K	10.17	12/31/2008
	(xxiii)	Amendment No. One to Rabbi Trust for Summit Community Bank, Inc. (successor in interest to Capital State Bank, Inc.) Directors Deferral Plan		10-K	10.18	12/31/2008
	(xxiv)	Amendment No. One to Rabbi Trust for Summit Community Bank, Inc. (successor in interest to Shenandoah Valley National Bank, Inc.) Directors Deferral Plan		10-K	10.19	12/31/2008
	(xxv)	Amendment No. One to Rabbi Trust for Summit Community Bank, Inc. (successor in interest to South Branch Valley National Bank) Directors Deferral Plan		10-K	10.20	12/31/2008
	(xxvi)	Summit Financial Group, Inc. Incentive Plan		8-K	10.2	12/14/2007
	(xxvii)	Summit Community Bank Incentive Compensation Plan		8-K	10.4	12/14/2007
	(xxviii)	Form of Non-Qualified Stock Option Grant Agreement		10-Q	10.3	03/31/2006
	(xxix)	Form of First Amendment to Non-Qualified Stock Option Grant Agreement		10-Q	10.4	03/31/2006
	(xxx)	2009 Officer Stock Option Plan		8-K	10.1	05/14/2009
(12)	Statements Re: Computation of Ratios			10-K	12	12/31/2008
(21)	Subsidiaries of Registrant			10-K	21	12/31/2008
(23)	Consent of Arnett Foster Toothman, P.L.L.C		X			
(24)	Power of Attorney		X			
(31.1)	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer		X			
(31.2)	Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer		X			
(32.1)**	Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer		X			
(32.2)**			X			

	Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer	
(101)***	Interactive date file (XBRL)	X

* The SEC reference number for all exhibits incorporated by reference is 0-16587.
** Furnished, not filed.
*** As provided in Rule 406T

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.
a West Virginia Corporation
(registrant)

By: /s/ H. Charles Maddy, III 2/28/2014 By: /s/ Julie R. Cook 2/28/2014
H. Charles Maddy, III Date Julie R. Cook Date
President & Chief Executive Officer Vice President &
Chief Accounting Officer

By: /s/ Robert S. Tissue 2/28/2014
Robert S. Tissue Date
Senior Vice President &
Chief Financial Officer

The Directors of Summit Financial Group, Inc. executed a power of attorney appointing Robert S. Tissue and/or Julie R. Cook their attorneys-in-fact, empowering them to sign this report on their behalf.

By: /s/ Robert S. Tissue 2/28/2014
Robert S. Tissue Date
Attorney-in-fact

Table of Contents