

SUMMIT FINANCIAL GROUP INC
Form 10-Q
November 09, 2007

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

FORM 10 - Q

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

For the quarterly period ended **September 30, 2007**.

or

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

Commission File Number **0-16587**

Summit Financial Group, Inc.

(Exact name of registrant as specified in its charter)

West Virginia	55-0672148
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

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

(304) 530-1000

(Registrant's telephone number, including area code)

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

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

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

Common Stock, \$2.50 par value
7,402,941 shares outstanding as of November 5, 2007

Summit Financial Group, Inc. and Subsidiaries**Table of Contents**

	Page	
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements	
	Consolidated balance sheets September 30, 2007 (unaudited), December 31, 2006, and September 30, 2006 (unaudited)	4
	Consolidated statements of income for the three months and nine months ended September 30, 2007 and 2006 (unaudited)	5
	Consolidated statements of shareholders' equity for the nine months ended September 30, 2007 and 2006 (unaudited)	6
	Consolidated statements of cash flows for the nine months ended September 30, 2007 and 2006 (unaudited)	7-8
	Notes to consolidated financial statements (unaudited)	9-25
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	26-37
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	35
Item 4.	Controls and Procedures	36-37

Summit Financial Group, Inc. and Subsidiaries**Table of Contents****PART II. OTHER INFORMATION**

Item 1.	Legal Proceedings	38
Item 1A.	Risk Factors	38
Item 2.	Changes in Securities and Use of Proceeds	None
Item 3.	Defaults upon Senior Securities	None
Item 4.	Submission of Matters to a Vote of Security Holders	None
Item 5.	Other Information	None
Item 6.	Exhibits	
	Exhibits	
	Exhibit 11	Statement re: Computation of Earnings per Share – Information contained in Note 6 to the Consolidated Financial Statements on page 14 of this Quarterly Report is incorporated herein by reference.
	Exhibit 31.1	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer
	Exhibit 31.2	Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer
	Exhibit 32.1	Sarbanes-Oxley Act Section 906 Certification of Chief Executive Officer
	Exhibit 32.2	Sarbanes-Oxley Act Section 906 Certification of Chief Financial Officer
SIGNATURES		39

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

<i>(dollars in thousands)</i>	September 30, 2007 (unaudited)	December 31, 2006	September 30, 2006 (unaudited) (* (Restated)
ASSETS			
Cash and due from banks	\$ 13,435	\$ 12,031	\$ 11,604
Interest bearing deposits with other banks	179	271	119
Federal funds sold	2,499	517	399
Securities available for sale	279,289	247,874	246,332
Loans held for sale, net	1,596	-	-
Loans, net	986,437	916,045	894,836
Property held for sale	810	41	174
Premises and equipment, net	22,004	22,446	22,837
Accrued interest receivable	7,239	6,352	6,069
Intangible assets	10,143	3,196	3,234
Other assets	16,794	17,031	17,222
Assets related to discontinued operations	254	9,715	8,369
Total assets	\$ 1,340,679	\$ 1,235,519	\$ 1,211,195
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Deposits			
Non interest bearing	\$ 65,230	\$ 62,592	\$ 64,760
Interest bearing	763,369	826,096	800,312
Total deposits	828,599	888,688	865,072
Short-term borrowings	124,699	60,428	90,422
Long-term borrowings	263,679	176,109	146,127
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	10,218	9,844	10,297
Liabilities related to discontinued operations	420	2,109	207
Total liabilities	1,247,204	1,156,767	1,131,714
Commitments and Contingencies			
Shareholders' Equity			
Common stock and related surplus, \$2.50 par value; authorized 20,000,000 shares, issued and outstanding 2007 - 7,402,666; December 2006 - 7,084,980 shares; September 2006 - 7,102,702 shares	24,376	18,021	18,310
Retained earnings	69,104	61,083	62,011
Accumulated other comprehensive income	(5)	(352)	(840)

Total shareholders' equity	93,475	78,752	79,481
Total liabilities and shareholders' equity	\$ 1,340,679	\$ 1,235,519	\$ 1,211,195

(*) - December 31, 2006 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

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

	Three Months Ended		Nine Months Ended	
	September		September	
	30,	30,	30,	30,
	2007	2006	2007	2006
		(Restated)		(Restated)
<i>(dollars in thousands, except per share amounts)</i>				
Interest income				
Interest and fees on loans				
Taxable	\$ 19,794	\$ 17,947	\$ 57,349	\$ 49,595
Tax-exempt	127	113	363	315
Interest and dividends on securities				
Taxable	2,898	2,452	8,216	6,836
Tax-exempt	548	546	1,616	1,595
Interest on interest bearing deposits with other banks	3	3	12	23
Interest on Federal funds sold	6	13	31	30
Total interest income	23,376	21,074	67,587	58,394
Interest expense				
Interest on deposits	8,627	7,761	26,537	19,322
Interest on short-term borrowings	1,180	1,777	3,098	5,572
Interest on long-term borrowings and subordinated debentures	3,573	2,272	9,226	6,977
Total interest expense	13,380	11,810	38,861	31,871
Net interest income	9,996	9,264	28,726	26,523
Provision for loan losses	525	260	1,305	915
Net interest income after provision for loan losses	9,471	9,004	27,421	25,608
Other income				
Insurance commissions	1,303	218	1,719	696
Service fees	788	700	2,141	2,056
Securities gains (losses)	-	-	-	-
Net cash settlement on interest rate swaps	(181)	(154)	(544)	(337)
Change in fair value of interest rate swap	742	579	695	(140)
Gain (loss) on sale of assets	1	(4)	(31)	(8)
Other	253	147	679	420
Total other income	2,906	1,486	4,659	2,687
Other expense				
Salaries and employee benefits	4,054	2,817	10,518	8,921
Net occupancy expense	466	387	1,292	1,179
Equipment expense	496	476	1,436	1,421
Supplies	283	214	652	602
Professional fees	176	188	543	640
Amortization of intangibles	87	38	163	113
Other	1,258	1,157	3,584	3,434
Total other expense	6,820	5,277	18,188	16,310
Income before income taxes	5,557	5,213	13,892	11,985

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

Income tax expense	1,802	1,659	4,223	3,674
Income from continuing operations	3,755	3,554	9,669	8,311
Discontinued Operations				
Exit costs	-	-	123	-
Operating (loss)	(200)	(1,059)	(798)	(377)
(Loss) from discontinued operations before income tax (benefit)	(200)	(1,059)	(675)	(377)
Income tax (benefit)	(69)	(374)	(231)	(116)
(Loss) from discontinued operations	(131)	(685)	(444)	(261)
Net Income	\$ 3,624	\$ 2,869	\$ 9,225	\$ 8,050
Basic earnings from continuing operations per common share				
	\$ 0.51	\$ 0.50	\$ 1.34	\$ 1.17
Basic earnings per common share	\$ 0.49	\$ 0.40	\$ 1.28	\$ 1.13
Diluted earnings from continuing operations per common share				
	\$ 0.50	\$ 0.49	\$ 1.33	\$ 1.16
Diluted earnings per common share	\$ 0.49	\$ 0.39	\$ 1.27	\$ 1.12
Dividends per common share	\$ 0.17	\$ 0.16	\$ 0.17	\$ 0.16

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries

Consolidated Statements of Shareholders' Equity (unaudited)

<i>(dollars in thousands, except per share amounts)</i>	Common Stock and Related Surplus	Retained Earnings	Accumulated Other Compre- hensive Income	Total Share- holders' Equity
Balance, December 31, 2006	\$ 18,021	\$ 61,083	\$ (352)	\$ 78,752
Nine Months Ended September 30, 2007				
Comprehensive income:				
Net income	-	9,225	-	9,225
Other comprehensive income, net of deferred tax benefit of \$213:				
Net unrealized gain on securities of \$560:	-	-	347	347
Total comprehensive income				9,572
Issuance of 317,686 shares at \$19.93 per share	6,331			6,331
Stock compensation expense	24	-	-	24
Cash dividends declared (\$0.17 per share)	-	(1,204)	-	(1,204)
Balance, September 30, 2007	\$ 24,376	\$ 69,104	\$ (5)	\$ 93,475
	Common		Accumulated	Total
	Stock and	Retained	Other	Share-
	Related	Earnings	Compre-	holders'
	Surplus	(Restated)	hensive	Equity
			Income	(Restated)
Balance, December 31, 2005	\$ 18,857	\$ 55,102	\$ (1,268)	\$ 72,691
Nine Months Ended September 30, 2006				
Comprehensive income:				
Net income	-	8,050	-	8,050
Other comprehensive income, net of deferred tax benefit of \$262,714:				
Net unrealized gain on securities of \$428,638	-	-	428	428
Total comprehensive income				8,478
Exercise of stock options	44	-	-	44
Stock compensation expense	26			26
Repurchase of common shares	(617)			(617)
Cash dividends declared (\$0.16 per share)	-	(1,141)	-	(1,141)
Balance, September 30, 2006	\$ 18,310	\$ 62,011	\$ (840)	\$ 79,481

See Notes to Consolidated Financial Statements

6

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

	Nine Months Ended September 30,	
	September 30, 2007	2006 (Restated)
<i>(dollars in thousands)</i>		
Cash Flows from Operating Activities		
Net income	\$ 9,225	\$ 8,050
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	1,141	1,313
Provision for loan losses	1,555	1,285
Stock compensation expense	24	26
Deferred income tax (benefit)	244	(317)
Loans originated for sale	(16,698)	(189,952)
Proceeds from loans sold	24,162	206,596
(Gain) on sales of loans held for sale	(631)	(6,569)
Securities (gains)	-	-
Change in fair value of derivative instruments	(540)	140
Exit costs related to discontinued operations	(123)	-
Loss on disposal of other assets	31	8
Amortization of securities premiums (accretion of discounts), net	(113)	98
Amortization of goodwill and purchase accounting adjustments, net	171	122
(Decrease) in accrued interest receivable	(891)	(1,243)
(Increase) in other assets	(472)	(187)
Increase(decrease) in other liabilities	(607)	1,068
Net cash provided by (used in) operating activities	16,478	20,438
Cash Flows from Investing Activities		
Net (increase) decrease in interest bearing deposits with other banks	92	1,418
Proceeds from maturities and calls of securities available for sale	13,596	8,572
Proceeds from sales of securities available for sale	9,030	14,921
Principal payments received on securities available for sale	21,868	18,488
Purchases of securities available for sale	(75,237)	(63,964)
Net (increase) decrease in Federal funds sold	(1,982)	3,251
Net loans made to customers	(72,659)	(102,834)
Purchases of premises and equipment	(672)	(1,763)
Proceeds from sales of other assets	168	198
Purchase of life insurance contracts	-	(880)
Net cash acquired in acquisitions	233	-
Net cash provided by (used in) investing activities	(105,563)	(122,593)
Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and		

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

savings accounts	4,573	25,773
Net increase(decrease) in time deposits	(64,720)	165,383
Net increase(decrease) in short-term borrowings	64,271	(91,606)
Proceeds from long-term borrowings	110,000	18,551
Repayment of long-term borrowings	(22,430)	(25,164)
Exercise of stock options	-	44
Dividends paid	(1,205)	(1,141)
Repurchase of common stock	-	(617)
Net cash provided by financing activities	90,489	91,223
Increase (decrease) in cash and due from banks	1,404	(10,932)
Cash and due from banks:		
Beginning	12,031	22,536
Ending	\$ 13,435	\$ 11,604

(Continued)

See Notes to Consolidated Financial Statements

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

**Nine Months Ended
September
30,**

**September
30,
2007**

**2006
(Restated)**

(dollars in thousands)

Supplemental Disclosures of Cash Flow Information

Cash payments for:

Interest	\$ 37,984	\$ 31,809
Income taxes	\$ 3,472	\$ 3,856

Supplemental Schedule of Noncash Investing and Financing Activities

Other assets acquired in settlement of loans	\$ 891	\$ 50
--	--------	-------

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Note 1. Restatement**

Summit Financial Group, Inc. (“We”, “Company”, or “Summit”) is restating its consolidated financial statements and other financial information for September 30, 2006 to correct errors related to our derivative accounting under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS. No. 133”).

In 2003, we entered into four interest rate swap agreements on certain convertible rate advances from the Federal Home Loan Bank (“FHLB”) that were designated as fair value hedges. The terms of the FHLB convertible rate advances include an option of the FHLB to convert the debt’s fixed interest rate to a variable rate on a quarterly basis. We evaluated these hedging relationships and concluded that the short-cut method of hedge accounting could be applied and the assumption of no ineffectiveness was valid based upon: (a) the criteria in paragraph 68 of SFAS 133 were met, and (b) the conversion options in the FHLB advances were mirrored in the interest rate swaps.

Recently, we learned that the above interpretation of paragraph 68 is incorrect. The conversion is not specifically listed in paragraph 68, and the presence of that term prohibits the application of the short-cut method of hedge accounting, even if the terms are mirrored between the interest rate swap and the hedged item. Eliminating the application of fair value hedge accounting reverses the fair value adjustments that have been made to the advances and results in all fair value changes for the interest rate swaps being recognized in noninterest income. Additionally, the net cash settlement payments received/paid during each period for these interest rate swaps were reclassified from interest expense on long-term borrowings to noninterest income.

The following tables reflect a summary of both the originally reported and restated amounts:

Consolidated Balance Sheets*(dollars in thousands)*

	September 30, 2006	
	As Previously Reported	As Restated
Other assets	\$ 16,518	\$ 17,222
Total assets	1,210,491	1,211,195
Long-term borrowings	144,275	146,127
Total liabilities	1,129,861	1,131,714
Retained earnings	63,159	62,011
Total shareholders' equity	80,630	79,481
Total liabilities and shareholders' equity	1,210,491	1,211,195

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Consolidated Statements of Income***(dollars in thousands)*

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
			As Previously	
	As Previously Reported	As Restated	Reported	As Restated
Interest income	\$ 21,074	\$ 21,074	\$ 58,394	\$ 58,394
Interest expense	11,999	11,810	32,287	31,871
Net interest income	9,075	9,264	26,107	26,523
Provision for loan losses	260	260	915	915
Noninterest income:				
Net cash settlement on derivative instruments	-	(154)	-	(337)
Change in fair value of derivative instruments	-	579	-	(140)
Other noninterest income	1,049	1,061	3,161	3,164
Noninterest expense	5,277	5,277	16,310	16,310
Income from continuing operations before income taxes	4,587	5,213	12,043	11,985
Income tax expense	1,421	1,659	3,696	3,674
Income from continuing operations				
Income (loss) from discontinued operations, net of income taxes	3,166	3,554	8,347	8,311
Net income	\$ 2,481	\$ 2,869	\$ 8,086	\$ 8,050
Diluted earnings per share:				
Income from continuing operations	\$ 0.45	\$ 0.49	\$ 1.16	\$ 1.16
Net income	\$ 0.35	\$ 0.39	\$ 1.12	\$ 1.12
Average diluted shares outstanding	7,187,274	7,187,274	7,194,351	7,194,351

**Consolidated Statements of
Shareholders' Equity**
(dollars in thousands)

	September 30, 2006	
	As Previously Reported	As Restated
Balance, beginning of period	\$ 73,803	\$ 72,691
Increase attributable to net income	8,086	8,050
Balance, end of period	80,630	79,481

In addition, the following Notes to Consolidated Financial Statements have been restated: 6, 12, and 15.

Summit Financial Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (unaudited)

Note 2. Basis of Presentation

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

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

The results of operations for the nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year. The consolidated financial statements and notes included herein should be read in conjunction with our 2006 audited financial statements and Annual Report on Form 10-K/A. Certain accounts in the consolidated financial statements for December 31, 2006 and September 30, 2006, as previously presented, have been reclassified to conform to current year classifications.

Note 3. Significant New Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109*" (FIN 48), which clarifies the accounting and disclosure for uncertain tax positions, as defined. FIN 48 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. FIN 48 also provides guidance on measurement, derecognition of tax benefits, classification, interim period accounting disclosure, and transition requirements in accounting for uncertain tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company will be required to apply the provisions of FIN 48 to all tax positions upon initial adoption with any cumulative effect adjustment to be recognized as an adjustment to retained earnings. We adopted the provisions of this statement January 1, 2007, which has not had a material effect on our financial statements.

In September 2006, the FASB issued Statement No. 157, "*Fair Value Measurements*" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements, but does not require any new fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and early application is encouraged. We are currently evaluating the adoption of this statement and have not determined the impact it will have on our financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standard No. 159 ("SFAS 159"), "*The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115.*" The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at

specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are to be reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method , (ii) is irrevocable (unless a new election date occurs), and (iii) is applied only to entire instruments and not to portions

Summit Financial Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (unaudited)

of instruments. This statement becomes effective for us January 1, 2008. We are currently evaluating the adoption of this statement and have not determined the impact it will have on our financial statements.

Note 4. Acquisitions

Effective July 2, 2007, we acquired Kelly Insurance Agency, Inc. and Kelly Property and Casualty, Inc., two Virginia corporations located in Leesburg, Virginia, which were merged into Summit Insurance Services, LLC, our wholly owned subsidiary. We have deemed this transaction to be an immaterial acquisition.

As announced on April 12, 2007, we entered into an Agreement and Plan of Reorganization (the "Agreement") with Greater Atlantic Financial Corporation, Inc. ("Greater Atlantic"), headquartered in Reston, Virginia.

Under the terms of the Agreement, we will pay a combination of cash and shares of Summit common stock for each share of Greater Atlantic common stock outstanding, subject to a "stock collar" limiting the maximum and minimum number of shares we will issue. The stock collar is described more fully below. Subject to the stock collar, the total consideration for Greater Atlantic's stock will be paid 70% in the form of Summit common stock and 30% cash, with each share of Greater Atlantic common stock exchanged for shares of Summit common stock valued at \$4.20 and \$1.80 in cash.

The number of shares of Summit common stock to be issued for each share of Greater Atlantic common stock will be determined by an exchange ratio at closing. At the closing, we will determine the exchange ratio by dividing \$4.20 by the average closing price of Summit common stock reported on NASDAQ for the twenty (20) trading days prior to closing (the "Average Closing Price"). The exchange ratio is subject to a stock collar, which sets the maximum and minimum numbers of shares that we will issue. If the Average Closing Price of Summit common stock is less than \$17.82, the exchange ratio will be calculated by dividing \$4.20 by \$17.82. If the Average Closing Price is greater than \$24.01, the exchange ratio will be calculated by dividing \$4.20 by \$24.10.

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

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Note 5. Discontinued Operations**

The following table lists the assets and liabilities of Summit Mortgage included in the balance sheet as assets and liabilities related to discontinued operations.

<i>(dollars in thousands)</i>	September 30, 2007	December 31, 2006	September 30, 2006
Assets:			
Loans held for sale, net	\$ -	\$ 8,428	\$ 6,510
Loans, net	-	180	430
Premises and equipment, net	-	-	669
Property held for sale	-	75	75
Other assets	254	1,032	685
Total assets	\$ 254	\$ 9,715	\$ 8,369
Liabilities:			
Accrued expenses and other liabilities	\$ 421	\$ 2,109	\$ 216
Total liabilities	\$ 421	\$ 2,109	\$ 216

The results of Summit Mortgage are presented as discontinued operations in a separate category on the income statements following the results from continuing operations. The income (loss) from discontinued operations for the periods ended September 30, 2007 and 2006 is presented below.

Statements of Income from Discontinued Operations

<i>(dollars in thousands)</i>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Interest income	\$ (3)	\$ 300	\$ 131	\$ 1,274
Interest expense	-	144	45	689
Net interest income	(3)	156	86	585
Provision for loan losses	-	150	250	370
Net interest income after provision for loan losses	(3)	6	(164)	215
Noninterest income				
Mortgage origination revenue	(4)	4,028	812	16,557
(Loss) on sale of assets	-	-	(51)	-
Total noninterest income	(4)	4,028	761	16,557
Noninterest expense				
Salaries and employee benefits	-	1,485	542	5,394
Net occupancy expense	(12)	177	(3)	527
Equipment expense	5	78	28	227

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

Professional fees	179	186	376	508
Postage	-	1,587	-	5,012
Advertising	-	1,128	98	3,582
Impairment of long-lived assets	-	-	-	-
Exit costs	-	-	(123)	-
Other	95	452	429	1,899
Total noninterest expense	267	5,093	1,347	17,149
Income (loss) before income tax expense	(274)	(1,059)	(750)	(377)
Income tax expense (benefit)	(94)	(374)	(257)	(116)
Income (loss) from discontinued operations	\$ (180)	\$ (685)	\$ (493)	\$ (261)

13

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

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

<i>(dollars in thousands)</i>	Operating Lease Terminations	Vendor Contract Terminations	Severance Payments	Total
Balance, December 31, 2006	\$ 734	\$ 740	\$ 385	\$ 1,859
Less:				
Payments from the accrual	(573)	(509)	(305)	(1,387)
Addition to the accrual	188	-	-	188
Reversal of over accrual	-	(231)	(80)	(311)
Balance, September 30, 2007	\$ 349	\$ -	\$ -	\$ 349

Note 6. Earnings per Share

The computations of basic and diluted earnings per share follow:

<i>(dollars in thousands, except per share amounts)</i>	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	2007	(restated)	2007	(restated)
Numerator for both basic and diluted earnings per share:				
Income from continuing operations	\$ 3,755	\$ 3,554	\$ 9,669	\$ 8,311
Income (loss) from discontinued operations	(131)	(685)	(444)	(261)
Net Income	3,624	2,869	9,225	8,050
Denominator				
Denominator for basic earnings per share - weighted average common shares outstanding	7,399,213	7,127,650	7,190,875	7,130,276
Effect of dilutive securities:				
Stock options	59,302	59,624	61,903	64,075
	59,302	59,624	61,903	64,075
Denominator for diluted earnings per share - weighted average common shares outstanding and assumed conversions	7,458,515	7,187,274	7,252,778	7,194,351
Basic earnings per share from continuing operations	\$ 0.51	\$ 0.50	\$ 1.34	\$ 1.17
Basic earnings per share from discontinued operations	(0.02)	(0.10)	(0.06)	(0.04)
Basic earnings per share	\$ 0.49	\$ 0.40	\$ 1.28	\$ 1.13

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

Diluted earnings per share from continuing operations	\$	0.51	\$	0.49	\$	1.34	\$	1.16
Diluted earnings per share from discontinued operations		(0.02)		(0.10)		(0.06)		(0.04)
Diluted earnings per share	\$	0.49	\$	0.39	\$	1.27	\$	1.12

14

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Note 7. Securities**

The amortized cost, unrealized gains, unrealized losses and estimated fair values of securities at September 30, 2007, December 31, 2006, and September 30, 2006 are summarized as follows:

<i>(dollars in thousands)</i>	Amortized Cost	September 30, 2007		Estimated Fair Value
		Unrealized Gains	Losses	
Available for Sale				
Taxable:				
U. S. Government agencies and corporations	\$ 38,414	\$ 86	\$ 150	\$ 38,350
Mortgage-backed securities	170,007	766	1,919	168,854
State and political subdivisions	3,759	16	-	3,775
Corporate debt securities	1,675	15	14	1,676
Federal Home Loan Bank stock	15,453	-	-	15,453
Other equity securities	844	-	-	844
Total taxable	230,152	883	2,083	228,952
Tax-exempt:				
State and political subdivisions	44,669	818	122	45,365
Other equity securities	4,472	525	25	4,972
Total tax-exempt	49,141	1,343	147	50,337
Total	\$ 279,293	\$ 2,226	\$ 2,230	\$ 279,289

<i>(dollars in thousands)</i>	Amortized Cost	December 31, 2006		Estimated Fair Value
		Unrealized Gains	Losses	
Available for Sale				
Taxable:				
U. S. Government agencies and corporations	\$ 37,671	\$ 3	\$ 334	\$ 37,340
Mortgage-backed securities	146,108	470	2,262	144,316
State and political subdivisions	3,759	25	-	3,784
Corporate debt securities	1,682	19	2	1,699
Federal Reserve Bank stock	669	-	-	669
Federal Home Loan Bank stock	12,094	-	-	12,094
Other equity securities	151	-	-	151

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

Total taxable	202,134	517	2,598	200,053
Tax-exempt:				
State and political subdivisions	40,329	1,026	68	41,287
Other equity securities	5,975	573	14	6,534
Total tax-exempt	46,304	1,599	82	47,821
Total	\$ 248,438	\$ 2,116	\$ 2,680	\$ 247,874

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

	Amortized Cost	September 30, 2006 Unrealized Gains Losses		Estimated Fair Value
Available for Sale				
Taxable:				
U. S. Government agencies and corporations	\$ 38,304	\$ 4	\$ 417	\$ 37,891
Mortgage-backed securities State and political subdivisions	141,372	292	2,807	138,857
Corporate debt securities	3,759	11	12	3,758
Federal Reserve Bank stock	2,185	19	3	2,201
Federal Home Loan Bank stock	669	-	-	669
Other equity securities	12,562	-	-	12,562
Total taxable	150	-	-	150
Tax-exempt:	199,001	326	3,239	196,088
State and political subdivisions	42,691	1,229	63	43,857
Other equity securities	5,976	428	17	6,387
Total tax-exempt	48,667	1,657	80	50,244
Total	\$ 247,668	\$ 1,983	\$ 3,319	\$ 246,332

The maturities, amortized cost and estimated fair values of securities at September 30, 2007, are summarized as follows:

<i>(dollars in thousands)</i>	Available for Sale	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 61,720	\$ 60,788
Due from one to five years	113,830	112,986
Due from five to ten years	43,487	44,288
Due after ten years	39,488	39,959
Equity securities	20,768	21,268
	\$ 279,293	\$ 279,289

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Note 8. Loans**

Loans are summarized as follows:

<i>(dollars in thousands)</i>	September 30, 2007	December 31, 2006	September 30, 2006
Commercial	\$ 87,018	\$ 69,470	\$ 67,352
Commercial real estate	352,396	314,198	300,675
Construction and development	212,570	215,820	207,545
Residential real estate	305,016	282,512	283,944
Consumer	33,254	36,455	36,885
Other	6,794	6,969	7,086
Total loans	997,048	925,424	903,487
Less unearned income	1,884	1,868	1,806
Total loans net of unearned income	995,164	923,556	901,681
Less allowance for loan losses	8,727	7,511	6,845
Loans, net	\$ 986,437	\$ 916,045	\$ 894,836

Note 9. Allowance for Loan Losses

An analysis of the allowance for loan losses for the nine month periods ended September 30, 2007 and 2006, and for the year ended December 31, 2006 is as follows:

<i>(dollars in thousands)</i>	Nine Months Ended		Year Ended December 31, 2006
	September 30, 2007	2006	
Balance, beginning of period	\$ 7,511	\$ 6,112	\$ 6,112
Losses:			
Commercial	50	32	32
Commercial real estate	59	39	185
Construction and development	-	-	-
Real estate - mortgage	569	-	35
Consumer	133	114	200
Other	135	243	289
Total	946	428	741
Recoveries:			
Commercial	2	1	1
Commercial real estate	10	43	46
Construction and development	20	-	-
Real estate - mortgage	7	6	6

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

Consumer	36	44	63
Other	90	152	179
Total	165	246	295
Net losses	781	182	446
Provision for loan losses	1,555	915	1,845
Reclassification of reserves related to loans previously reflected in discontinued operations	442	-	-
Balance, end of period	\$ 8,727	\$ 6,845	\$ 7,511

Summit Financial Group, Inc. and Subsidiaries**Notes to Consolidated Financial Statements (unaudited)****Note 10. Goodwill and Other Intangible Assets**

The following tables present our goodwill at September 30, 2007 and other intangible assets at September 30, 2007, December 31, 2006, and September 30, 2006.

	Goodwill
<i>(dollars in thousands)</i>	Activity
Balance, January 1, 2007	\$ 2,088
Acquired goodwill, net	4,110
Balance, September 30, 2007	\$ 6,198

	Other Intangible Assets		
<i>(dollars in thousands)</i>	September 30, 2007	December 31, 2006	September 30, 2006
Unidentifiable intangible assets			
Gross carrying amount	\$ 2,267	\$ 2,267	\$ 267
Less: accumulated amortization	1,272	1,159	1,121
Net carrying amount	\$ 995	\$ 1,108	\$ (854)
Identifiable customer intangible assets			
Gross carrying amount	\$ 3,000	\$ -	\$ -
Less: accumulated amortization	50	-	-
Net carrying amount	\$ 2,950	\$ -	\$ -

We recorded amortization expense of approximately \$163,000 for the nine months ended September 30, 2007 relative to our other intangible assets. Annual amortization is expected to be approximately \$251,000 for the year ending 2007 and \$351,000 for each of the years ending 2008 through 2011.

Note 11. Deposits

The following is a summary of interest bearing deposits by type as of September 30, 2007 and 2006 and December 31, 2006:

	September 30, 2007	December 31, 2006	September 30, 2006
<i>(dollars in thousands)</i>			
Interest bearing demand deposits	\$ 230,491	\$ 220,167	\$ 223,992
Savings deposits	39,596	47,984	44,980
Retail time deposits	303,316	278,322	264,571
Brokered time deposits	189,966	279,623	266,769
Total	\$ 763,369	\$ 826,096	\$ 800,312

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

Brokered deposits represent certificates of deposit acquired through a third party. The following is a summary of the maturity distribution of certificates of deposit in denominations of \$100,000 or more as of September 30, 2007:

<i>(dollars in thousands)</i>	Amount	Percent
Three months or less	\$ 54,972	20.2%
Three through six months	46,205	16.9%
Six through twelve months	79,075	29.0%
Over twelve months	92,408	33.9%
Total	\$ 272,660	100.0%

A summary of the scheduled maturities for all time deposits as of September 30, 2007 is as follows:

<i>(dollars in thousands)</i>	
Three month period ending	
December 31, 2007	\$ 138,332
Year ending December 31, 2008	263,111
Year ending December 31, 2009	53,486
Year ending December 31, 2010	32,850
Year ending December 31, 2011	2,169
Thereafter	3,334
	\$ 493,282

Note 12. Borrowed Funds

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

	Nine Months Ended September 30, 2007		
	Short-term		Federal
	FHLB	Repurchase	Funds
<i>(dollars in thousands)</i>	Advances	Agreements	Purchased and Lines of Credit
Balance at September 30	\$ 117,361	\$ 5,211	\$ 2,127
	69,770	6,063	2,168

Average balance outstanding for
the period

Maximum balance outstanding at			
any month end during period	117,361	7,358	2,669
Weighted average interest rate for the period	5.33%	4.09%	7.54%
Weighted average interest rate for balances			
outstanding at September 30	5.11%	3.61%	7.25%

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

	Year Ended December 31, 2006		
	Short-term FHLB Advances	Repurchase Agreements	Federal Funds Purchased and Lines of Credit
<i>(dollars in thousands)</i>			
Balance at December 31	\$ 54,765	\$ 4,731	\$ 932
Average balance outstanding for the period	123,953	5,793	1,026
Maximum balance outstanding at			
any month end during period	175,408	7,037	1,171
Weighted average interest rate for the period	5.08%	4.03%	7.49%
Weighted average interest rate for balances			
outstanding at December 31	5.39%	4.08%	7.75%

	Nine Months Ended September 30, 2006		
	Short-term FHLB Advances	Repurchase Agreements	Federal Funds Purchased and Lines of Credit
Balance at September 30	\$ 84,399	\$ 5,216	\$ 807
Average balance outstanding for the period	141,998	5,971	908
Maximum balance outstanding at			
any month end during period	175,408	7,037	1,164
Weighted average interest rate for the period	5.01%	4.00%	7.60%
Weighted average interest rate for balances			
outstanding at September 30	5.30%	4.15%	7.75%

Long-term borrowings: Our long-term borrowings of \$263,679,000, \$176,109,000 and \$146,127,000 at September 30, 2007, December 31, 2006, and September 30, 2006 respectively, consisted primarily of advances from the Federal Home Loan Bank ("FHLB").

These borrowings bear both fixed and variable rates and mature in varying amounts through the year 2016.

The average interest rate paid on long-term borrowings for the nine month period ended September 30, 2007 was 5.16% compared to 4.88% for the first nine months of 2006.

Subordinated Debentures: We have three statutory business trusts that were formed for the purpose of issuing mandatorily redeemable securities (the “capital securities”) for which we are obligated to third party investors and investing the proceeds from the sale of the capital securities in our junior subordinated debentures (the “debentures”). The debentures held by the trusts are their sole assets. Our subordinated debentures totaled \$19,589,000 at September 30, 2007, December 31, 2006, and September 30, 2006.

In October 2002, we sponsored SFG Capital Trust I, in March 2004, we sponsored SFG Capital Trust II, and in December 2005, we sponsored SFG Capital Trust III, of which 100% of the common equity of each trust is owned by us. SFG Capital Trust I issued \$3,500,000 in capital securities and \$109,000 in common securities and invested the proceeds in \$3,609,000 of debentures. SFG Capital Trust II issued \$7,500,000 in capital securities and \$232,000 in common securities and invested the proceeds in \$7,732,000 of debentures. SFG Capital Trust III issued \$8,000,000 in capital securities and \$248,000 in common securities and invested the proceeds in \$8,248,000 of debentures.

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

Distributions on the capital securities issued by the trusts are payable quarterly at a variable interest rate equal to 3 month LIBOR plus 345 basis points for SFG Capital Trust I, 3 month LIBOR plus 280 basis points for SFG Capital Trust II, and 3 month LIBOR plus 145 basis points for SFG Capital Trust III, and equals the interest rate earned on the debentures held by the trusts, and is recorded as interest expense by us. The capital securities are subject to mandatory redemption in whole or in part, upon repayment of the debentures. We have entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of the guarantee. The debentures of SFG Capital Trust I, SFG Capital Trust II, and SFG Capital Trust III are first redeemable by us in November 2007, March 2009, and March 2011, respectively.

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

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

(dollars in thousands)

Year Ending December 31,	Amount
2007	\$ 889
2008	52,377
2009	63,911
2010	54,533
2011	12,465
Thereafter	99,093
	\$ 283,268

Note 13. Stock Option Plan

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

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

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

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

The fair value of our employee stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options at the time of grant. There were no option grants during the first nine months of 2007 or 2006.

During the first nine months of 2007, we recognized \$24,000 of compensation expense for share-based payment arrangements in our income statement, with a deferred tax asset of \$9,000, compared to \$26,000 compensation expense for the first nine months of 2006 with a deferred tax asset of \$10,000. At September 30, 2007, we had approximately \$20,000 total compensation cost related to nonvested awards not yet recognized and we expect to recognize it over the next fifteen months.

A summary of activity in our Officer Stock Option Plan during the first nine months of 2007 and 2006 is as follows:

	For the Nine Months Ended			
	September 30, 2007		September 30, 2006	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding, January 1	349,080	\$ 17.83	361,740	\$ 17.41
Granted	-	-	-	-
Exercised	-	-	(8,900)	4.89
Forfeited	-	-	-	-
Outstanding, September 30	349,080	\$ 17.83	352,840	\$ 17.73

Other information regarding options outstanding and exercisable at September 30, 2007 is as follows:

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

Range of exercise price	# of shares	Options Outstanding			Options Exercisable		
		WAEP	Wted. Avg. Remaining Contractual Life (yrs)	Aggregate Intrinsic Value (in thousands)	# of shares	WAEP	Aggregate Intrinsic Value (in thousands)
4.63 - \$ \$6.00	83,600	\$ 5.34	5.10	\$ 1,082	83,600	\$ 5.34	1,082
6.01 - 10.00	31,680	9.49	8.26	278	24,480	9.49	215
10.01 - 17.50	3,500	17.43	6.42	3	3,500	17.43	3
17.51 - 20.00	51,800	17.79	9.21	26	31,000	17.79	15
20.01 - 25.93	178,500	25.19	7.82	-	178,500	25.19	-
	349,080	17.83		\$ 1,389	321,080	18.02	\$ 1,315

Note 14. Commitments and Contingencies*Off-Balance Sheet Arrangements*

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

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

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

	September
	30,
	2007
<i>(dollars in thousands)</i>	
Commitments to extend credit:	
Revolving home equity and	

credit card lines	\$	35,400
Construction loans		85,010
Other loans		43,652
Standby letters of credit		13,006
Total	\$	177,068

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.

Summit Financial Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (unaudited)

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

Note 15. Restrictions on Capital

We and our subsidiaries are subject to various regulatory capital requirements administered by the banking regulatory agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we and each of our subsidiaries must meet specific capital guidelines that involve quantitative measures of our and our subsidiaries' assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. We and each of our subsidiaries' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us and each of our subsidiaries to maintain minimum amounts and ratios of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). We believe, as of September 30, 2007, that we and each of our subsidiaries met all capital adequacy requirements to which they were subject.

The most recent notifications from the banking regulatory agencies categorized us and each of our subsidiaries as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, we and each of our subsidiaries must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below.

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

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

	Actual		Minimum Required Regulatory Capital		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(dollars in thousands)</i>						
As of September 30, 2007						
Total Capital (to risk weighted assets)						
Summit	\$ 112,338	11.1%	\$ 81,234	8.0%	\$ 101,542	10.0%
Summit Community	110,300	10.9%	80,588	8.0%	100,734	10.0%
Tier I Capital (to risk weighted assets)						
Summit	\$ 103,386	10.2%	40,617	4.0%	60,925	6.0%
Summit Community	101,347	10.1%	40,294	4.0%	60,441	6.0%
Tier I Capital (to average assets)						
Summit	\$ 103,386	8.0%	39,009	3.0%	65,015	5.0%
Summit Community	101,347	7.9%	38,699	3.0%	64,498	5.0%
As of December 31, 2006						
Total Capital (to risk weighted assets)						
Summit	\$ 103,102	10.7%	77,086	8.0%	96,357	10.0%
Summit Community	59,684	10.4%	45,911	8.0%	57,388	10.0%
Shenandoah	41,243	10.9%	30,355	8.0%	37,944	10.0%
Tier I Capital (to risk weighted assets)						
Summit	94,899	9.9%	38,343	4.0%	57,515	6.0%
Summit Community	55,041	9.6%	22,934	4.0%	34,401	6.0%
Shenandoah	37,683	9.9%	15,178	4.0%	22,766	6.0%
Tier I Capital (to average assets)						
Summit	94,899	7.8%	36,496	3.0%	60,826	5.0%
Summit Community	55,041	7.4%	22,314	3.0%	37,190	5.0%
Shenandoah	37,683	8.0%	14,097	3.0%	23,495	5.0%

Summit Financial Group, Inc. and Subsidiaries

**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

INTRODUCTION

The following discussion and analysis focuses on significant changes in our financial condition and results of operations of Summit Financial Group, Inc. ("Company" or "Summit") and our operating units, Summit Community Bank ("Summit Community"), and Summit Insurance Services, LLC for the periods indicated. This discussion and analysis should be read in conjunction with our 2006 audited financial statements and Annual Report on Form 10-K/A.

The Private Securities Litigation Act of 1995 indicates that the disclosure of forward-looking information is desirable for investors and encourages such disclosure by providing a safe harbor for forward-looking statements by us. Our following discussion and analysis of financial condition and results of operations contains certain forward-looking statements that involve risk and uncertainty. In order to comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed in those forward-looking statements.

RESTATEMENT

As discussed in Note 1, Restatement, in the Notes to Consolidated Financial Statements, we are restating financial statements and other financial information for the quarter ended and nine months ended September 30, 2006.

In 2003, we entered into four interest rate swap agreements on certain convertible rate advances from the Federal Home Loan Bank ("FHLB") that were designated as fair value hedges. The terms of the FHLB convertible rate advances include an option of the FHLB to convert the debt's fixed interest rate to a variable rate on a quarterly basis. We evaluated these hedging relationships and concluded that the short-cut method of hedge accounting could be applied and the assumption of no ineffectiveness was valid based upon: (a) the criteria in paragraph 68 of SFAS 133 were met, and (b) the conversion options in the FHLB advances were mirrored in the interest rate swaps.

Based on comments received from the Securities and Exchange Commission, we learned that the above interpretation of paragraph 68 is incorrect. The conversion is not specifically listed in paragraph 68, and the presence of that term prohibits the application of the short-cut method of hedge accounting, even if the terms are mirrored between the interest rate swap and the hedged item. Eliminating the application of fair value hedge accounting reverses the fair value adjustments that have been made to the advances and results in all fair value changes for the interest rate swaps being recognized in noninterest income. Additionally, the net cash settlement payments received/paid during each period for these interest rate swaps were reclassified from interest expense on long-term borrowings to noninterest income.

OVERVIEW

Our primary source of income is net interest income from loans and deposits. Business volumes tend to be influenced by the overall economic factors including market interest rates, business spending, and consumer confidence, as well as competitive conditions within the marketplace.

Growth in our interest earning assets resulted in an increase of 6.21%, or \$1,743,000 in our net interest earnings on a tax equivalent basis for the first nine months in 2007 compared to the same period of 2006.

26

Summit Financial Group, Inc. and Subsidiaries

Management's Discussion and Analysis of Financial Condition and Results of Operations

CRITICAL ACCOUNTING POLICIES

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

Our most significant accounting policies are presented in Note 2 to the consolidated financial statements of our 2006 Annual Report on Form 10-K/A. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, we have identified the determination of the allowance for loan losses and the valuation of goodwill to be the accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

The allowance for loan losses represents our estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on our consolidated balance sheet. To the extent actual outcomes differ from our estimates, additional provisions for loan losses may be required that would negatively impact earnings in future periods. Note 2 to the consolidated financial statements of our 2006 Annual Report on Form 10-K/A describes the methodology used to determine the allowance for loan losses and a discussion of the factors driving changes in the amount of the allowance for loan losses is included in the Asset Quality section of the financial review of the 2006 Annual Report on Form 10-K/A.

Goodwill is subject to impairment testing at least annually to determine whether write-downs of the recorded balances are necessary. A fair value is determined based on at least one of three various market valuation methodologies. If the fair value equals or exceeds the book value, no write-down of recorded goodwill is necessary. If the fair value is less than the book value, an expense may be required on our books to write down the goodwill to the proper carrying value. During the third quarter, we completed the required annual impairment test for 2007 and no impairment charges were necessary. We cannot assure you that future goodwill impairment tests will not result in a charge to earnings. See Notes 2 and 10 of the consolidated financial statements of our Annual Report on Form 10-K/A for further discussion of our intangible assets, which include goodwill.

Summit Financial Group, Inc. and Subsidiaries

Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS

Earnings Summary

Income from continuing operations for the nine months ended September 30, 2007 grew 16.34% to \$9,669,000, or \$1.33 per diluted share as compared to \$8,311,000, or \$1.16 per diluted share for the nine months ended September 30, 2006. For the quarter ended September 30, 2007, income from continuing operations increased 5.66% to \$3,755,000, or \$0.50 per diluted share as compared to \$3,554,000, or \$0.49 per diluted share for the same period of 2006. Consolidated net income, which includes the results of discontinued operations, grew to \$9,225,000 for the nine months ended September 30, 2007 compared to \$8,050,000 for the same period of 2006. On a quarterly basis, consolidated net income grew 26.32% to \$3,624,000 for third quarter 2007 compared to \$2,869,000 for the third quarter 2006. Consolidated returns on average equity and assets for the first nine months of 2007 were 14.41% and 0.97%, respectively, compared with 13.79% and 0.93% for the same period of 2006.

Net Interest Income

Net interest income is the principal component of our earnings and represents the difference between interest and fee income generated from earning assets and the interest expense paid on deposits and borrowed funds. Fluctuations in interest rates as well as changes in the volume and mix of earning assets and interest bearing liabilities can materially impact net interest income.

Our consolidated net interest income on a fully tax-equivalent basis totaled \$29,802,000 for the nine month period ended September 30, 2007 compared to \$28,059,000 for the same period of 2006, representing an increase of \$1,743,000 or 6.21%. This increase resulted from growth in interest earning assets, primarily loans, which served to more than offset the 44 basis points increase in the cost of interest bearing liabilities during the same period. Average interest earning assets grew 10.34% from \$1,103,395,000 during the first nine months of 2006 to \$1,217,493,000 for the first nine months of 2007. Average interest bearing liabilities grew 10.51% from \$1,007,694,000 at September 30, 2006 to \$1,113,610,000 at September 30, 2007, at an average yield for the first nine months of 2007 of 4.67% compared to 4.23% for the same period of 2006.

Our consolidated net interest margin decreased to 3.27% for the nine month period ended September 30, 2007, compared to 3.40% for the same period in 2006. On a quarterly basis, our net interest margin declined to 3.28% at September 30, 2007, from 3.40% for the quarter ended September 30, 2006. Our net interest margin remained stable compared to the linked quarter. Our margin continues to be affected by our loan growth in an extremely competitive environment. The current competitive pressures are causing loan rates to be lower. Also, our loan growth is at a faster pace than we have been able to grow lower cost retail funds, causing us to rely more on higher cost, non-retail deposit funding vehicles. The current competitive and market conditions are also causing deposit rates to be higher. For the nine months ended September 30, 2007 compared to September 30, 2006, the yields on earning assets increased 28 basis points, while the cost of our interest bearing funds increased by 44 basis points.

We anticipate modest growth in our net interest income to continue over the near term as the growth in the volume of interest earning assets will more than offset the expected continued decline in our net interest margin. However, if market interest rates remain significantly unchanged, or go lower over the next 12 to 18 months, the spread between interest earning assets and interest bearing liabilities could narrow such that its impact could not be offset by growth in

earning assets. 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.

Summit Financial Group, Inc. and Subsidiaries
**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

**Table I - Average Balance Sheet and Net Interest Income
Analysis**

(dollars in thousands)

	For the Nine Months Ended						
	September 30, 2007			September 30, 2006			
	Average Balance	Earnings/ Expense	Yield/ Yield/ Rate	Average Balance	Earnings/ Expense (Restated)	Yield/ Rate (Restated)	
Interest earning assets							
Loans, net of unearned income							
Taxable	\$ 945,496	\$ 57,435	8.12%	\$ 857,851	\$ 50,180	7.82%	
Tax-exempt							
(1)	9,274	550	7.93%	8,373	476	7.60%	
Securities							
Taxable	214,602	8,216	5.12%	189,768	6,837	4.82%	
Tax-exempt							
(1)	46,931	2,419	6.89%	45,950	2,385	6.94%	
Federal funds sold and interest bearing deposits with other banks	1,190	43	4.83%	1,453	52	4.78%	
Total interest earning assets	1,217,493	68,663	7.54%	1,103,395	59,930	7.26%	
Noninterest earning assets							
Cash & due from banks	14,003			13,760			
Premises and equipment	22,207			23,552			
Other assets	29,132			26,160			
Allowance for loan losses	(8,564)			(6,683)			
Total assets	\$ 1,274,271			\$ 1,160,184			
Interest bearing liabilities							
Interest bearing demand deposits	\$ 227,461	\$ 6,120	3.60%	\$ 213,518	\$ 5,410	3.39%	
Savings deposits	43,449	561	1.73%	40,826	311	1.02%	

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

Time deposits	536,784	19,856	4.95%	428,224	13,601	4.25%
Short-term borrowings	78,002	3,098	5.31%	148,876	5,572	5.00%
Long-term borrowings and capital trust securities	227,914	9,226	5.41%	176,250	6,977	5.29%
Total interest bearing liabilities	1,113,610	38,861	4.67%	1,007,694	31,871	4.23%
Noninterest bearing liabilities and shareholders' equity						
Demand deposits	64,028			64,618		
Other liabilities	11,297			10,059		
Shareholders' equity	85,336			77,813		
Total liabilities and shareholders' equity	\$ 1,274,271			\$ 1,160,184		
Net interest earnings		\$ 29,802			\$ 28,059	
Net yield on interest earning assets			3.27%			3.40%

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

The tax equivalent adjustment resulted in an increase in interest income of \$990,000 and \$951,000 for the periods ended

September 30, 2007 and September 30 2006, respectively.

Summit Financial Group, Inc. and Subsidiaries
**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

Table II - Changes in Interest Margin Attributable to Rate and Volume
(dollars in thousands)

	For the Nine Months Ended		
	September 30, 2007 versus September 30, 2006		
	Increase (Decrease)		
	Due to Change in:		
	Volume	Rate	Net
Interest earned on:			
Loans			
Taxable	\$ 5,270	\$ 1,985	\$ 7,255
Tax-exempt	53	21	74
Securities			
Taxable	933	446	1,379
Tax-exempt	51	(17)	34
Federal funds sold and interest bearing deposits with other banks			
	(9)	-	(9)
Total interest earned on interest earning assets	6,298	2,435	8,733
Interest paid on:			
Interest bearing demand deposits			
	364	346	710
Savings deposits	21	229	250
Time deposits	3,792	2,463	6,255
Short-term borrowings	(2,797)	323	(2,474)
Long-term borrowings and capital			
trust securities	2,088	161	2,249
Total interest paid on interest bearing liabilities	3,468	3,522	6,990
Net interest income	\$ 2,830	\$ (1,087)	\$ 1,743

Noninterest Income

Total noninterest income from continuing operations increased to \$4,659,000 for the nine months ended September 30, 2007, compared to \$2,687,000 for the same period of 2006. Further detail regarding noninterest income is reflected in the following table.

Summit Financial Group, Inc. and Subsidiaries
**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

Noninterest Income*Dollars in thousands*

	For the Quarter Ended September 30, 2006		For the Nine Months Ended September 30, 2006	
	2007	(Restated)	2007	(Restated)
Insurance commissions	\$ 1,303	\$ 218	\$ 1,719	\$ 696
Service fees	788	700	2,141	2,056
Net cash settlement on interest rate swaps	(181)	(154)	(544)	(337)
Change in fair value of interest rate swaps	742	579	695	(140)
Gain (loss) on sale of assets	1	(4)	(31)	(8)
Other	253	147	679	420
Total	\$ 2,906	\$ 1,486	\$ 4,659	\$ 2,687

Insurance commissions: The increase in insurance commissions for both the three months and nine months ended September 30, 2007 is primarily the result of the acquisition of the Kelly Agencies during third quarter 2007.

Change in fair value of interest rate swaps: The increase in fair value of interest rate swaps for both the quarter and nine months ended September 30, 2007 were the result of a change in market sentiment to anticipate future declines in short term interest rates.

Noninterest Expense

Total noninterest expense for continuing operations increased approximately \$1,878,000, or 11.5% during the first nine months of 2007 as compared to the same period in 2006 and \$1,543,000 or 29.2% for third quarter 2007 compared to third quarter 2006. Salaries and employee benefits expense represented the largest category of expense growth, which resulted primarily from additional employees attributable to the newly acquired Kelly Agencies, and general merit raises. Table III below shows the breakdown of these increases.

**Table III -
Noninterest
Expense**
*(dollars in
thousands)*

For the Quarter Ended September 30, Change				For the Nine Months Ended September 30, Change			
2007	\$	%	2006	2007	\$	%	2006
\$ 4,054	\$ 1,237	43.9%	\$ 2,817	\$ 10,518	\$ 1,597	17.9%	\$ 8,921

Salaries and employee benefits								
Net occupancy expense	466	79	20.4%	387	1,292	113	9.6%	1,179
Equipment expense	496	20	4.2%	476	1,436	15	1.1%	1,421
Supplies	283	69	32.2%	214	652	50	8.3%	602
Professional fees	176	(12)	-6.4%	188	543	(97)	-15.2%	640
Amortization of intangibles	87	49	128.9%	38	163	50	44.2%	113
Other	1,258	101	8.7%	1,157	3,584	150	4.4%	3,434
Total	\$ 6,820	\$ 1,543	29.2%	\$ 5,277	\$ 18,188	\$ 1,878	11.5%	\$ 16,310

Credit Experience

The provision for loan losses represents charges to earnings necessary to maintain an adequate allowance for potential future loan losses. Our determination of the appropriate level of the allowance is based on an ongoing analysis of credit quality and loss potential in the loan portfolio, change in the composition and risk characteristics of the loan portfolio, and the anticipated influence of national and local economic conditions. The adequacy of the allowance for loan losses is reviewed quarterly and adjustments are made as considered necessary.

We recorded a \$1,305,000 provision for loan losses for the first nine months of 2007, compared to \$915,000 for the same period in 2006. Net loan charge offs for the first nine months of 2007 were \$781,000, as compared to

Summit Financial Group, Inc. and Subsidiaries**Management's Discussion and Analysis of Financial Condition and Results of Operations**

\$182,000 over the same period of 2006. Included in the 2007 net loan charge offs were \$464,000 of charge offs related to loans that had been originated and sold by our secondary mortgage unit and had been repurchased under recourse provisions by us. At September 30, 2007, the allowance for loan losses totaled \$8,728,000 or 0.88% of loans, net of unearned income, compared to \$7,511,000 or 0.81% of loans, net of unearned income at December 31, 2006.

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

Table IV - Summary of Past Due Loans and Non-Performing Assets
(dollars in thousands)

	September 30,		December
	2007	2006	31,
			2006
Accruing loans past due 90 days or more	\$ 5,279	\$ 660	\$ 4,638
Nonperforming assets:			
Nonaccrual loans	1,637	614	638
Foreclosed properties	810	174	77
Repossessed assets	5	6	-
Total	\$ 7,731	\$ 1,454	\$ 5,353
Total nonperforming loans as a percentage of total loans	0.69%	0.14%	0.57%
Total nonperforming assets as a percentage of total assets	0.58%	0.12%	0.43%

Relationships with two developers comprise nearly 50 percent of total nonperforming loans. Each of these loans is well-collateralized and adequate reserves are in place. We have experienced an upward trend in our internally classified assets. This trend has primarily been in residential real estate development loans due to the recent slowdown in the sales of newly constructed homes.

In addition, as a result of our internal loan review process, the ratio of internally classified loans to total loans increased from 4.12% at December 31, 2006 to 6.20% at September 30, 2007. Our internal loan review process includes a watch list of loans that have been specifically identified through the use of various sources, including past due loan reports, previous internal and external loan evaluations, classified loans identified as part of regulatory agency loan reviews and reviews of new loans representative of current lending practices. Once this watch list is reviewed to ensure it is complete, we review the specific loans for collectibility, performance and collateral

protection. In addition, a grade is assigned to the individual loans utilizing internal grading criteria, which is somewhat similar to the criteria utilized by each subsidiary bank's primary regulatory agency. The increase in internally classified loans at September 30, 2007 is primarily due to three customer relationships. Management downgraded these three relationships, as they fell outside of our internal lending policy guidelines and does not expect any material future losses related to these three relationships. Refer to the Asset Quality section of the financial review of the 2006 Annual Report on Form 10-K/A for further discussion of the processes related to internally classified loans.

FINANCIAL CONDITION

Our total assets were \$1,340,679,000 at September 30, 2007, compared to \$1,235,519,000 at December 31, 2006, representing an 8.5% increase. Table V below serves to illustrate significant changes in our financial position between December 31, 2006 and September 30, 2007.

Summit Financial Group, Inc. and Subsidiaries
**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

Table V - Summary of Significant Changes in Financial Position
(dollars in thousands)

	Balance December 31, 2006	Increase (Decrease)		Balance September 30, 2007
		Amount (Restated)	Percentage (Restated)	
Assets				
Securities available for sale	\$ 247,874	31,415	12.7%	\$ 279,289
Loans, net	916,045	70,392	7.7%	986,437
Intangible assets	3,196	6,947	217.4%	10,143
Liabilities				
Deposits	\$ 888,688	\$ (60,089)	-6.8%	\$ 828,599
Short-term borrowings	60,428	64,271	106.4%	124,699
Long-term borrowings and subordinated debentures	195,698	40,649	20.8%	283,268

Loan growth during the first nine months of 2007, occurring principally in the commercial real estate portfolio, was funded primarily by borrowings from the FHLB.

Deposits decreased approximately \$60 million during the first nine months of 2007. This decrease was primarily in brokered deposits, which were replaced with FHLB borrowings.

Refer to Notes 7, 8, 10, 11, and 12 of the notes to the accompanying consolidated financial statements for additional information with regard to changes in the composition of our securities, loans, deposits and borrowings between September 30, 2007 and December 31, 2006.

LIQUIDITY

Liquidity reflects our ability to ensure the availability of adequate funds to meet loan commitments and deposit withdrawals, as well as provide for other transactional requirements. Liquidity is provided primarily by funds invested in cash and due from banks, Federal funds sold, non-pledged securities, and available lines of credit with the FHLB, the total of which approximated \$256 million, or 19.1% of total assets at September 30, 2007 versus \$275 million, or 22.3% of total assets at December 31, 2006.

Our liquidity position is monitored continuously to ensure that day-to-day as well as anticipated funding needs are met. We are not aware of any trends, commitments, events or uncertainties that have resulted in or are reasonably

likely to result in a material change to our liquidity.

33

Summit Financial Group, Inc. and Subsidiaries**Management's Discussion and Analysis of Financial Condition and Results of Operations****CAPITAL RESOURCES**

One of our continuous goals is maintenance of a strong capital position. Through management of our capital resources, we seek to provide an attractive financial return to our shareholders while retaining sufficient capital to support future growth. Shareholders' equity at September 30, 2007 totaled \$93,475,000 compared to \$78,752,000 at December 31, 2006.

Refer to Note 15 of the notes to the accompanying consolidated financial statements for information regarding regulatory restrictions on our capital as well as our subsidiaries' capital.

CONTRACTUAL CASH OBLIGATIONS

During our normal course of business, we incur contractual cash obligations. The following table summarizes our contractual cash obligations at September 30, 2007. The operating lease obligations include leases for both continuing and discontinued operations, as we remain obligated to pay the leases of two properties that were used by Summit Mortgage.

<i>(dollars in thousands)</i>	Long Term Debt	Capital Trust Securities	Operating Leases
2007	\$ 889	\$ -	\$ 280
2008	52,377	-	997
2009	63,911	-	431
2010	54,533	-	123
2011	12,465	-	89
Thereafter	79,504	19,589	200
Total	\$ 263,679	\$ 19,589	\$ 2,120

OFF-BALANCE SHEET ARRANGEMENTS

We are involved with some off-balance sheet arrangements that have or are reasonably likely to have an effect on our financial condition, liquidity, or capital. These arrangements at September 30, 2007 are presented in the following table.

<i>(dollars in thousands)</i>	2007
Commitments to extend credit:	

Revolving home equity and credit card lines	\$	35,400
Construction loans		85,010
Other loans		43,652
Standby letters of credit		13,006
Total	\$	177,068

Summit Financial Group, Inc. and Subsidiaries**Management's Discussion and Analysis of Financial Condition and Results of Operations****MARKET RISK MANAGEMENT**

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. Interest rate risk is our primary market risk and results from timing differences in the repricing of assets, liabilities and off-balance sheet instruments, changes in relationships between rate indices and the potential exercise of imbedded options. The principal objective of asset/liability management is to minimize interest rate risk and our actions in this regard are taken under the guidance of our Asset/Liability Management Committee ("ALCO"), which is comprised of members of senior management and members of the Board of Directors. The ALCO actively formulates the economic assumptions that we use in our financial planning and budgeting process and establishes policies which control and monitor our sources, uses and prices of funds.

Some amount of interest rate risk is inherent and appropriate to the banking business. Our net income is affected by changes in the absolute level of interest rates. The nature of our lending and funding activities tends to drive our interest rate risk position to being liability sensitive in the intermediate term. That is, absent any changes in the volumes of our interest earning assets or interest bearing liabilities, liabilities are likely to reprice faster than assets, resulting in a decrease in net income in a rising rate environment. Net income would increase in a falling interest rate environment. Net income is also subject to changes in the shape of the yield curve. In general, a flattening yield curve would result in a decline in our earnings due to the compression of earning asset yields and funding rates, while a steepening would result in increased earnings as margins widen.

Several techniques are available to monitor and control the level of interest rate risk. We primarily use earnings simulations modeling to monitor interest rate risk. The earnings simulation model forecasts the effects on net interest income under a variety of interest rate scenarios that incorporate changes in the absolute level of interest rates and changes in the shape of the yield curve. Each increase or decrease in interest rates is assumed to gradually take place over the next 12 months, and then remain stable. Assumptions used to project yields and rates for new loans and deposits are derived from historical analysis. Securities portfolio maturities and prepayments are reinvested in like instruments. Mortgage loan prepayment assumptions are developed from industry estimates of prepayment speeds. Noncontractual deposit repricings are modeled on historical patterns.

The following table shows our projected earnings sensitivity as of September 30, 2007 which is well within our ALCO policy limit of a 10% reduction in net interest income over the ensuing twelve month period.

Change in Interest Rates (basis points)	Estimated % Change in Net Interest Income Over:	
	0 - 12 Months	0 - 24 Months
Down 200 (1)	1.78%	4.97%
Down 200, steepening yield curve (2)	3.31%	11.24%
Up 100 (1)	0.72%	0.36%

Up 200 (1)	1.19%	-5.15%
------------	-------	--------

(1) assumes a parallel shift in the
yield curve

(2) assumes steepening curve whereby short term rates
decline by
200 basis points, while long term rates decline by 50
basis points

Summit Financial Group, Inc. and Subsidiaries

Management's Discussion and Analysis of Financial Condition and Results of Operations

CONTROLS AND PROCEDURES

(a) Restatement

As a result of a review by the Staff of the Securities and Exchange Commission (the "Staff") of Summit's Form 10-K filed for the year ended December 31, 2006, the Company determined that its interpretation with respect to applying the short-cut method of hedge accounting under paragraph 68 of SFAS 133 to certain of its interest rate swaps was incorrect.

In August 2003, Summit entered into four interest rate swaps with notional values totaling \$36 million that were designated as fair value hedges of certain convertible rate advances from the Federal Home Loan Bank ("FHLB"). The terms of the FHLB convertible rate advances include an option of the FHLB to convert the debt's fixed interest rate to a variable rate on a quarterly basis. Summit evaluated these hedging relationships and concluded that the short-cut method of hedge accounting could be applied and the assumption of no ineffectiveness was valid based upon: (a) the criteria in paragraph 68 of SFAS 133 were met, and (b) the conversion options in the FHLB advances were mirrored in the interest rate swaps.

Based on comments received from the Staff, Summit learned that the above interpretation of paragraph 68 is incorrect. The conversion is not specifically listed in paragraph 68, and the presence of that term prohibits the application of the short-cut method of hedge accounting, even if the terms are mirrored between the interest rate swap and the hedged item. Although these hedging relationships would have qualified for hedge accounting if the "long haul" method had been applied, SFAS 133 does not permit the use of the "long haul" method retroactively. Consequently, the restatement assumes hedge accounting was not applied to these derivatives and the related hedged item during the periods under review.

On August 16, 2007, Management, the Audit Committee of the Board of Directors and the Executive Committee of the Board of Directors of Summit Financial Group, Inc. ("Summit" or the "Company") concluded that a restatement of its financial statements and other financial information for the year ended December 31, 2006 and for the quarters ended March 31 and June 30 of 2007 (including the financial statements and other financial information for all comparative periods contained therein, and for the comparative financial statements and other comparative financial information as of and for the quarter ended September 30, 2006 included in this form 10-Q for the quarter ended September 30, 2007) with respect to the accounting for certain derivatives transactions under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended ("SFAS 133") was necessary.

(b) Evaluation of Disclosure Controls and Procedures

Our management, including the Chief Executive Officer and Chief Financial Officer, have conducted as of September 30, 2007, an evaluation of the effectiveness of disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures as of September 30, 2007 were effective.

(c) Remediation of Material Weakness in Internal Control

We have fully remediated the material weakness in our internal control over financial reporting with respect to accounting for derivative transactions used as hedges as of September 30, 2007. The remedial actions included:

- implementing additional management and oversight controls to review and approve hedging strategies and related documentation to ensure hedge accounting is appropriately applied with respect to SFAS 133 and related guidance;

Summit Financial Group, Inc. and Subsidiaries

**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

- retesting our internal financial controls with respect to the deficiencies related to the material weakness to ensure they are operating effectively to ensure compliance with SFAS 133; and
- improving training, education and accounting reviews to ensure that all relevant personnel involved in derivatives transactions understand and apply hedge accounting in compliance with generally accepted accounting principles, including SFAS 133 and its related interpretations.

(d) Changes in Internal Control Over Financial Reporting

Except for the remediation of the material weakness in the accounting for derivative transactions as described above, there were no changes in our internal control over financial reporting during the quarter ended September 30, 2007 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting

Summit Financial Group, Inc. and Subsidiaries

Part II. Other Information

Item 1. Legal Proceedings

We are involved in various legal actions arising in the ordinary course of business. In the opinion of counsel, the outcome of these matters will not have a significant adverse effect on the consolidated financial statements. The Company is also involved in other legal proceedings described more fully below.

On December 26, 2003, two of our subsidiaries, Summit Financial, LLC and Shenandoah Valley National Bank, and various employees of Summit Financial, LLC were served with a Petition for Temporary Injunction and a Bill of Complaint filed in the Circuit Court of Fairfax County, Virginia by Corinthian Mortgage Corporation. The filings allege various claims against Summit Financial, LLC and Shenandoah Valley National Bank arising out of the hiring of former employees of Corinthian Mortgage Corporation (“Corinthian”) and the alleged use of its proprietary information. The individual defendants have also been sued based on allegations arising out of their former employment relationship with Corinthian and their employment with Summit Financial, LLC. In an 8-K filed on November 15, 2006, Summit announced it would close its mortgage operations which at the time operated as Summit Mortgage, a division of Shenandoah Valley National Bank .

The plaintiff seeks damages in the amount proven at trial on each claim and punitive damages in the amount of \$350,000. Plaintiff also seeks permanent and temporary injunctive relief prohibiting the alleged use of proprietary information by Summit Financial and the alleged solicitation of Corinthian’s employees. On January 22, 2004, the Circuit Court of Fairfax County, Virginia denied Corinthian’s petition for a temporary injunction.

On November 20, 2006, Corinthian filed an Amended Complaint which joined Summit Financial Group as a defendant and requested damages in the amount of 20 million dollars. Trial of this matter is currently scheduled to begin on January 14, 2008. Based on the progress of settlement negotiations among the parties, we estimate there is a reasonable possibility of loss in the range of \$0 to \$9 million dollars. The Company has not accrued for this loss and the loss is uninsured.

If the case does not settle, after consultation with legal counsel, we believe that significant and meritorious defenses exist as to all the claims including with respect to plaintiff’s claim for damages. We will continue to evaluate the claims in the Corinthian lawsuit and intend to vigorously defend against them. Management, at the present time, is unable to estimate the impact, if any, an adverse decision may have on our results of operations or financial condition. However, an adverse decision resulting in a large damage award could have a significant negative impact on Summit’s regulatory capital thereby limiting Summit’s near term growth and its ability to pay dividends to its shareholders.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K/A for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K/A are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

SIGNATURES

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

SUMMIT FINANCIAL GROUP, INC.
(registrant)

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

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

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

Date: November 9, 2007