Summit
FINANCIAL GROUP

# 2003 ANNUAL REPORT

STRENGTH • VISION • PROSPERITY

## CORPORATE PROFILE

SUMMIT FINANCIAL GROUP, INC. IS A $791 MILLION FINANCIAL HOLDING COMPANY HEADQUARTERED IN MOOREFIELD, WEST VIRGINIA. THE COMPANY PROVIDES A FULL RANGE OF BANKING SERVICES TO INDIVIDUALS AND BUSINESSES THROUGH ITS THREE WHOLLY OWNED SUBSIDIARY BANKS—SUMMIT COMMUNITY BANK, CAPITAL STATE BANK AND SHENANDOAH VALLEY NATIONAL BANK — HAVING A COMBINED TOTAL OF 13 BANKING OFFICES LOCATED IN WEST VIRGINIA AND VIRGINIA.

SUMMIT ALSO OPERATES SUMMIT FINANCIAL, LLC, A RESIDENTIAL MORTGAGE LOAN ORIGINATOR LOCATED IN HERNDON, VIRGINIA.

CONTENTS

# FINANCIAL HIGHLIGHTS

| (DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | **2003** | 2002 | PERCENT CHANGE |
|---|---|---|---|
| **FOR THE YEAR** | | | |
| Interest income | **$ 41,224** | $ 40,689 | 1.3% |
| Interest expense | **17,530** | 18,842 | -7.0% |
| Net interest income | **23,694** | 21,847 | 8.5% |
| Provision for loan losses | **915** | 1,215 | -24.7% |
| Noninterest income | **5,824** | 1,945 | 199.4% |
| Noninterest expense | **16,884** | 12,607 | 33.9% |
| Net income | **8,208** | 7,238 | 13.4% |
| **AT YEAR END** | | | |
| Assets | **$ 791,465** | $ 671,894 | 17.8% |
| Securities | **235,409** | 212,598 | 10.7% |
| Loans | **509,374** | 419,205 | 21.5% |
| Deposits | **511,801** | 458,648 | 11.6% |
| Shareholders' equity | **57,188** | 52,080 | 9.8% |
| **PER SHARE DATA** | | | |
| Basic earnings | **$ 2.34** | $ 2.06 | 13.6% |
| Diluted earnings | **2.32** | 2.05 | 13.2% |
| Shareholders' equity | **16.30** | 14.87 | 9.6% |
| Cash dividends | **0.43** | 0.375 | 14.7% |
| **RATIOS** | | | |
| Return on average equity | **15.03%** | 15.15% | -0.8% |
| Return on average assets | **1.14%** | 1.15% | -0.9% |
| Dividend payout | **18.4%** | 18.2% | 1.1% |
| Equity to assets | **7.2%** | 7.8% | -7.7% |

## LETTER TO SHAREHOLDERS

Our news is excellent. We achieved record earnings for the 16th year in a row. We also laid the foundation for continuing prosperity. We began a mortgage-loan origination operation; added a full-service branch in one of the fastest growing counties in Virginia; increased the number of our bank product offerings; and completed a new headquarters facility that gave us the additional space we desperately needed for further expansion.

### Shareholder Gains

Nor was our continued success overlooked by the investment community. Shareholders received a 2-for-1 stock split and saw their stock price increase 75.0 percent on a year-to-year basis in 2003. They also experienced a 14.7 percent rise in their cash dividend—from an adjusted 37.5 cents a share in 2002 to 43 cents per share in 2003. It marked the 14th consecutive year of increased dividends.

### Economic Environment

We are particularly pleased with the company's performance given the context in which it took place. The historically low interest-rate environment continued to be a challenge in 2003. Both the local and national economies remained sluggish until late in the year when we saw the first signs of a recovery.

Our superior results affirm our strategy of incorporating the highly personalized services of a community bank with the expanded product offerings of much larger financial institutions. For many years we have tailored our business approach to the distinct needs of the varied personal and business financial needs within the communities we serve. This approach has enabled us to significantly broaden our customer base each year.

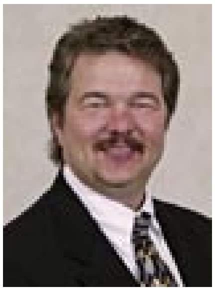
At the same time, we have been able to consolidate and streamline all functions that operate out-of-sight of our customers, such as data processing, check clearing, rendering of monthly statements, auditing and accounting. By doing so, we are achieving efficiency levels that are unusual for a bank of our size.

### Expanding our Market Reach

Last year, we transformed our loan production office in Harrisonburg, Virginia, into a full-fledged,

*"A community bank that adds sophisticated financial products to its personalized way of treating customers has hit upon a winning formula that has substantial growth potential."*

*—Oscar M. Bean, Chairman of the Board*



*"The two principal events of 2003 were the launch of Summit Financial LLC, which makes second mortgages to help customers reduce high-interest credit card debt, and the expansion of our loan office in Harrisonburg, Virginia into a full-fledged banking office."*

*—H. Charles Maddy III, President & Chief Executive Officer*

full-service branch office. This could be very meaningful. It is located in one of the fastest growing counties in Virginia and home to James Madison University. Clearly, the opportunity to make substantial inroads in the banking climate in this area is at hand.

We also sought to expand our income stream in ways not typical for banks of our size. A recent example of this was last year's launch of Summit Financial, LLC, a mortgage-loan originator. It specializes in direct-mail appeals to *prospects across the nation*. We target potential customers with reasonably good credit histories that, most often, want to reduce their credit card and other consumer debt via second-mortgage debt-consolidation loans. This new operation came online late in the third quarter. By the 4th quarter, it had achieved profitability, and we look forward to it making a significant contribution to our income in 2004.

### Recruiting—The Critical Factor

Our focus on both "high-touch" services and cutting-edge product innovations is a sound strategy on paper, but meaningless without first-rate people to implement it. Apart from solid educational credentials and high personal ethics, we look for people who intend to spend their working lives in their local communities. This is especially important in smaller towns as customers want to deal with bankers who will take care of their financial needs year after year.

Consequently, in our recruiting we take extreme care to get the best and brightest both from within and beyond our communities.

Each recruit prospect offers certain advantages. The local person intuitively understands what our customers value most and is thus able to bond with a customer almost immediately. The out-of-towner brings us new ideas, different experiences and a new-found appreciation for the tranquility of small-town life that invigorate our entire corporation. It is a strategy that gives us the best of both worlds.

### Stock Listing

Our stock now meets the requirements for a NASDAQ Small Cap Market, and we intend to seek its listing in 2004. It will bring our stock to the attention of a nation-wide investor audience and give the stock a greater price stability and less volatility from trade to trade.

### Outlook

Our outlook for the year 2004 is quite positive as the economy appears to be on an upswing, and if this continues, we expect another year of superior financial performance.

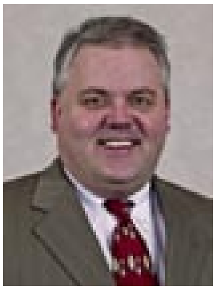
In closing, we want to express our appreciation for the contributions of our talented and hard-working staff. We are also grateful for the loyalty of our shareholders and customers, and commit ourselves to continually earning their trust.

Oscar M. Bean
April 9, 2004

H. Charles Maddy, III
Moorefield, WV

## FUNDAMENTALS BEHIND OUR CONSISTENT GROWTH

- HIGH TOUCH, PERSONALIZED SERVICES
- NEW LINES OF BUSINESS
- NEW BRANCH OFFICES
- NEW PRODUCT INTRODUCTIONS
- EXPANDING MARKETS
- MODEST OVERHEAD, EXCELLENT COST CONTROLS



*"I was pleased we were able to decrease our provision for loan losses by nearly 25 percent last year, which is a testament to the quality of our loan portfolio."*

*—Robert S. Tissue, Senior Vice President & Chief Financial Officer*

In terms of our financial performance, 2003 was our best year ever. We recorded growth in both interest and non-interest income, and our net income set a new record. Our assets increased substantially, and shareholders enjoyed significant gains in both their stock price and dividend.

Net income for 2003 was $8,208,000, or $2.32 per diluted share, up 13.2 percent on an earnings per share basis compared to $7,238,000 or $2.05 per diluted share for the same period of 2002. Operating earnings for 2003, which excludes one time income and expense items, were $7,926,000 or 2.23 per diluted share, up 10.9 percent on an earnings per share basis, as compared to the $7,090,000 or $2.01 per diluted share for the same period of 2002. Earnings have now increased 16 years in a row.

**Diluted Earnings Per Share**


Other financial highlights were:

- An 8.5 percent increase in net interest income. It grew to $23.7 million from $21.8 million. This gain is attributed to a combination of a 1.5% increase in interest income and a 7.0% decline in interest expense.
- A near three-fold increase in non-interest income to $5.8 million from $1.9 million. The majority of this increase reflected the revenues generated by our new mortgage-loan-origination subsidiary, Summit Financial, LLC, which was in operation for only the last four months of 2003.
- A 17.8 percent increase in assets at 2003 year-end to $791.5 million from $671.9 million.
- A 9.8 percent gain in shareholders' equity to $57.2 million from $52.1 million.
- A fractional decline in return on average equity to 15.03 percent from 15.15 percent in 2002.
- A virtual no-change in return on average assets of 1.14 percent in 2003 compared with 1.15 percent in 2002.

**Net Interest Income**
**($—Millions)**


### Revenue Growth

Our goal is to achieve consistent income growth primarily by increasing loan volume and closely managing our net interest margin. In recent years, we have given added attention to increasing loan volumes as prevailing low interest rates made enhancing net interest margins and percentage returns on our investment portfolio difficult.

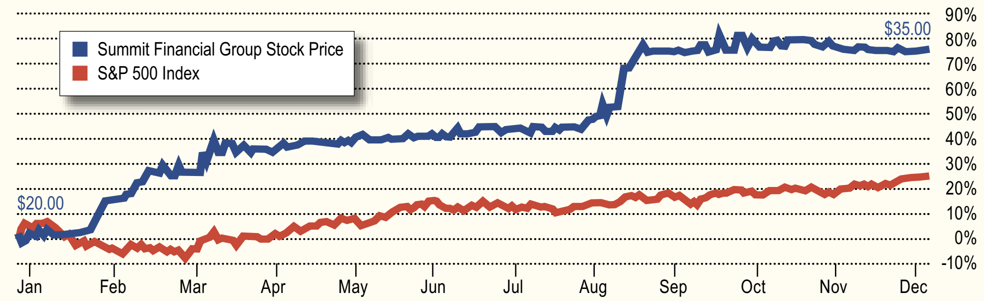
Commercial lending continues to be an important factor in achieving revenue growth. It has historically represented a solid and healthy leg of our business, and 2003 was no exception. While our overall lending remained solid throughout the recent economic downturn, we were pleased to note exceptionally strong commercial lending in the fourth quarter of 2003 and believe it bodes well for 2004.

## OPERATIONS

Internet banking is one of the many additional services we offer our customers. It provides them many advantages, including, for example, the convenience of paying their bills or checking their account balances from the privacy of their own homes. In addition, we offer debit cards, adjustable rate mortgages and home equity lines of credit. These added services have given us a decisive competitive advantage over other community banks in our markets.

Comparative Performance
(Jan. 1, 2003 - Dec. 31, 2003)

Our stock price outperformed the S&P 500 index by a margin of 2.9-to-1 last year. Our closing stock price rose 75.0% while the S&P index gained 26.4% from January 1, 2003 to December 31, 2003.




### Revenue Diversity

Traditionally, our company has relied on net interest income as our primary income. Over the past several years we have been developing multiple sources of revenue, which proved especially important in 2003. We launched a loan-origination operation last year. It enabled us to increase our non-interest income by $3.9 million over that of 2002.

Going forward, we expect a further increase in our fee revenue through a partnership we began in 2003 to deliver selected investment services, with an initial rollout in our Virginia banking offices.

**Non-Interest Income**
**($—Millions)**


### Asset Quality

Our asset quality improved overall last year. We were able to reduce our provision for loan losses by 24.7 percent to $915,000, down from $1.22 million. By maintaining tight controls on credit standards, we were able to maintain our traditionally low ratio of non-performing assets to total assets, which was 0.28 percent at year-end 2003. This superlative ratio places us well above the average of our peer banking group.

### New Headquarters

Last year, we completed the construction of a new headquarters facility in Moorefield, WV. This project was necessitated by our growth in recent years. The new building will enable us to operate with greater efficiency. It also gives us the physical space to accommodate more professional people experienced in marketing and new product development, which are disciplines needed to continue our growth.

### Shareholder Benefits

The market price of our stock increased 75.0 percent between the closing price of $20.00 on December 31, 2002 (adjusted for the 2-for-1 stock split in March of 2003) and the 2003 year-end closing price of $35.00.

Shareholder dividends increased 14.7 percent in 2003 to 43 cents a share from 37.5 cents a share paid during 2002. It was the 14th consecutive year of increased dividends.

**Dividends Per Share**

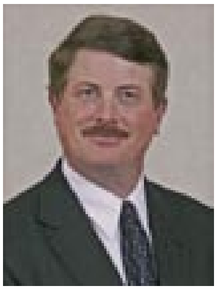

The essence of our business is personalized, community banking to which we add many sophisticated banking products and services that were once the exclusive domain of huge, multi-national banks. Maintaining our community-banking identity is an absolute must, because it is our strength.

### A Stark Contrast

When mega-banks merge or acquire one another, they immediately set out to change their banks' name to that of the surviving corporation. In

## DIVERSIFIED CLIENT BASE

Commercial loans to small businesses reflected a sharp increase last year, particularly in the fourth quarter as the economy turned stronger. Should this economic resurgence continue in 2004, we anticipate achieving another record year.



*"Maintaining a close watch on costs and centralizing and computerizing all back office operations has enabled us to accommodate additional customers without a proportionate increase in overhead."*

*—Scott Jennings, Chief Operating Officer*

so doing, they lose their community identity, often with disastrous results. Many of their customers have wearied of the constant name and personnel changes that inevitably follow. They grow skeptical of what benefits, if any, they might receive from the merger or acquisition.

Certain facts become increasingly evident every time such combinations occur. Their customers know they will have to deal with many new faces, particularly at the loan decision-making level. They will get a new fee schedule that rarely works in their favor. Many will also sense that their new bank is enamored more with size than people. As a result, modest-sized depositors and small businesses often count for little, which can drive customers away from these large banks, particularly in smaller communities. Consequently, each merger of banking giants results in their customers' increased anxiety, and many seek new banking relationships. This plays into our strengths. In effect, these mergers create a new market opportunity for us.

**Return on Average Equity**


## Our Strategy

With regard to market penetration, we seek to obtain an optimum presence rather than a maximum presence. The latter would be difficult and costly to achieve because of the law of diminishing returns and the traditional loyalty that community residents have with other local community banks.

To compete successfully for customers of the mega-city branch offices in our area, we emphasize our highly-personalized approach that includes an increasing number of sophisticated financial products that differentiate us from other community banks. We believe our customers must never be limited to traditional small-town banker thinking. Consequently, we offer such advantages as internet banking with full bill-pay capabilities, debit cards, adjustable rate mortgages and home equity lines of credit with check access.

To increase our efficiency on delivering these additional products, we increased our personnel training. We also consolidated our back-office operations for all of our 13 retail banking offices into one location. We continue to seek other ways to streamline and centralize those parts of our operation that are not visible to our customers. These include check imaging, data processing and accounting. Our philosophy is that all functions customers cannot see should take place in one computerized, central location.

We create further efficiencies by exposing our present customers to additional products and services such as debit cards and internet operations. As a result, revenue per customer increases and thus proportionate costs per customer decrease. Debit cards, for example, are much less costly to process than paper checks. Our move to check imaging allows customers to view canceled checks online while saving us the cost of returning canceled checks to customers.

## BROAD–BASE MARKETS

We are presently expanding our marketing efforts and including even more sophisticated banking products to meet increasing customer demands, especially in the growing markets in northern Virginia where we have recently increased our presence.

*"We launched a mortgage-origination, debt consolidation program targeted to credit-worthy individuals with high credit card debt. By taking out a second mortgage on their homes to pay off that debt, many were able to reduce their monthly payments by half because of the difference in interest rates, and we were able to substantially increase our non-interest income."*

*—Patrick Frye, Chief Credit Officer*

## New Product Line

Perhaps the most significant accomplishment of 2003 was the creation of Summit Financial, LLC, a wholly-owned subsidiary. The unit originates–with the intent to resell–residential second-mortgage debt-consolidation loans marketed *throughout the nation*. It also originates residential first-mortgage loans for our customers in northern Virginia.

Primarily customers are homeowners with both good incomes and homes with substantial equity. We target customers based on credit scores, seeking those who may be somewhat overextended, but whose credit remains sound. In typical cases, borrowers use our second-mortgage loans to pay off their high-interest debt and substitute it for much lower interest rates on their second mortgages. After originating these loans, we sell them to secondary-market investors.

We reach prospects through direct-mail appeals and thus far have been extremely successful in winning the business of those who respond to our mailings. The success of this campaign can be attributed both to the talent of our employees taking prospect calls and to the value we are able to offer these prospects.

The new mortgage-origination operation was established in the third quarter and by the fourth quarter it had achieved profitability. We expect it to make significant contributions to our earnings in 2004. Though the business unit was operational for only four months during 2003, it played a large role in the dramatic increase in our non-interest income, which grew nearly 200 percent last year.

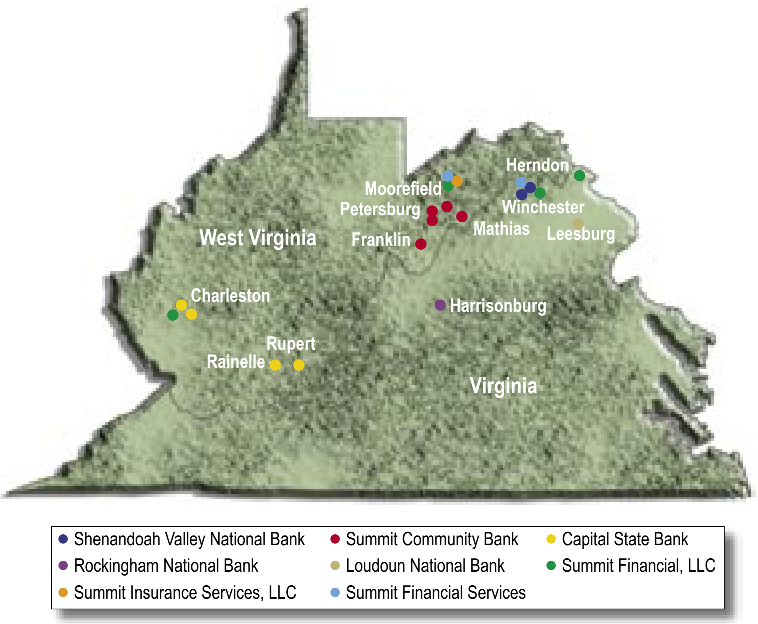

## Markets and Growth Prospects

The diversity of our economic base is an asset that serves us well. Our markets, taken together, provided a solid base for growth in 2003. Even our operations located in more challenging economic environments increased their contributions to earnings last year, which helped us capitalize on the significant growth opportunities elsewhere in our banking territories.

Our new location in Harrisonburg, Virginia, began to prosper in 2003. Originally launched as a loan-production office, it became a full-service banking facility at mid-year 2003. Since then it has had solid success generating both loans and deposits. Its prospects are enhanced by a strong local economy, which is tied to the rapid growth in manufacturing in that area and to the presence of fast-growing James Madison University. We seek to achieve further growth by opening a branch near its campus to attract college-student business, which historically has been profitable.

Consequently, our greater opportunities for growth are found among dissatisfied customers of mega-banks by providing them our "personal touch" together with products and services that match their needs, and by expanding further into Virginia, which is experiencing above-average growth. ■

## LOCATIONS




### SUMMIT COMMUNITY BANK

**Moorefield**
310 North Main Street
Moorefield, WV 26836
(304) 530-1000

**Mathias**
One Main Street
Mathias, WV 26812
(304) 897-5977

**Petersburg**
4 North Main Street
Petersburg, WV 26847
(304) 257-1244

**Petersburg**
96 South Grove Street
Petersburg, WV 26847
(304) 257-1551

**Franklin**
626 Main Street
Franklin, WV 26847
(304) 358-2388

**Web Address**
www.summitcommunitybank.com

### CAPITAL STATE BANK

**Charleston**
Southridge Centre
2402 Mountaineer Boulevard
Charleston, WV 25309
(304) 746-4600

**Charleston**
620 Virginia Street, East
Charleston, WV 25301
(304) 343-9200

**Rainelle**
28 Main Street
Rainelle, WV 25962
(304) 438-6171

**Rupert**
910 Clay Street
Rupert, WV 25984
(304) 392-6314

**Web Address**
www.capstate.com

### SHENANDOAH VALLEY NATIONAL BANK

**Winchester**
100 West Jubal Early Drive
Winchester, VA 22601
(540) 678-0300

**Wal-Mart (Winchester)**
2350 South Pleasant Valley Road
Winchester, VA 22601
(540) 667-9393

**Web Address**
www.shenandoahvnb.com

### LOUDOUN NATIONAL BANK

9-J Catoctin Circle, SW
Leesburg, VA 20175
(703) 777-6556

**Web Address**
www.loudounnationalbank.com

### ROCKINGHAM NATIONAL BANK

182 Neff Avenue, W-11
Harrisonburg, VA 22801
(540) 437-0500

**Web Address**
www.rockinghamnationalbank.com

### SUMMIT FINANCIAL, LLC

13530 Dulles Technology Drive
Suite 600
Herndon, VA 20171
(800) 550-3588

### SUMMIT INSURANCE SERVICES, LLC

DBA Sager Insurance Agency
107 South Main Street
Moorefield, WV 26836
(304) 530-2255

### SUMMIT FINANCIAL SERVICES

**Moorefield**
310 North Main Street
Moorefield, WV 26836
(304) 530-0560

**Winchester**
100 West Jubal Early Drive
Winchester, VA 22601
(540) 678-0300

TABLE OF CONTENTS

## SELECTED FINANCIAL DATA

(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| FOR THE YEAR ENDED (UNLESS OTHERWISE NOTED) | **2003** | 2002 | 2001 | 2000 | 1999 |
|---|---|---|---|---|---|
| **SUMMARY OF OPERATIONS** | | | | | |
| Interest income | **$ 41,224** | $ 40,689 | $ 37,919 | $ 32,264 | $ 25,114 |
| Interest expense | **17,530** | 18,842 | 20,438 | 18,276 | 12,234 |
| Net interest income | **23,694** | 21,847 | 17,481 | 13,988 | 12,880 |
| Provision for loan losses | **915** | 1,215 | 830 | 558 | 370 |
| Net interest income after provision for loan losses | **22,779** | 20,632 | 16,651 | 13,430 | 12,510 |
| Noninterest income | **5,824** | 1,945 | 1,810 | 1,228 | 821 |
| Noninterest expense | **16,884** | 12,607 | 10,737 | 9,865 | 8,718 |
| Income before income taxes | **11,719** | 9,970 | 7,724 | 4,793 | 4,613 |
| Income taxes | **3,511** | 2,732 | 2,458 | 1,543 | 1,570 |
| Net income | **$ 8,208** | $ 7,238 | $ 5,266 | $ 3,250 | $ 3,043 |
| **BALANCE SHEET DATA (AT YEAR END)** | | | | | |
| Assets | **$791,465** | $671,894 | $591,757 | $481,239 | $385,767 |
| Securities | **235,409** | 212,598 | 207,117 | 176,741 | 112,770 |
| Loans | **509,374** | 419,205 | 347,526 | 274,153 | 238,299 |
| Deposits | **511,801** | 458,648 | 396,205 | 345,962 | 297,139 |
| Short-term borrowings | **49,714** | 20,191 | 24,033 | 9,391 | 32,348 |
| Long-term borrowings and subordinated debentures | **168,255** | 137,396 | 123,445 | 81,086 | 17,943 |
| Shareholders' equity | **57,188** | 52,080 | 44,287 | 39,773 | 35,083 |
| **PER SHARE DATA** | | | | | |
| Basic earnings | **$ 2.34** | $ 2.06 | $ 1.50 | $ 0.93 | $ 0.85 |
| Diluted earnings | **2.32** | 2.05 | 1.50 | 0.93 | 0.85 |
| Shareholders' equity (at year end) | **16.30** | 14.87 | 12.62 | 11.33 | 9.95 |
| Cash dividends | **0.43** | 0.375 | 0.35 | 0.30 | 0.24 |
| **PERFORMANCE RATIOS** | | | | | |
| Return on average equity | **15.03%** | 15.15% | 12.38% | 8.93% | 8.52% |
| Return on average assets | **1.14%** | 1.15% | 1.00% | 0.75% | 0.88% |
| Dividend payout | **18.4%** | 18.2% | 23.3% | 32.5% | 27.3% |
| Equity to assets | **7.2%** | 7.8% | 7.5% | 8.3% | 9.1% |

**DESCRIPTION OF BUSINESS**

We are a $791 million community-based financial holding company that provides a full range of banking and other financial services to individuals and businesses through our three wholly owned banks – Summit Community Bank, Capital State Bank and Shenandoah Valley National Bank – having a combined total of 13 banking offices located in West Virginia and Virginia. In addition, our new mortgage banking venture, Summit Financial, LLC, originates mortgage loans to consumers located throughout the United States.

**FORWARD LOOKING STATEMENTS**

This annual report contains certain forward-looking statements (as defined in the Private Securities Litigation Act of 1995), which reflect our beliefs and expectations based on information currently available. These forward-looking statements are inherently subject to significant risks and uncertainties, including changes in general economic and financial market conditions, our ability to effectively carry out our business plans and changes in regulatory or legislative requirements. Other factors that could cause or contribute to such differences are changes in competitive conditions and continuing consolidation in the financial services industry. Although we believe the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

**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.

During 2003, interest rates reached record low levels. Although our net interest income actually increased in 2003, our net interest margin declined compared to 2002. To offset the decline in net interest margin, we are entering other business opportunities which earn noninterest income. Thus, in the second half of 2003, we started our mortgage banking segment, Summit Financial, LLC ("SFLLC"). SFLLC originates for resale loans to customers throughout the United States from its headquarters in Herndon, Virginia.

**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 1 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 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 1 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.

With the adoption of SFAS No. 142 on January 1, 2002, we discontinued the amortization of goodwill resulting from acquisitions. Goodwill is now 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

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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 of 2003, we completed the required annual impairment test and determined that no impairment write-offs were necessary. We can not assure you that future goodwill impairment tests will not result in a charge to earnings.

See Notes 1 and 9 of the accompanying consolidated financial statements for further discussion of our intangible assets, which include goodwill.

### 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:

| (IN THOUSANDS) | **2003** | 2002 | 2001 |
|---|---|---|---|
| Community banking | **$8,540** | $7,326 | $5,552 |
| Mortgage banking | **96** | 13 | (19) |
| Parent | **(428)** | (101) | (267) |
| Consolidated net income | **$8,208** | $7,238 | $5,266 |

### RESULTS OF OPERATIONS

#### Earnings Summary

Net income for the three years ended December 31, 2003, 2002 and 2001, was $8,208,000, $7,238,000, and $5,266,000 respectively. On a per share basis, diluted net income was $2.32 in 2003 compared to $2.05 in 2002, and $1.50 in 2001. Return on average equity was 15.03% in 2003 compared to 15.15% in 2002, and 12.38% in 2001. Return on average assets for the year ended December 31, 2003 was 1.14% compared to 1.15% in 2002 and 1.00% in 2001. 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 2003, 2002 and 2001 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, adjusted to a fully tax equivalent basis, totaled $24,812,000, $22,873,000 and $18,013,000 for the years ended December 31, 2003, 2002 and 2001, respectively. Our net interest margin was 3.63% for 2003 compared to 3.86% and 3.65% for 2002 and 2001, respectively. The net interest margin recognizes earning asset growth by expressing net interest income as a percentage of total average earning assets. Our net interest margin decreased 23 basis points in 2003 as the yields on taxable securities and loans declined 128 and 83 basis points, respectively. Consistent with the experience of many other financial institutions, this margin compression is the result of earning assets repricing at historically low yields, while at the same time, we have limited ability to decrease correspondingly the rates paid on interest bearing liabilities. Further contributing to this situation are historically high prepayments of loans and mortgage-backed securities which necessitate the reinvestment of significant cash flows at rates well below each respective portfolio's overall yield. The increase in our net interest margin of 21 basis points from 2001 to 2002 was primarily due to growth in our volumes of interest earning assets, and the continued downturn of the economy, which pushed rates down, thus lowering our cost of funds.

As identified in Table II, tax equivalent net interest income grew $1,939,000 and $4,860,000 during 2003 and 2002, respectively, due primarily to the substantial growth in the volumes of the interest earning assets in both years.

If market interest rates were to rise significantly in 2004, the spread between interest earning assets and interest bearing liabilities could narrow even more, thus negatively impacting our net interest income. 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.

**TABLE I – AVERAGE DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY, INTEREST EARNINGS & EXPENSES, AND AVERAGE YIELDS/RATES**

(DOLLARS IN THOUSANDS)

| | 2003 | | | 2002 | | | 2001 | | |
|---|---|---|---|---|---|---|---|---|---|
| | **AVERAGE BALANCES** | **EARNINGS/ EXPENSE** | **YIELD/ RATE** | AVERAGE BALANCES | EARNINGS/ EXPENSE | YIELD/ RATE | AVERAGE BALANCES | EARNINGS/ EXPENSE | YIELD/ RATE |
| **ASSETS** | | | | | | | | | |
| **Interest earning assets** | | | | | | | | | |
| Loans, net of unearned interest (1) | | | | | | | | | |
| Taxable | **$455,526** | **$30,842** | **6.77%** | $376,745 | $28,626 | 7.60% | $301,030 | $25,592 | 8.50% |
| Tax-exempt (2) | **5,933** | **489** | **8.24%** | 6,268 | 529 | 8.44% | 3,201 | 320 | 10.00% |
| Securities | | | | | | | | | |
| Taxable | **175,821** | **7,952** | **4.52%** | 169,728 | 9,840 | 5.80% | 164,303 | 10,897 | 6.63% |
| Tax-exempt (2) | **41,537** | **2,889** | **6.96%** | 34,968 | 2,572 | 7.36% | 18,526 | 1,385 | 7.48% |
| Federal funds sold and interest bearing deposits with other banks | **5,368** | **170** | **3.17%** | 5,458 | 148 | 2.71% | 7,002 | 257 | 3.67% |
| | **684,185** | **42,342** | **6.19%** | 593,167 | 41,715 | 7.03% | 494,062 | 38,451 | 7.78% |
| **Noninterest earning assets** | | | | | | | | | |
| Cash and due from banks | **8,970** | | | 8,981 | | | 8,872 | | |
| Bank premises and equipment | **14,168** | | | 13,079 | | | 12,533 | | |
| Other assets | **19,746** | | | 16,966 | | | 11,552 | | |
| Allowance for loan losses | **(4,325)** | | | (3,649) | | | (2,777) | | |
| **Total assets** | **$722,744** | | | $628,544 | | | $524,242 | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | | | | | | |
| **Liabilities** | | | | | | | | | |
| **Interest bearing liabilities** | | | | | | | | | |
| Interest bearing demand deposits | **$100,084** | **$ 793** | **0.79%** | $ 93,001 | $ 1,302 | 1.40% | $ 74,430 | $ 1,889 | 2.5% |
| Savings deposits | **46,985** | **256** | **0.54%** | 45,766 | 550 | 1.20% | 40,052 | 893 | 2.2% |
| Time deposits | **280,064** | **8,950** | **3.20%** | 247,587 | 9,712 | 3.92% | 224,068 | 11,984 | 5.3% |
| Short-term borrowings | **31,907** | **441** | **1.38%** | 15,973 | 326 | 2.04% | 11,879 | 452 | 3.8% |
| Long-term borrowings and subordinated debentures | **158,040** | **7,090** | **4.49%** | 134,384 | 6,952 | 5.17% | 93,231 | 5,220 | 5.6% |
| | **617,080** | **17,530** | **2.84%** | 536,711 | 18,842 | 3.51% | 443,660 | 20,438 | 4.6% |
| **Noninterest bearing liabilities** | | | | | | | | | |
| Demand deposits | **46,166** | | | 39,364 | | | 33,679 | | |
| Other liabilities | **4,870** | | | 4,687 | | | 4,383 | | |
| Total liabilities | **668,116** | | | 580,762 | | | 481,722 | | |
| **Shareholders' equity** | **54,628** | | | 47,782 | | | 42,520 | | |
| **Total liabilities and shareholders' equity** | **$722,744** | | | $628,544 | | | $524,242 | | |
| **NET INTEREST EARNINGS** | | **$24,812** | | | $22,873 | | | $18,013 | |
| **NET INTEREST YIELD ON EARNING ASSETS** | | | **3.63%** | | | 3.86% | | | 3.65% |

(1) For purposes of this table, non-accrual loans are included in average loan balances. Included in interest and fees on loans are loan fees of $416,000, $288,000 and $227,000 for the years ended December 31, 2003, 2002 and 2001 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 $1,118,000, $1,026,000 and $533,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

**TABLE II – CHANGES IN INTEREST MARGIN ATTRIBUTABLE TO RATE AND VOLUME**
(DOLLARS IN THOUSANDS)

| | 2003 VERSUS 2002 INCREASE (DECREASE) DUE TO CHANGE IN: | | | 2002 VERSUS 2001 INCREASE (DECREASE) DUE TO CHANGE IN: | | |
|---|---|---|---|---|---|---|
| | VOLUME | RATE | NET | VOLUME | RATE | NET |
| **Interest earned on:** | | | | | | |
| Loans | | | | | | |
| Taxable | $ 5,557 | $(3,341) | $ 2,216 | $ 5,956 | $(2,922) | $ 3,034 |
| Tax-exempt | (28) | (12) | (40) | 266 | (57) | 209 |
| Securities | | | | | | |
| Taxable | 342 | (2,230) | (1,888) | 351 | (1,408) | (1,057) |
| Tax-exempt | 463 | (146) | 317 | 1,210 | (23) | 1,187 |
| Federal funds sold and interest bearing deposits with other banks | (2) | 24 | 22 | (50) | (59) | (109) |
| Total interest earned on interest earning assets | 6,332 | (5,705) | 627 | 7,733 | (4,469) | 3,264 |
| **Interest paid on:** | | | | | | |
| Interest bearing demand deposits | 93 | (602) | (509) | 395 | (982) | (587) |
| Savings deposits | 15 | (309) | (294) | 113 | (456) | (343) |
| Time deposits | 1,176 | (1,938) | (762) | 1,163 | (3,435) | (2,272) |
| Short-term borrowings | 246 | (131) | 115 | 125 | (251) | (126) |
| Long-term borrowings and subordinated debentures | 1,131 | (993) | 138 | 2,155 | (423) | 1,732 |
| Total interest paid on interest bearing liabilities | 2,661 | (3,973) | (1,312) | 3,951 | (5,547) | (1,596) |
| **Net interest income** | $ 3,671 | $(1,732) | $ 1,939 | $ 3,782 | $ 1,078 | $ 4,860 |

**Provision for Loan Losses**

The provision for loan losses represents our determination of the amount necessary to be charged against the current period's earnings in order to maintain the allowance for loan losses at a level which is considered adequate in relation to the estimated risk inherent in the loan portfolio. The provision for loan losses for each of the years ended December 31, 2003, 2002 and 2001 totaled $915,000, $1,215,000 and $830,000, respectively. As further discussed in the Loan Portfolio and Risk Elements sections of this analysis, we decreased our provision for loan losses $300,000 in 2003, and increased the provision for loan losses $385,000 in 2002. An analysis of the components comprising the allowance for loan losses for each of the past five years, including charge offs and recoveries within each significant loan classification, is presented in Table VIII.

**Noninterest Income**

On the strength of mortgage origination revenue, noninterest income increased to $5,824,000 in 2003, compared to $1,945,000 in 2002 and $1,810,000 in 2001. Mortgage origination revenue grew 779% from 2002 and includes mortgage loan origination and sales activity conducted through SFLLC.

The growth in mortgage origination revenue during 2003 was a result of our establishing a presence in the 2nd mortgages market via direct mail marketing from SFLLC. Loans originated for resale in 2003 totaled $62.7 million, while the total sales of this type of loans totaled $57.2 million.

Noninterest income totaled 0.81%, 0.31% and 0.34% of average assets, in 2003, 2002, and 2001, respectively. Also included in noninterest income for 2003 are gains on securities of $212,000, and $336,000 in gains on sales of assets. Included in noninterest income for 2002 is $140,000 in securities losses and $357,000 in mortgage origination revenue. Further detail regarding noninterest income follows in Table III. Also, refer to Note 17 of the accompanying consolidated financial statements for our segment information.

**Noninterest Expense**

Noninterest expense totaled $16,884,000, $12,606,000 and $10,737,000 or 2.34%, 2.01% and 2.04% of average assets for each of the years ended December 31, 2003, 2002 and 2001, respectively. Total noninterest expense increased $4,278,000 in 2003 compared to 2002 and $1,869,000 in 2002 compared to 2001. The primary factor contributing to growth in noninterest expense in both 2003 and 2002 was an increase in salaries and employee benefits expense. The 2003 increase was substantially due to the formation of SFLLC, and its staffing requirements. In 2002, the increase was a result of general merit raises, and the addition of new staff positions required as a result of our growth. Two other major contributors to the increase in total noninterest expense during 2003 were advertising and postage expense. Combined, these expenses increased 296%, which resulted from SFLLC's direct mail method of obtaining customers. Further detail regarding noninterest expense follows in Table III. Also, refer to Note 17 of the accompanying consolidated financial statements for our segment information.

**TABLE III – NONINTEREST INCOME AND EXPENSE**
(DOLLARS IN THOUSANDS)

| | 2003 | 2002 | 2001 |
|---|---|---|---|
| **Noninterest income** | | | |
| Insurance commissions | $ 239 | $ 187 | $ 105 |
| Service fees | 1,586 | 1,341 | 1,055 |
| Mortgage origination revenue | 3,138 | 357 | 73 |
| Securities gains (losses) | 212 | (140) | 379 |
| Gain (loss) on sale of assets | 336 | (9) | 12 |
| Other | 313 | 209 | 186 |
| **Total** | $ 5,824 | $ 1,945 | $ 1,810 |
| **Noninterest expense** | | | |
| Salaries and employee benefits | $ 9,004 | $ 6,864 | $ 5,670 |
| Net occupancy expense | 868 | 784 | 706 |
| Equipment expense | 1,320 | 1,248 | 1,171 |
| Supplies | 481 | 475 | 330 |
| Professional fees | 565 | 434 | 454 |
| Postage | 985 | 195 | 157 |
| Advertising expenses | 773 | 249 | 204 |
| Amortization of intangibles | 151 | 151 | 282 |
| Other | 2,737 | 2,206 | 1,763 |
| **Total** | $16,884 | $12,606 | $10,737 |

### Income Tax Expense

Income tax expense for the three years ended December 31, 2003, 2002 and 2001 totaled $3,511,000, $2,732,000 and $2,457,000, 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

Total average assets in 2003 were $722,744,000, an increase of 15.0% over 2002's average of $628,544,000. Similarly, average assets grew 19.9% in 2002, from $524,242,000 in 2001. The primary growth in 2003 was in loans throughout our company during the year. Significant changes in the components of our balance sheet in 2003 and 2002 are discussed below.

### Securities

Securities comprised approximately 29.7% of total assets at December 31, 2003 compared to 31.6% at December 31, 2002. Average securities approximated $217,358,000 for 2003 or 6.2% more than 2002's average of $204,696,000. The growth in our securities portfolio in 2003 reflects increased investments primarily in mortgage backed securities, which were funded both by increased deposits, primarily at Shenandoah, and increased FHLB borrowings. 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 SFAS No. 115, 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. Due to a decrease in the credit rating of one of our corporate bonds during 2002, we recognized a $213,000 write down on that security, as we felt that the loss was other than temporary. At December 31, 2003, 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, 2003, together with the weighted average yields for each range of maturity, are summarized in Table IV. The stated average yields are actual yields and are not stated on a tax equivalent basis.

**TABLE IV – 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 | $ 3,912 | 3.7% | $ 7,877 | 4.2% | $ 9,535 | 5.7% | $ – | – |
| Mortgage backed securities | 51,194 | 4.7% | 69,597 | 4.6% | 9,954 | 4.8% | 1,285 | 5.7% |
| State and political subdivisions | 1,728 | 6.6% | 3,648 | 6.5% | 9,944 | 6.4% | 29,200 | 7.1% |
| Corporate debt securities | 4,812 | 6.1% | 11,357 | 5.7% | 347 | 6.8% | – | – |
| Other | – | – | – | – | – | – | 18,458 | 1.8% |
| Total | $61,646 | 4.8% | $92,479 | 4.8% | $29,780 | 5.6% | $48,943 | 5.3% |

**Loan Portfolio**

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

**TABLE V – LOANS BY TYPE**
(DOLLARS IN THOUSANDS)

| | **2003** | | 2002 | | 2001 | | 2000 | | 1999 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **AMOUNT** | **PERCENT OF TOTAL** | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL |
| Commercial, financial, and agricultural | **$256,251** | **50.9%** | $206,567 | 49.4% | $148,041 | 42.8% | $108,114 | 39.4% | $ 78,894 | 33.1% |
| Real estate – construction | **2,369** | **0.5%** | 4,494 | 1.1% | 2,394 | 0.7% | 2,729 | 1.0% | 2,012 | 0.8% |
| Real estate – mortgage | **196,135** | **39.0%** | 161,006 | 38.5% | 149,050 | 43.1% | 124,326 | 45.3% | 116,779 | 49.0% |
| Consumer | **40,043** | **8.0%** | 39,841 | 9.5% | 40,777 | 11.8% | 36,983 | 13.5% | 38,091 | 16.0% |
| Other | **8,223** | **1.6%** | 6,390 | 1.5% | 5,750 | 1.6% | 2,001 | 0.8% | 2,524 | 1.1% |
| Total loans | **$503,021** | **100.0%** | $418,298 | 100.0% | $346,012 | 100.0% | $274,153 | 100.0% | $238,300 | 100.0% |

Total net loans averaged $461,459,000 in 2003 and comprised 63.8% of total average assets compared to $383,013,000 or 60.9% of total average assets during 2002. The increase in the dollar volume of loans is primarily attributable to two factors, the continuation of our strategy, which began in 1996, to aggressively seek quality commercial and real estate loans, and also the formation of SFLLC in 2003 to originate and sell 2nd mortgages. At December 31, 2003, SFLLC had $6,618,000 of loans that had been originated and in the process of being sold. These loans are included on our balance sheet.

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, 2003.

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.

**Property Held for Sale**

At December 31, 2003, we had $480,000 classified as property held for sale. This consists of a piece of property that we foreclosed on. See Note 7 of the accompanying consolidated financial statements for more details. SFAS No. 144 requires that we record this property at the lower of carrying value or estimated fair value. Our anticipated sale price of this property is slightly greater than our carrying value, thus no impairment charges have been recorded.

**Deposits**

Total deposits at December 31, 2003 increased $53,154,000 or 11.6% compared to December 31, 2002. Average deposits increased $40,779,000, or 10.6% during 2003. This increase resulted primarily from the growth of Shenandoah's deposits.

Included in total deposits at December 31, 2003 and 2002 are brokered deposits totaling $33,193,000 and $7,380,000, respectively. Brokered deposits represent certificates of deposit acquired through a third party.

See Table I for average deposit balance and rate information by deposit type for 2003, 2002 and 2001 and Note 10 of the accompanying consolidated financial statements for a maturity distribution of time deposits as of December 31, 2003.

**Borrowings**

*Lines of Credit:* We have available lines of credit from various correspondent banks totaling $18,700,000 at December 31, 2003. These lines are utilized when temporary day to day funding needs arise. They are reflected on the consolidated balance sheet as short-term borrowings. We also have remaining available lines of credit from the Federal Home Loan Bank totaling $45,780,000 at December 31, 2003. 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.

*Short-term Borrowings:* Total short-term borrowings increased $29,523,000 from $20,191,000 at December 31, 2002 to $49,714,000 at December 31, 2003. See Note 11 of the accompanying consolidated financial statements for additional disclosures regarding our short-term borrowings.

*Long-term Borrowings:* Total long-term borrowings of $164,646,000 at December 31, 2003, consisting primarily of funds borrowed on available lines of credit from the Federal Home Loan Bank, increased $30,859,000 compared to the $133,787,000 outstanding at December 31, 2002. These borrowings were made principally to fund our loan growth. Refer to Note 11 of the accompanying consolidated financial statements for additional information regarding our long-term borrowings.

**ASSET QUALITY**

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

**TABLE VI - NONPERFORMING ASSETS**

(DOLLARS IN THOUSANDS)

| | **2003** | 2002 | 2001 | 2000 | 1999 |
|---|---|---|---|---|---|
| Nonaccrual loans | **$1,014** | $ 917 | $ 788 | $ 568 | $ 522 |
| Accruing loans past due 90 days or more | **342** | 574 | 328 | 267 | 476 |
| Restructured loans | **–** | – | – | – | – |
| Total nonperforming loans | **1,356** | 1,491 | 1,116 | 835 | 998 |
| Foreclosed properties | **497** | 81 | 81 | – | – |
| Nonaccrual securities | **396** | 421 | – | – | – |
| Total nonperforming assets | **$2,249** | $ 1,993 | $ 1,197 | $ 835 | $ 998 |
| Total nonperforming loans as a percentage of total loans | **0.27%** | 0.36% | 0.32% | 0.30% | 0.42% |
| Total nonperforming assets as a percentage of total assets | **0.28%** | 0.30% | 0.20% | 0.17% | 0.26% |

## MANAGEMENT'S DISCUSSION AND ANALYSIS

As illustrated in Table VI, the quality of our loan portfolio remains sound. Total nonaccrual loans and accruing loans past due 90 days or more decreased from $1,491,000 at December 31, 2002 to $1,356,000 at December 31, 2003, remaining at historically moderate levels in relation to the loan portfolio's size and substantially below recent industry averages. Refer to Note 6 of the accompanying consolidated financial statements for a discussion of impaired loans which are included in the above balances.

Included in the net balance of loans are non-accrual loans amounting to $1,014,000 and $917,000 at December 31, 2003 and 2002, respectively. If these loans had been on accrual status throughout 2003, the amount of interest income that we would have recognized would have been $83,000. The actual amount of interest income recognized in 2003 on these loans was $39,000.

We maintain an allowance for loan losses at a level considered adequate to provide for losses that can be reasonably anticipated. We conduct quarterly evaluations of our loan portfolio to determine its adequacy. The evaluation is based on assessments of specifically identified loans, loss experience factors, current and anticipated economic conditions and other factors to identify and estimate inherent losses from homogeneous pools of loans. In addition, we conduct comprehensive, ongoing reviews of our loan portfolio, which encompasses the identification of all potential problem credits to be included on an internally generated watch list.

The identification of loans for inclusion on the watch list is facilitated 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 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. Based on the results of these reviews, specific reserves for potential losses are identified and the allowance for loan losses is adjusted appropriately through a provision for loan losses.

While there may be some loans or portions of loans identified as potential problem credits which are not specifically identified as either nonaccrual or accruing loans past due 90 or more days, we consider them to be insignificant to the overall disclosure and are, therefore, not specifically quantified within this discussion. In addition, we feel these additional loans do not represent or result from trends or uncertainties which we reasonably expect will materially impact future operating results, liquidity or capital resources. Also, these loans do not represent material credits about which we are aware of any information which would cause the borrowers to not comply with the loan repayment terms.

We allocate specific reserves to non-performing loans based on the quarterly evaluation of expected loan loss reserve requirements. In addition, a portion of the reserve is determined through the use of loan loss experience factors which do not provide for identification of specific potential problem loans. As noted above, some of the loans, which are not deemed significant, are included in the watch list of potential problem loans and have specific reserves allocated to them.

The allocated portion of the subsidiary banks' allowance for loan losses is established on a loan-by-loan and pool-by-pool basis. The unallocated portion is for inherent losses that probably exist as of the evaluation date, but which have not been specifically identified by the processes used to establish the allocated portion due to inherent imprecision in the objective processes we utilize to identify probable and estimable losses. This unallocated portion is subjective and requires judgment based on various qualitative factors in the loan portfolio and the market in which we operate. At December 31, 2003 and 2002, respectively, the unallocated portion of the allowance approximated $14,000 and $62,000, or 0.3% and 1.5% of the total allowance. This unallocated portion of the allowance is considered necessary based on consideration of the known risk elements in certain pools of loans in the loan portfolio and our assessment of the economic environment in which we operate. More specifically, while loan quality remains good, the subsidiary banks have typically experienced greater losses within certain homogeneous loan pools when our market area has experienced economic downturns or other significant negative factors or trends, such as increases in bankruptcies, unemployment rates or past due loans.

At December 31, 2003 and 2002, our allowance for loan losses totaled $4,681,000, or 0.93% of total loans and $4,053,000 or 0.97% of total loans, respectively, and is considered adequate to cover inherent losses in our loan portfolio. Table VII presents an allocation of the allowance for loan losses by loan type at each respective year end date, as follows:

**TABLE VII – ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES**
(DOLLARS IN THOUSANDS)

| | 2003 | | 2002 | | 2001 | | 2000 | | 1999 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 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 | **$2,353** | **50.8%** | $2,054 | 49.4% | $1,036 | 42.8% | $1,037 | 39.4% | $ 951 | 33.1% |
| Real estate | **1,127** | **39.4%** | 939 | 39.6% | 985 | 43.8% | 127 | 46.3% | 383 | 49.8% |
| Installment | **1,174** | **8.2%** | 998 | 9.5% | 937 | 11.8% | 1,313 | 13.5% | 806 | 16.0% |
| Other | **13** | **1.6%** | – | 1.5% | – | 1.6% | – | 0.8% | – | 1.1% |
| Unallocated | **14** | **–** | 62 | – | 152 | – | 94 | – | 92 | – |
| | **$4,681** | **100.0%** | $4,053 | 100.0% | $3,110 | 100.0% | $2,571 | 100.0% | $2,232 | 100.0% |

At December 31, 2003, we had approximately $480,000 in other real estate owned which was obtained as the result of foreclosure proceedings. Foreclosures have been insignificant throughout 2003 and we do not anticipate any material losses on the property currently held in other real estate owned.

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

**TABLE VIII – ALLOWANCE FOR LOAN LOSSES**
(DOLLARS IN THOUSANDS)

| | 2003 | 2002 | 2001 | 2000 | 1999 |
|---|---|---|---|---|---|
| **Balance, beginning of year** | **$4,053** | $3,110 | $2,571 | $2,232 | $2,113 |
| **Losses:** | | | | | |
| Commercial, financial & agricultural | **98** | 138 | 108 | – | 165 |
| Residential – mortgage | **60** | 30 | 47 | 63 | 32 |
| Consumer | **178** | 173 | 191 | 175 | 144 |
| Other | **73** | 75 | 76 | 49 | 37 |
| Total | **409** | 416 | 422 | 287 | 378 |
| **Recoveries:** | | | | | |
| Commercial, financial & agricultural | **5** | 39 | 10 | 2 | 40 |
| Residential – mortgage | **–** | 17 | 1 | 2 | 10 |
| Consumer | **79** | 71 | 99 | 53 | 71 |
| Other | **38** | 17 | 21 | 11 | 6 |
| Total | **122** | 144 | 131 | 68 | 127 |
| **Net losses** | **287** | 272 | 291 | 219 | 251 |
| Provision for loan losses | **915** | 1,215 | 830 | 558 | 370 |
| **Balance, end of year** | **$4,681** | $4,053 | $3,110 | $2,571 | $2,232 |

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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 (net of float and reserves), Federal funds sold, non-pledged securities, and available lines of credit with the Federal Home Loan Bank, which totaled approximately $115 million or 14.7% of total consolidated assets at December 31, 2003.

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.

### 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 senior management and members of the Board of Directors. The ALCO actively formulates the economic assumptions that we use in our financial planning and budgeting process and establishes policies which control and monitor our sources, uses and prices of funds.

Some amount of interest rate risk is inherent and appropriate to the banking business. Our net income is affected by changes in the absolute level of interest rates. Our interest rate risk position is liability sensitive; that is, liabilities are likely to reprice faster than assets, resulting in a decrease in net income in a rising rate environment. Our net income would remain relatively unchanged 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. 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.

As of December 31, 2003, our earnings simulation model projects net interest income would decrease by approximately 1.7% if rates rise evenly by 200 basis points over the next year, as compared to projected stable rate net interest income. Also, the model projects that if rates fall evenly by 200 basis points over the next year, our net interest income would decrease by approximately 0.1%, as compared to projected stable rate net interest income. These projected changes are well within our ALCO policy limit of +/- 10%.

### 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, 2003.

| | LONG TERM DEBT |
|---|---:|
| 2004 | $ 20,428,432 |
| 2005 | 20,811,559 |
| 2006 | 13,749,060 |
| 2007 | 5,519,208 |
| 2008 | 14,344,851 |
| Thereafter | 93,402,098 |
| **Total** | $168,255,208 |

## 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, 2003 are presented in the following table.

| | |
|---|---|
| **Commitments to extend credit:** | |
| Revolving home equity and credit card lines | $ 20,550 |
| Construction loans | 39,941 |
| Other loans | 23,627 |
| **Standby letters of credit** | 3,718 |
| **Total** | $ 87,836 |

## CAPITAL RESOURCES

Our capital position remains strong, despite our continued growth. Stated as a percentage of total assets, our equity ratio was 7.2% and 7.8% at December 31, 2003 and 2002, respectively. Our risk weighted tier I capital, total capital and leverage capital ratios approximated 10.1%, 11.0% and 7.3%, respectively, at December 31, 2003, all of which are in excess of the minimum guidelines to be "well capitalized" under the regulatory prompt corrective action provisions. Our subsidiary banks are also subject to minimum capital ratios as further discussed in Note 16 of the accompanying consolidated financial statements.

Cash dividends per share rose 14.7% to $0.43 in 2003 compared to $0.375 in 2002, representing dividend payout ratios of 18.4% and 18.2% for 2003 and 2002, respectively. It is our intention to continue to pay dividends on a similar schedule during 2004. Future cash dividends will depend on the earnings and financial condition of our subsidiary banks as well as general economic conditions.

The primary source of funds for the dividends paid to our shareholders is dividends received from our subsidiary banks. Dividends paid by our subsidiary banks are subject to restrictions by banking regulations. The most restrictive provision requires approval by the respective 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 2004, the net retained profits available for distribution to Summit as dividends without regulatory approval are approximately $11,803,000, plus net income for the interim periods through the date of declaration.

On February 21, 2003, our Board of Directors authorized a 2-for-1 split of our common stock to be effected in the form of a 100% stock dividend which was distributed on March 14, 2003 to shareholders of record as of March 3, 2003.

## QUARTERLY FINANCIAL INFORMATION

| (DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | FIRST QUARTER | SECOND QUARTER | THIRD QUARTER | FOURTH QUARTER | FULL YEAR |
|---|---|---|---|---|---|
| **2003** | | | | | |
| Interest income | $10,130 | $10,168 | $10,292 | $10,634 | $41,224 |
| Interest expense | 4,461 | 4,467 | 4,350 | 4,252 | 17,530 |
| Net interest income | 5,669 | 5,701 | 5,942 | 6,382 | 23,694 |
| Provision for loan losses | 218 | 233 | 232 | 232 | 915 |
| Securities gains | 41 | 65 | – | 106 | 212 |
| Other noninterest income | 532 | 732 | 810 | 3,538 | 5,612 |
| Noninterest expense | 3,340 | 3,439 | 3,797 | 6,308 | 16,884 |
| Income before income taxes | 2,684 | 2,826 | 2,723 | 3,486 | 11,719 |
| Income taxes | 820 | 818 | 880 | 993 | 3,511 |
| Net income | 1,864 | 2,008 | 1,843 | 2,493 | 8,208 |
| Basic earnings per share | 0.53 | 0.57 | 0.53 | 0.71 | 2.34 |
| Diluted earnings per share | 0.53 | 0.57 | 0.52 | 0.70 | 2.32 |
| Dividends paid per share | – | 0.20 | – | 0.23 | 0.43 |
| **2002** | | | | | |
| Interest income | $ 9,835 | $10,043 | $10,345 | $10,466 | $40,689 |
| Interest expense | 4,655 | 4,690 | 4,803 | 4,694 | 18,842 |
| Net interest income | 5,180 | 5,353 | 5,542 | 5,772 | 21,847 |
| Provision for loan losses | 293 | 307 | 307 | 308 | 1,215 |
| Securities gains (losses) | 53 | 12 | 9 | (214) | (140) |
| Other noninterest income | 309 | 563 | 592 | 621 | 2,085 |
| Noninterest expense | 2,977 | 3,288 | 3,115 | 3,227 | 12,607 |
| Income before income taxes | 2,272 | 2,333 | 2,721 | 2,644 | 9,970 |
| Income taxes | 641 | 693 | 798 | 600 | 2,732 |
| Net income | 1,631 | 1,640 | 1,923 | 2,044 | 7,238 |
| Basic earnings per share | 0.46 | 0.47 | 0.55 | 0.58 | 2.06 |
| Diluted earnings per share | 0.46 | 0.46 | 0.54 | 0.58 | 2.05 |
| Dividends paid per share | – | 0.185 | – | 0.19 | 0.375 |

## REPORT OF INDEPENDENT AUDITORS

ARNETT & FOSTER
Certified Public Accountants, P.L.L.C.

To the Board of Directors
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, 2003 and 2002, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. 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 auditing standards generally accepted in the United States of America. 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, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Arnett & Foster, P.L.L.C.

Charleston, West Virginia
January 30, 2004

## CONSOLIDATED BALANCE SHEETS

| | DECEMBER 31, 2003 | 2002 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 14,412,120** | $ 11,470,311 |
| Interest bearing deposits with other banks | **3,141,092** | 2,185,369 |
| Federal funds sold | **244,000** | 3,390,135 |
| Securities available for sale | **235,409,228** | 212,597,975 |
| Loans held for sale, net | **6,352,836** | 906,900 |
| Loans, net | **498,340,211** | 414,245,082 |
| Property held for sale, net | **480,000** | 1,859,650 |
| Premises and equipment, net | **17,846,269** | 11,199,037 |
| Accrued interest receivable | **3,778,139** | 4,026,188 |
| Intangible assets | **3,049,976** | 3,201,128 |
| Other assets | **8,411,333** | 6,812,636 |
| **Total assets** | **$791,465,204** | $671,894,411 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Liabilities | | |
| Deposits | | |
| Non interest bearing | **$ 51,004,403** | $ 46,312,596 |
| Interest bearing | **460,797,017** | 412,334,977 |
| **Total deposits** | **511,801,420** | 458,647,573 |
| Short-term borrowings | **49,714,246** | 20,191,103 |
| Long-term borrowings | **164,646,208** | 133,787,020 |
| Subordinated debentures owed to unconsolidated subsidiary trust | **3,609,000** | 3,609,000 |
| Other liabilities | **4,506,787** | 3,579,919 |
| **Total liabilities** | **734,277,661** | 619,814,615 |
| **Commitments and Contingencies** | | |
| **Shareholders' Equity** | | |
| Preferred stock, $1.00 par value; authorized 250,000 shares; no shares issued | **–** | – |
| Common stock, $2.50 par value; authorized 5,000,000; issued 2003 – 3,566,960 shares; 2002 – 3,561,660 shares | **8,917,400** | 8,904,150 |
| Capital surplus | **3,845,906** | 3,805,891 |
| Retained earnings | **43,427,000** | 36,726,583 |
| Less cost of shares acquired for the treasury – 57,940 shares | **(627,659)** | (619,711) |
| Accumulated other comprehensive income | **1,624,896** | 3,262,883 |
| **Total shareholders' equity** | **57,187,543** | 52,079,796 |
| **Total liabilities and shareholders' equity** | **$791,465,204** | $671,894,411 |

See notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF INCOME

| | FOR THE YEAR ENDED DECEMBER 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Interest income** | | | |
| Interest and fees on loans | | | |
| Taxable | **$30,842,054** | $28,626,505 | $25,592,985 |
| Tax-exempt | **323,148** | 348,840 | 210,744 |
| Interest and dividends on securities | | | |
| Taxable | **7,952,074** | 9,840,024 | 10,896,837 |
| Tax-exempt | **1,936,831** | 1,724,616 | 961,270 |
| Interest on interest bearing deposits with other banks | **151,068** | 92,417 | 22,983 |
| Interest on Federal Funds sold | **18,391** | 56,495 | 234,342 |
| **Total interest income** | **41,223,566** | 40,688,897 | 37,919,161 |
| **Interest expense** | | | |
| Interest on deposits | **9,998,904** | 11,563,915 | 14,765,031 |
| Interest on short-term borrowings | **441,447** | 326,650 | 452,340 |
| Interest on long-term borrowings and subordinated debentures | **7,089,635** | 6,951,485 | 5,220,402 |
| **Total interest expense** | **17,529,986** | 18,842,050 | 20,437,773 |
| **Net interest income** | **23,693,580** | 21,846,847 | 17,481,388 |
| Provision for loan losses | **915,000** | 1,215,000 | 830,000 |
| **Net interest income after provision for loan losses** | **22,778,580** | 20,631,847 | 16,651,388 |
| **Noninterest income** | | | |
| Insurance commissions | **239,356** | 186,888 | 105,179 |
| Service fees | **1,585,778** | 1,340,542 | 1,054,799 |
| Mortgage origination revenue | **3,137,702** | 357,486 | 72,783 |
| Securities gains (losses) | **211,897** | (140,308) | 379,048 |
| Gain (loss) on sale of assets | **335,969** | (8,770) | 11,563 |
| Other | **313,687** | 209,180 | 186,178 |
| **Total noninterest income** | **5,824,389** | 1,945,018 | 1,809,550 |
| **Noninterest expenses** | | | |
| Salaries and employee benefits | **9,004,422** | 6,863,690 | 5,670,072 |
| Net occupancy expense | **868,261** | 783,705 | 706,346 |
| Equipment expense | **1,320,353** | 1,247,593 | 1,170,491 |
| Supplies | **481,157** | 474,666 | 329,813 |
| Professional fees | **564,477** | 434,074 | 454,393 |
| Postage | **984,929** | 195,317 | 157,001 |
| Advertising | **772,358** | 249,490 | 203,626 |
| Amortization of intangibles | **151,152** | 151,152 | 282,192 |
| Other | **2,736,579** | 2,206,750 | 1,763,407 |
| **Total noninterest expenses** | **16,883,688** | 12,606,437 | 10,737,341 |
| **Income before income tax expense** | **11,719,281** | 9,970,428 | 7,723,597 |
| Income tax expense | **3,510,925** | 2,732,130 | 2,457,135 |
| **Net income** | **$ 8,208,356** | $ 7,238,298 | $ 5,266,462 |
| **Basic earnings per common share** | **$ 2.34** | $ 2.06 | $ 1.50 |
| **Diluted earnings per common share** | **$ 2.32** | $ 2.05 | $ 1.50 |
| **Average common shares outstanding** | | | |
| Basic | **3,505,003** | 3,507,964 | 3,508,898 |
| Diluted | **3,536,643** | 3,526,080 | 3,510,284 |

See notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2003, 2002 AND 2001

| | COMMON STOCK | CAPITAL SURPLUS | RETAINED EARNINGS | TREASURY STOCK | ACCUMULATED OTHER COMPREHENSIVE INCOME | TOTAL SHAREHOLDERS' EQUITY |
|---|---|---|---|---|---|---|
| **Balance, December 31, 2000** | $8,903,900 | $3,804,951 | $26,765,097 | $(517,725) | $ 816,978 | $39,773,201 |
| Comprehensive income: | | | | | | |
| Net income | – | – | 5,266,462 | – | – | 5,266,462 |
| Other comprehensive income, net of deferred taxes of $300,601: | | | | | | |
| Net unrealized gain on securities of $725,464, net of reclassification adjustment for gains included in net income of $235,010 | – | – | – | – | 490,454 | 490,454 |
| Total comprehensive income | – | – | – | – | – | 5,756,916 |
| Purchase of treasury shares | – | – | – | (14,754) | – | (14,754) |
| Cash dividends declared ($0.35 per share) | – | – | (1,228,016) | – | – | (1,228,016) |
| **Balance, December 31, 2001** | 8,903,900 | 3,804,951 | 30,803,543 | (532,479) | 1,307,432 | 44,287,347 |
| Comprehensive income: | | | | | | |
| Net income | – | – | 7,238,298 | – | – | 7,238,298 |
| Other comprehensive income, net of deferred taxes of $1,198,502: | | | | | | |
| Net unrealized gain on securities of $1,868,460, net of reclassification adjustment for (losses) included in net income of ($86,991) | – | – | – | – | 1,955,451 | 1,955,451 |
| Total comprehensive income | – | – | – | – | – | 9,193,749 |
| Exercise of stock options | 250 | 940 | – | – | – | 1,190 |
| Purchase of treasury shares | – | – | – | (87,232) | – | (87,232) |
| Cash dividends declared ($0.375 per share) | – | – | (1,315,258) | – | – | (1,315,258) |
| **Balance, December 31, 2002** | 8,904,150 | 3,805,891 | 36,726,583 | (619,711) | 3,262,883 | 52,079,796 |
| Comprehensive income: | | | | | | |
| Net income | – | – | 8,208,356 | – | – | 8,208,356 |
| Other comprehensive income, net of deferred tax (benefit) of ($1,003,928): | | | | | | |
| Net unrealized (loss) on securities of ($1,506,611), net of reclassification adjustment for gains included in net income of $131,376 | – | – | – | – | (1,637,987) | (1,637,987) |
| Total comprehensive income | – | – | – | – | – | 6,570,369 |
| Exercise of stock options | 13,250 | 40,015 | – | – | – | 53,265 |
| Purchase of treasury shares | – | – | – | (7,948) | – | (7,948) |
| Cash dividends declared ($0.43 per share) | – | – | (1,507,939) | – | – | (1,507,939) |
| **Balance, December 31, 2003** | $8,917,400 | $3,845,906 | $43,427,000 | $(627,659) | $1,624,896 | $57,187,543 |

See notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | **2003** | 2002 | 2001 |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | **$ 8,208,356** | $ 7,238,298 | $ 5,266,462 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation | **1,058,354** | 1,026,485 | 899,554 |
| Provision for loan losses | **915,000** | 1,215,000 | 830,000 |
| Deferred income tax (benefit) | **(368,650)** | (779,570) | (277,540) |
| Loans originated for sale | **(62,670,581)** | (19,446,545) | – |
| Proceeds from loans sold | **57,224,645** | 20,053,045 | – |
| Security (gains) losses | **(211,897)** | 140,308 | (379,048) |
| (Gain) loss on disposal of premises, equipment and other assets | **(171,590)** | 8,770 | 91,695 |
| Amortization of securities premiums (accretion of discounts), net | **1,341,955** | 389,007 | (291,338) |
| Amortization of goodwill and purchase accounting adjustments, net | **171,010** | 174,330 | 284,901 |
| (Increase) decrease in accrued interest receivable | **248,049** | (151,165) | (113,301) |
| (Increase) in other assets | **(910,575)** | (267,021) | (38,028) |
| Increase (decrease) in other liabilities | **1,174,571** | (455,917) | 786,508 |
| **Net cash provided by operating activities** | **6,008,647** | 9,145,025 | 7,059,865 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Proceeds from maturities and calls of securities held to maturity | **–** | 150,000 | 250,000 |
| Proceeds from maturities and calls of securities available for sale | **33,368,900** | 14,386,000 | 56,133,634 |
| Proceeds from sales of securities available for sale | **12,206,105** | 26,934,632 | 40,206,987 |
| Principal payments received on securities available for sale | **89,184,506** | 50,602,473 | 26,554,708 |
| Purchases of securities available for sale | **(161,303,052)** | (94,970,210) | (154,138,998) |
| Net (increase) decrease in federal funds sold | **3,146,135** | (1,542,006) | (37,129) |
| Net loans made to customers | **(85,792,687)** | (72,627,710) | (73,781,647) |
| Purchases of premises and equipment | **(8,273,263)** | (1,124,723) | (1,705,880) |
| Proceeds from sales of premises, equipment and other assets | **2,890,424** | 60,700 | 134,239 |
| (Purchases of) proceeds from interest bearing deposits with other banks | **(955,723)** | 76,457 | (1,788,826) |
| Purchases of life insurance contracts | **–** | (2,250,000) | (74,200) |
| **Net cash (used in) investing activities** | **(115,528,655)** | (80,304,387) | (108,247,112) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Net increase in demand deposit, NOW and savings accounts | **18,275,248** | 28,835,408 | 27,161,535 |
| Net increase in time deposits | **34,940,815** | 33,753,264 | 22,952,264 |
| Net increase (decrease) in short–term borrowings | **29,523,143** | (3,841,687) | 14,641,976 |
| Proceeds from long–term borrowings | **37,320,000** | 26,590,000 | 42,738,000 |
| Repayments of long–term borrowings | **(6,134,767)** | (16,461,443) | (379,398) |
| Net proceeds from issuance of trust preferred securities | **–** | 3,379,200 | – |
| Purchases of treasury stock | **(7,948)** | (87,232) | (14,754) |
| Exercise of stock options | **53,265** | 1,190 | – |
| Dividends paid | **(1,507,939)** | (1,315,258) | (1,228,016) |
| **Net cash provided by financing activities** | **112,461,817** | 70,853,442 | 105,871,607 |
| Increase (decrease) in cash and due from banks | **2,941,809** | (305,920) | 4,684,360 |
| **Cash and due from banks:** | | | |
| Beginning | **11,470,311** | 11,776,231 | 7,091,871 |
| Ending | **$ 14,412,120** | $ 11,470,311 | $ 11,776,231 |

See notes to consolidated financial statements

## CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | **2003** | 2002 | 2001 |
| **SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION** | | | |
| Cash payments for: | | | |
| Interest | **$ 17,346,163** | $ 18,863,103 | $ 20,699,231 |
| Income taxes | **$ 3,420,000** | $ 3,245,289 | $ 2,442,000 |
| **SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES** | | | |
| Other assets acquired in settlement of loans | **$ 779,896** | $ 63,675 | $ 127,870 |

See notes to consolidated financial statements

**NOTE 1. SIGNIFICANT ACCOUNTING POLICIES**

**Nature of business:** Summit Financial Group, Inc. ("We", "Company" or "Summit") is a financial holding company headquartered in Moorefield, West Virginia. We operate two business segments, community banking and mortgage banking. Our community banking segment 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 provide these services through our three community bank subsidiaries: Summit Community Bank ("Summit Community"), Capital State Bank, Inc. ("Capital State"), and Shenandoah Valley National Bank ("Shenandoah") (collectively, the "Bank Subsidiaries"). Summit Financial, LLC ("SFLLC"), our mortgage banking segment, originates loans to customers throughout the United States from its headquarters in Herndon, Virginia.

**Basis of financial statement presentation:** 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. As further discussed in Notes 2 and 11, SFG Capital Trust I, which had been previously consolidated within our financial statements, is no longer consolidated.

**Presentation of cash flows:** For purposes of reporting cash flows, cash and due from banks includes cash on hand and amounts due from banks (including cash items in process of clearing). Cash flows from federal funds sold, 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.

**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.

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.

**Loans and allowance for loan losses:** Loans are generally stated at the amount of unpaid principal, reduced by unearned discount and allowance for loan losses. Loans held for sale are valued at the lower of aggregate carrying cost or fair value.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Our subsidiary banks make continuous credit reviews of the loan portfolio and consider current economic conditions, historical loan loss experience, review of specific problem loans and other factors in determining the adequacy of the allowance for loan losses. Loans are charged against the allowance for loan losses when we believe that collectibility 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.

A loan is impaired when, 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 specific loan agreement. Impaired loans, other than certain large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, are required to be reported at the present value of expected future cash flows discounted using the loan's original effective interest rate or, alternatively, at the loan's observable market price, or at the fair value of the loan's collateral if the loan is collateral dependent. The method selected to measure impairment is made on a loan-by-loan basis, unless foreclosure is deemed to be probable, in which case the fair value of the collateral method is used.

Generally, after our evaluation, loans are placed on non-accrual status when principal or interest is greater than 90 days

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

past due based upon the loan's contractual terms. Interest is accrued daily on impaired loans unless the loan is placed on non-accrual status. Impaired loans are placed on non-accrual 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 non-accrual loans is recognized primarily using the cost-recovery method.

Unearned interest on discounted loans is amortized to income over the life of the loans, using methods which approximate the interest method. For all other loans, interest 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.

**Property held for sale:** Property held for sale consists of premises qualifying as held for sale under Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, 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. Gains or losses not previously recognized resulting from the sale of property held for sale is recognized on the date of sale. Changes in value subsequent to transfer are recorded in noninterest income. Depreciation is not recorded on property held for sale. Expenses incurred in connection with operating foreclosed properties are charged to noninterest expense.

**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. Total interest capitalized during 2003 was approximately $40,000. No interest was capitalized during 2002 or 2001.

**Intangible assets:** In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), which addresses the accounting and reporting for acquired goodwill and other intangible assets. Under the provisions of SFAS 142, goodwill and certain other intangible assets with indefinite useful lives are no longer amortized into net income over an estimated life, but rather are tested at least annually for impairment based on specific guidance provided in the new standard. However, SFAS 142 did not supersede Statement of Financial Accounting Standards No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions* ("SFAS 72"), and therefore, any goodwill accounted for in accordance with SFAS 72 will continue to be amortized. SFAS 142 also requires that intangible assets determined to have definite useful lives be amortized over their estimated useful lives and also be subject to impairment testing.

In October 2002, the FASB issued Statement of Financial Accounting Standards No. 147, *Acquisitions of Certain Financial Institutions* ("SFAS 147"). SFAS 147 removes acquisitions of financial institutions from the scope of SFAS 72 and requires that these transactions be accounted for in accordance with FASB Statement No. 141, *Business Combinations*, and SFAS 142. In addition, SFAS 147 clarifies that the acquisition of a less-than-whole financial institution (e.g. a branch acquisition) that meets the definition of a business should be accounted for as a business combination, otherwise the transaction should be accounted for as an acquisition of net assets that does not result in the recognition of goodwill. SFAS 147 also amends FASB Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*, to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower- relationship intangible assets. SFAS 147 was effective on October 1, 2002 and did not materially impact our financial position, results of operations, or liquidity.

**Securities sold under agreements to repurchase:** 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.

**Advertising:** We expense advertising costs as they are incurred.

**Guarantees:** In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), *Guarantor's Accounting and*

*Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation expands the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees and requires the guarantor to recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 clarifies the requirements of SFAS 5, *Accounting for Contingencies*, relating to guarantees. In general, FIN 45 applies to contracts or indemnification agreements that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, liability, or equity security of the guaranteed party. Certain guarantee contracts are excluded from both the disclosure and recognition requirements of this interpretation, including, among others, guarantees relating to employee compensation, residual value guarantees under capital lease arrangements, commercial letters of credit, loan commitments, subordinated interests in an SPE, and guarantees of a company's own future performance. Other guarantees are subject to the disclosure requirements of FIN 45 but not to the recognition provisions and include, among others, a guarantee accounted for as a derivative instrument under SFAS 133, a parent's guarantee of debt owed to a third party by its subsidiary or vice versa, and a guarantee which is based on performance, not price.

**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.

**Stock-based compensation:** In accordance with Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, we have elected to follow Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for our employee stock options.

**Basic and diluted earnings per share:** Basic earnings per share is computed by dividing net income by the weighted-average number of shares of common stock outstanding. Diluted earnings per share is computed by dividing net income by the weighted-average number of shares outstanding increased by the number of shares of common stock which would be issued assuming the exercise of employee stock options.

**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.

**Derivative instruments and hedging activities:** In accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, 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 used for risk management purposes 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.

During 2003, 2002, and 2001 we were party to instruments that qualified for fair-value hedge accounting and other instruments that were held for risk management purposes that did not qualify for hedge accounting.

**Reclassifications:** Certain accounts in the consolidated financial statements for 2002 and 2001, as previously presented, have been reclassified to conform to current year classifications.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 2. SIGNIFICANT NEW ACCOUNTING PRONOUNCEMENTS**

**Loan commitments:** During 2003, we adopted the provisions of Statement of Financial Accounting Standards No. 149 ("SFAS 149"), *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.* SFAS 149 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. The adoption of SFAS 149 did not have a material impact on our results of operations, financial position, or liquidity.

**Variable interest entities:** In December 2003 the Financial Accounting Standards Board (FASB) issued revised Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46-R"). In accordance with FIN 46-R, 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 FIN 46-R, 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 FIN 46-R require deconsolidation of subsidiary trusts which issued guaranteed preferred beneficial interests in subordinated debentures (Trust Preferred Securities).

Prior to the adoption of FIN 46-R, we consolidated the trust and the balance sheet included the guaranteed beneficial interests in the subordinated debentures of the trust. Upon adoption of FIN 46-R at December 31, 2003, the trust has been deconsolidated and the junior subordinated debentures of the Company owned by the trust are being disclosed. 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 FIN 46-R. The adoption of the provisions of FIN 46-R 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.

**NOTE 3. CASH CONCENTRATION**

At December 31, 2003 and 2002, we had concentrations totaling $9,612,296 and $10,490,628, respectively, with unaffiliated financial institutions. These concentrations consisted of due from bank account balances and Federal funds sold. Deposits with correspondent banks are generally unsecured and have limited insurance under current banking insurance regulations.

**NOTE 4. SECURITIES**

The amortized cost, unrealized gains and losses, and estimated fair values of securities at December 31, 2003 and 2002, are summarized as follows:

| 2003 | AMORTIZED COST | UNREALIZED GAINS | UNREALIZED LOSSES | ESTIMATED FAIR VALUE |
|---|---|---|---|---|
| **Available for sale** | | | | |
| **Taxable:** | | | | |
| U. S. Government agencies and corporations | $ 21,323,741 | $ 556,785 | $ 37,831 | $ 21,842,695 |
| Mortgage–backed securities | 132,030,288 | 959,890 | 532,445 | 132,457,733 |
| State and political subdivisions | 4,008,910 | 24,685 | – | 4,033,595 |
| Corporate debt securities | 16,516,090 | 774,306 | – | 17,290,396 |
| Federal Reserve Bank stock | 436,000 | – | – | 436,000 |
| Federal Home Loan Bank stock | 10,319,400 | – | – | 10,319,400 |
| Other equity securities | 175,535 | – | – | 175,535 |
| **Total taxable** | 184,809,964 | 2,315,666 | 570,276 | 186,555,354 |
| **Tax–exempt:** | | | | |
| State and political subdivisions | 40,510,819 | 1,448,023 | 31,757 | 41,927,085 |
| Federal Reserve Bank stock | 8,400 | – | – | 8,400 |
| Other equity securities | 7,519,216 | – | 600,827 | 6,918,389 |
| **Total tax–exempt** | 48,038,435 | 1,448,023 | 632,584 | 48,853,874 |
| **Total** | $232,848,399 | $3,763,689 | $1,202,860 | $235,409,228 |

| 2002 | AMORTIZED COST | UNREALIZED GAINS | UNREALIZED LOSSES | ESTIMATED FAIR VALUE |
|---|---|---|---|---|
| **Available for sale** | | | | |
| **Taxable:** | | | | |
| U. S. Government agencies and corporations | $ 32,699,059 | $1,121,860 | $ – | $ 33,820,919 |
| Mortgage–backed securities | 94,022,894 | 1,925,599 | 168,040 | 95,780,453 |
| State and political subdivisions | 5,450,901 | 94,315 | – | 5,545,216 |
| Corporate debt securities | 27,961,831 | 1,163,744 | 7,352 | 29,118,223 |
| Federal Reserve Bank stock | 397,000 | – | – | 397,000 |
| Federal Home Loan Bank stock | 7,738,200 | – | – | 7,738,200 |
| Other equity securities | 88,348 | – | – | 88,348 |
| **Total taxable** | 168,358,233 | 4,305,518 | 175,392 | 172,488,359 |
| **Tax–exempt:** | | | | |
| State and political subdivisions | 34,003,131 | 1,166,600 | 101,629 | 35,068,102 |
| Federal Reserve Bank stock | 8,400 | – | – | 8,400 |
| Other equity securities | 5,065,152 | 106,169 | 138,207 | 5,033,114 |
| **Total tax–exempt** | 39,076,683 | 1,272,769 | 239,836 | 40,109,616 |
| **Total available for sale** | $207,434,916 | $5,578,287 | $ 415,228 | $212,597,975 |

Provided below is a summary of securities available for sale which were in an unrealized loss position at December 31, 2003. Approximately 32.7% of the unrealized loss was comprised of securities in a continuous loss position for twelve months or more, which consisted primarily of other equity securities with maturities or repricings of less than 1 year. We have the ability and intent to hold these securities until such time as the value recovers or the securities mature. Further, we believe that the deterioration in value is attributable to changes in market interest rates and not credit quality of the issuer.

| | LESS THAN 12 MONTHS | | 12 MONTHS OR MORE | | TOTAL | |
|---|---|---|---|---|---|---|
| | ESTIMATED FAIR VALUE | UNREALIZED LOSS | ESTIMATED FAIR VALUE | UNREALIZED LOSS | ESTIMATED FAIR VALUE | UNREALIZED LOSS |
| **Taxable:** | | | | | | |
| U. S. Government agencies and corporations | $ 4,462,169 | $ (37,831) | $ – | $ – | $ 4,462,169 | $ (37,831) |
| Mortgage–backed securities | 47,869,587 | (524,286) | 3,573,137 | (8,159) | 51,442,724 | (532,445) |
| **Tax–exempt:** | | | | | | |
| State and political subdivisions | 1,284,719 | (11,824) | 580,067 | (19,933) | 1,864,786 | (31,757) |
| Other equity securities | 5,279,518 | (236,024) | 1,638,872 | (364,803) | 6,918,390 | (600,827) |
| Total temporarily impaired securities | $58,895,993 | $(809,965) | $5,792,076 | $(392,895) | $64,688,069 | $(1,202,860) |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Federal Reserve Bank stock and Federal Home Loan Bank stock are equity securities, which are included in securities available for sale in the accompanying consolidated financial statements. Such securities are carried at cost, since they may only be sold back to the respective Federal Reserve Bank or Federal Home Loan Bank at par value.

Mortgage-backed obligations having contractual maturities ranging from 1 to 30 years, are reflected in the following maturity distribution schedules based on their anticipated average life to maturity, which ranges from 1 to 18 years. Accordingly, discounts are accreted and premiums are amortized over the anticipated average life to maturity of the specific obligation.

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

The maturities, amortized cost and estimated fair values of securities at December 31, 2003, are summarized as follows:

| | AMORTIZED COST | ESTIMATED FAIR VALUE |
|---|---|---|
| Due in one year or less | $ 61,645,591 | $ 62,100,104 |
| Due from one to five years | 92,479,306 | 93,560,830 |
| Due from five to ten years | 29,779,550 | 30,528,609 |
| Due after ten years | 30,485,401 | 31,361,960 |
| Equity securities | 18,458,551 | 17,857,725 |
| Total | $232,848,399 | $235,409,228 |

| | PROCEEDS FROM | | | GROSS REALIZED | |
|---|---|---|---|---|---|
| YEARS ENDED DECEMBER 31, | SALES | CALLS AND MATURITIES | PRINCIPAL PAYMENTS | GAINS | LOSSES |
| **2003** | | | | | |
| Securities available for sale | $12,206,105 | $33,368,900 | $89,184,506 | $334,597 | $122,700 |
| Securities held to maturity | – | – | – | – | – |
| | $12,206,105 | $33,368,900 | $89,184,506 | $334,597 | $122,700 |
| **2002** | | | | | |
| Securities available for sale | $26,934,632 | $14,386,000 | $50,602,473 | $319,235 | $246,543 |
| Securities held to maturity | – | 150,000 | – | – | – |
| | $26,934,632 | $14,536,000 | $50,602,473 | $319,235 | $246,543 |
| **2001** | | | | | |
| Securities available for sale | $40,206,987 | $56,133,634 | $26,554,708 | $459,653 | $ 80,605 |
| Securities held to maturity | – | 250,000 | – | – | – |
| | $40,206,987 | $56,383,634 | $26,554,708 | $459,653 | $ 80,605 |

At December 31, 2003 and 2002, securities with estimated fair values of $89,873,000 and $50,738,000, respectively, were pledged to secure public deposits, and for other purposes required or permitted by law.

At December 31, 2003, we had a concentration within our corporate debt obligations to issuers in the banking and financial services industry. The carrying value of this concentration was approximately $15,657,000 with an estimated fair value of $16,402,000. We had no concentrations with any one issuer of securities.

During 2002, due to a decrease in the credit rating of one of our mortgage-backed securities, we realized a $213,000 write down of that security, as this decline was deemed to be other than temporary.

### NOTE 5. LOANS

Loans are summarized as follows:

| | **2003** | 2002 |
|---|---|---|
| Commercial | **$ 46,860,481** | $ 34,745,430 |
| Commercial real estate | **209,391,036** | 171,822,280 |
| Residential – construction | **2,368,552** | 4,493,569 |
| Residential – mortgage | **196,134,926** | 161,005,744 |
| Consumer | **41,112,132** | 40,655,422 |
| Other | **8,223,033** | 6,389,812 |
| Total loans | **504,090,160** | 419,112,257 |
| Less unearned income | **1,069,324** | 814,044 |
| Total loans net of unearned income | **503,020,836** | 418,298,213 |
| Less allowance for loan losses | **4,680,625** | 4,053,131 |
| Loans, net | **$498,340,211** | $414,245,082 |

The following presents loan maturities at December 31, 2003.

| | WITHIN 1 YEAR | AFTER 1 BUT WITHIN 5 YEARS | AFTER 5 YEARS |
|---|---|---|---|
| Commercial | $16,559,865 | $ 17,270,982 | $ 13,029,634 |
| Commercial real estate | 31,215,193 | 36,072,084 | 142,103,759 |
| Residential– construction | 123,831 | 1,016,458 | 1,228,263 |
| Residential– mortgage | 10,218,929 | 12,002,734 | 173,913,263 |
| Consumer | 3,664,773 | 31,663,985 | 5,783,374 |
| Other | 930,257 | 2,678,855 | 4,613,921 |
| | $62,712,848 | $100,705,098 | $340,672,214 |

| | |
|---|---|
| Loans due after one year with: | |
| Variable rates | $ 84,870,552 |
| Fixed rates | 356,506,760 |
| | $441,377,312 |

**Concentrations of credit risk:** We grant commercial, residential and consumer loans to customers primarily located in the Eastern Panhandle and South Central regions of West Virginia, and the Northern region of Virginia. Although we strive to maintain a diverse loan portfolio, exposure to credit losses can be adversely impacted by downturns in local economic and employment conditions. Major employment within our market area is diverse, but primarily includes government, health care, education, poultry and various professional, financial and related service industries.

We evaluate the credit worthiness of each of our customers on a case-by-case basis and the amount of collateral we obtain is based upon this credit evaluation.

**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 stockholders (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):

| | **2003** | 2002 |
|---|---|---|
| **Balance, beginning** | **$ 5,721,118** | $4,789,067 |
| Additions | **13,332,322** | 3,273,101 |
| Amounts collected | **(3,236,398)** | (2,317,872) |
| Other changes, net | **–** | (23,178) |
| **Balance, ending** | **$15,817,042** | $5,721,118 |

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses for the years ended December 31, 2003, 2002 and 2001 is as follows:

| | **2003** | 2002 | 2001 |
|---|---|---|---|
| **Balance, beginning of year** | **$4,053,131** | $3,110,248 | $2,570,776 |
| **Losses:** | | | |
| Commercial | **1,308** | 105,650 | 38,624 |
| Commercial real estate | **96,640** | 31,500 | 69,233 |
| Residential – mortgage | **59,952** | 30,400 | 46,977 |
| Consumer | **178,305** | 173,430 | 190,804 |
| Other | **72,539** | 74,899 | 75,643 |
| Total | **408,744** | 415,879 | 421,281 |
| **Recoveries:** | | | |
| Commercial | **1,805** | 39,251 | 2,672 |
| Commercial real estate | **2,602** | – | 7,500 |
| Residential – mortgage | **413** | 16,489 | 728 |
| Consumer | **78,515** | 70,568 | 98,940 |
| Other | **37,903** | 17,454 | 20,913 |
| Total | **121,238** | 143,762 | 130,753 |
| Net losses | **287,506** | 272,117 | 290,528 |
| Provision for loan losses | **915,000** | 1,215,000 | 830,000 |
| **Balance, end of year** | **$4,680,625** | $4,053,131 | $3,110,248 |

Our total recorded investment in impaired loans at December 31, 2003 and 2002 approximated $1,014,000 and $904,000, respectively. The related allowance associated with impaired loans for 2003 and 2002 was approximately $271,000 and $160,000, respectively. At December 31, 2003, impaired loans with an associated allowance approximated $945,000, while approximately $69,000 of impaired loans had no related allowance. Our average investment in such loans approximated $353,000, $715,000, and $580,000 for the years ended December 31, 2003, 2002, and 2001 respectively. Impaired loans at December 31, 2003 and 2002 included loans that were collateral dependent, for which the fair values of the loans' collateral were used to measure impairment.

For purposes of evaluating impairment, we consider groups of smaller-balance, homogeneous loans to include: mortgage loans secured by residential property, other than those which significantly exceed our typical residential mortgage loan amount

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(currently those in excess of $100,000); small balance commercial loans (currently those less than $50,000); and consumer loans, exclusive of those loans in excess of $50,000.

For the years ended December 31, 2003, 2002, and 2001, we recognized no interest income on impaired loans after the date that the loans were deemed to be impaired. Using a cash-basis method of accounting, we would have recognized approximately the same amount of interest income on such loans.

### NOTE 7. PROPERTY HELD FOR SALE

Property held for sale at December 31, 2003 and 2002 is as follows:

| | 2003 | 2002 |
|---|---|---|
| Land | $ – | $ 673,227 |
| Buildings and improvements | – | 1,818,455 |
| Foreclosed property | 480,000 | 81,000 |
| | 480,000 | 2,572,682 |
| Less accumulated depreciation | – | 713,032 |
| **Total property held for sale** | $ 480,000 | $ 1,859,650 |

In 2003 we sold our primary branch facility in Petersburg, West Virginia. A new Petersburg facility is under construction and is expected to be completed during second quarter 2004. The total cost is expected to approximate $1,500,000. We also sold our corporate headquarters located in Moorefield, West Virginia and have constructed new corporate headquarters in Moorefield.

### NOTE 8. PREMISES AND EQUIPMENT

The major categories of premises and equipment and accumulated depreciation at December 31, 2003 and 2002, are summarized as follows:

| | 2003 | 2002 |
|---|---|---|
| Land | $ 3,815,446 | $ 2,060,736 |
| Buildings and improvements | 12,490,204 | 7,930,317 |
| Furniture and equipment | 8,296,033 | 6,992,299 |
| | 24,601,683 | 16,983,352 |
| Less accumulated depreciation | 6,755,414 | 5,784,315 |
| **Total premises and equipment** | $17,846,269 | $11,199,037 |

Depreciation expense for the years ended December 31, 2003, 2002 and 2001 approximated $1,058,000, $1,026,000 and $900,000, respectively.

### NOTE 9. INTANGIBLE ASSETS

With the adoption of SFAS 142 on January 1, 2002, we discontinued the amortization of goodwill resulting from acquisitions. Goodwill is now 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 2003 and determined that no impairment write-offs were necessary. Due to no longer having to amortize goodwill against earnings, our net income increased by approximately $131,000, or $0.04 per diluted share in both 2003 and 2002.

The following presents our consolidated results of operations adjusted as though the adoption of SFAS 142 occurred as of January 1, 2001.

| | YEARS ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| Reported net income | $8,208,356 | $7,238,298 | $5,266,462 |
| Add back goodwill amortization net of applicable tax effect | – | – | 131,040 |
| Adjusted net income | $8,208,356 | $7,238,298 | $5,397,502 |
| Basic earnings per share | | | |
| Reported net income | $ 2.34 | $ 2.06 | $ 1.50 |
| Add back goodwill amortization net of applicable tax effect | – | – | 0.04 |
| Adjusted net income | $ 2.34 | $ 2.06 | $ 1.54 |
| Diluted earnings per share | | | |
| Reported net income | $ 2.32 | $ 2.05 | $ 1.50 |
| Add back goodwill amortization net of applicable tax effect | – | – | 0.04 |
| Adjusted net income | $ 2.32 | $ 2.05 | $ 1.54 |

In addition, at December 31, 2003 and December 31, 2002, we had $1,561,946 and $1,713,098, respectively, in unamortized acquired intangible assets consisting entirely of unidentifiable intangible assets recorded in accordance with SFAS 72.

| | 2003 | 2002 |
|---|---|---|
| Unidentifiable intangible assets | | |
| Gross carrying amount | $2,267,324 | $2,267,323 |
| Less: accumulated amortization | 705,378 | 554,225 |
| Net carrying amount | $1,561,946 | $1,713,098 |
| Goodwill | 1,488,030 | 1,488,030 |
| **Total intangible assets** | $3,049,976 | $3,201,128 |

We recorded amortization expense of $151,000 for the year ended December 31, 2003 relative to our unidentifiable intangible assets. Annual amortization is expected to be approximately $151,000 for each of the years ending 2004 through 2008.

**NOTE 10. DEPOSITS**

The following is a summary of interest bearing deposits by type as of December 31, 2003 and 2002:

| | **2003** | 2002 |
|---|---|---|
| Demand deposits, interest bearing | **$112,670,844** | $ 99,752,155 |
| Savings deposits | **47,397,004** | 46,732,252 |
| Certificates of deposit | **274,543,713** | 241,439,194 |
| Individual Retirement Accounts | **26,185,456** | 24,411,376 |
| Total | **$460,797,017** | $412,334,977 |

Time certificates of deposit and Individual Retirement Account's (IRA's) in denominations of $100,000 or more totaled $103,892,739 and $70,304,610 at December 31, 2003 and 2002, respectively. Interest paid on time certificates of deposit and IRA's in denominations of $100,000 or more was $2,535,703, $2,428,040 and $3,057,697 for the years ended December 31, 2003, 2002 and 2001, respectively.

The following is a summary of the maturity distribution of certificates of deposit and IRA's in denominations of $100,000 or more as of December 31, 2003:

| | AMOUNT | PERCENT |
|---|---|---|
| Three months or less | $ 13,160,127 | 12.7% |
| Three through six months | 11,482,832 | 11.1% |
| Six through twelve months | 34,356,842 | 33.1% |
| Over twelve months | 44,892,938 | 43.1% |
| Total | $103,892,739 | 100.0% |

A summary of the scheduled maturities for all time deposits as of December 31, 2003, follows:

| | |
|---|---|
| 2004 | $192,605,771 |
| 2005 | 63,449,636 |
| 2006 | 14,880,209 |
| 2007 | 15,104,661 |
| 2008 | 13,815,493 |
| Thereafter | 873,399 |
| Total | $300,729,169 |

At December 31, 2003, our deposits of related parties including directors, executive officers, and their related interests approximated $14,295,000.

**NOTE 11. BORROWED FUNDS**

**Federal Home Loan Bank borrowings:** Our subsidiary banks are members 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.

At December 31, 2003, our subsidiary banks had combined additional borrowings availability of $45,780,000 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, 2003, we had $18,700,000 borrowing availability through credit lines and Federal funds purchased agreements. A summary of short-term borrowings is presented below.

| 2003 | SHORT-TERM FHLB ADVANCES | REPURCHASE AGREEMENTS | FEDERAL FUNDS PURCHASED AND LINES OF CREDIT |
|---|---|---|---|
| Balance at December 31 | $39,285,100 | $10,429,146 | $ – |
| Average balance outstanding for the year | 22,177,797 | 8,419,384 | 1,191,013 |
| Maximum balance outstanding at any month end | 39,285,100 | 10,429,146 | 6,851,000 |
| Weighted average interest rate for the year | 1.27% | 1.55% | 2.37% |
| Weighted average interest rate for balances outstanding at December 31 | 1.07% | 1.59% | – |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| 2002 | SHORT-TERM FHLB ADVANCES | REPURCHASE AGREEMENTS | FEDERAL FUNDS PURCHASED AND LINES OF CREDIT |
|---|---|---|---|
| Balance at December 31 | $11,595,000 | $ 8,596,103 | $ – |
| Average balance outstanding for the year | 6,057,233 | 8,960,391 | 934,768 |
| Maximum balance outstanding at any month end | 11,595,000 | 10,778,052 | 2,370,000 |
| Weighted average interest rate for the year | 2.21% | 1.71% | 4.19% |
| Weighted average interest rate for balances outstanding at December 31 | 1.48% | 1.57% | – |

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.

**Long-term borrowings:** Our long-term borrowings of $164,646,208 and $133,787,020 as of December 31, 2003 and 2002, respectively, consisted primarily of advances from the FHLB. These borrowings bear both fixed and variable interest rates and mature in varying amounts through the year 2016. The average interest rate paid on long-term borrowings during 2003 and 2002 approximated 4.49% and 5.17%, respectively.

**Subordinated Debentures:** In October 2002, we sponsored a statutory business trust, SFG Capital Trust I, of which 100% of the common equity is owned by us. This trust was formed for the purpose of issuing corporation obligated mandatorily redeemable securities (the "capital securities") 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 trust are its sole assets. Distributions on the capital securities issued by the trust are payable semi-annually at a variable interest rate equal to 3 month LIBOR plus 345 basis points, which is equal to the interest rate being earned by the trust on the debentures held by the trust and are 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 are first redeemable, whole, or in part, by us on November 7, 2007.

In the fourth quarter of 2003, as a result of applying the provisions of FIN 46-R, which governs when an equity interest should be consolidated, we were required to deconsolidate this subsidiary trust from our financial statements. The deconsolidation of the net assets and results of operations of the trust had virtually no impact on our financial statements or liquidity position, since we continue to be obligated to repay the debentures held by the trust and guarantee repayment of the capital securities issued by the trust. The consolidated debt obligation related to the trust increased from $3,500,000 to $3,609,000 upon deconsolidation with the difference representing our common ownership interest in the trust. The accompanying financial statements reflect the deconsolidation for all periods presented.

The capital securities held by SFG Capital Trust I qualify as Tier 1 capital under Federal Reserve Board guidelines. As a result of the issuance of FIN 46-R, the Federal Reserve Board is currently evaluating whether deconsolidation of the trust will affect the qualification of the capital securities as Tier 1 capital.

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

| YEAR ENDING DECEMBER 31, | AMOUNT |
|---|---|
| 2004 | $ 20,428,432 |
| 2005 | 20,811,559 |
| 2006 | 13,749,060 |
| 2007 | 5,519,208 |
| 2008 | 14,344,851 |
| Thereafter | 93,402,098 |
| **Total** | $168,255,208 |

**NOTE 12. INCOME TAXES**

The components of applicable income tax expense (benefit) for the years ended December 31, 2003, 2002 and 2001, are as follows:

| | **2003** | 2002 | 2001 |
|---|---|---|---|
| **Current** | | | |
| Federal | **$3,678,325** | $3,130,200 | $2,458,645 |
| State | **201,250** | 381,500 | 276,030 |
| | **3,879,575** | 3,511,700 | 2,734,675 |
| **Deferred** | | | |
| Federal | **(572,400)** | (507,220) | (261,060) |
| State | **203,750** | (272,350) | (16,480) |
| | **(368,650)** | (779,570) | (277,540) |
| **Total** | **$3,510,925** | $2,732,130 | $2,457,135 |

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, 2003, 2002 and 2001 is as follows:

| | 2003 | | 2002 | | 2001 | |
|---|---|---|---|---|---|---|
| | **AMOUNT** | **PERCENT** | AMOUNT | PERCENT | AMOUNT | PERCENT |
| Computed tax at applicable statutory rate | **$3,984,556** | **34** | $3,389,946 | 34 | $2,626,023 | 34 |
| Increase (decrease) in taxes resulting from: | | | | | | |
| Tax–exempt interest and dividends, net | **(768,393)** | **(6)** | (614,955) | (6) | (280,989) | (4) |
| State income taxes, net of Federal income tax benefit | **132,825** | **1** | 251,790 | 3 | 182,180 | 2 |
| Purchased state income tax credits | **–** | **–** | (240,000) | (2) | – | – |
| Nondeductible amortization of goodwill | **1,561** | **–** | 1,561 | – | 41,155 | 1 |
| Other, net | **160,376** | **1** | (56,212) | (1) | (111,234) | (1) |
| **Applicable income taxes** | **$3,510,925** | **30** | $2,732,130 | 27 | $2,457,135 | 32 |

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.

On December 31, 2002, we purchased $700,000 of West Virginia income tax credits for $460,000, which is reflected as a reduction in our 2002 state income tax expense and a deferred tax benefit.

The tax effects of temporary differences, which give rise to our deferred tax assets and liabilities as of December 31, 2003 and 2002, are as follows:

| | **2003** | 2002 |
|---|---|---|
| **Deferred tax assets** | | |
| Allowance for loan losses | **$1,623,413** | $1,317,350 |
| Deferred compensation | **433,393** | 259,439 |
| Purchased state tax credits | **–** | 240,000 |
| Other deferred costs and accrued expenses | **464,798** | 246,786 |
| | **2,521,604** | 2,063,575 |
| **Deferred tax liabilities** | | |
| Depreciation | **249,355** | 169,709 |
| Accretion on tax–exempt securities | **35,572** | 21,585 |
| Purchase accounting adjustments | **139,698** | 143,952 |
| Net unrealized gain on securities and other financial instruments | **855,375** | 1,819,488 |
| | **1,280,000** | 2,154,734 |
| Net deferred tax assets (liabilities) | **$1,241,604** | $ (91,159) |

## 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 $276,380, $190,124 and $185,694 for the years ended December 31, 2003, 2002 and 2001, 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, 2003, 2002 and 2001 were $217,120, $199,593 and $151,897, respectively. Dividends paid by us to the ESOP are reported as a reduction to retained earnings. The ESOP owned 93,109 shares of our common stock at December 31, 2003, 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.

**Directors Deferred Compensation Plan:** We, as well as each of our subsidiary banks, have established non-qualified deferred compensation plans for directors who voluntarily elect to defer payment of retainer, meeting and committee fees earned. The liability for deferred directors' compensation at December 31, 2003 and 2002, approximated $658,000 and $408,000, respectively, which is included in other liabilities in the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

accompanying consolidated balance sheets. In addition, we have purchased certain life insurance contracts to fund the liabilities arising under these plans. At December 31, 2003 and 2002, the cash surrender value of these insurance contracts was $334,000 and $315,000, respectively, and is included in other assets in the accompanying consolidated balance sheets.

**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, Capital State Bank and Shenandoah Valley National Bank adopted similar plans and during 2002, Summit Financial Group, Inc. adopted a similar plan. The liabilities accrued for the SERP's at December 31, 2003 and 2002 were $498,000 and $282,000 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, 2003 and 2002, the cash surrender value of these insurance contracts was $5,097,000 and $4,867,000, respectively, and is included in other assets in the accompanying consolidated balance sheets.

**Stock Option Plan:** The Officer Stock Option Plan, which provides for the granting of stock options for up to 480,000 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. Accordingly, no compensation expense is recognized for options granted under the Plan.

The following pro forma disclosures present for 2003, 2002 and 2001, our reported net income and basic and diluted earnings per share had we recognized compensation expense for our Officer Stock Option Plan based on the grant date fair values of the options (the fair value method described in Statement of Financial Accounting Standards No. 123).

| | YEARS ENDED DECEMBER 31, | | |
|---|---|---|---|
| (IN THOUSANDS, EXCEPT PER SHARE DATA) | **2003** | 2002 | 2001 |
| Net income: | | | |
| As reported | **$8,208** | $7,238 | $5,266 |
| Deduct total stock–based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (42) | (21) | (25) |
| Pro forma | **$8,166** | $7,217 | $5,241 |
| Basic earnings per share: | | | |
| As reported | **$ 2.34** | $ 2.06 | $ 1.50 |
| Pro forma | **$ 2.34** | $ 2.06 | $ 1.49 |
| Diluted earnings per share: | | | |
| As reported | **$ 2.32** | $ 2.05 | $ 1.50 |
| Pro forma | **$ 2.32** | $ 2.05 | $ 1.49 |

For purposes of computing the above pro forma amounts, we estimated the fair value of the options at the date of grant using a Black-Scholes option pricing model using the following weighted-average assumptions for grants in each respective year: risk free interest rates of 3.75% for 2003, 3.80% for 2002 and 4.50% for 2001; dividend yields of 1.21% for 2003, 2.00% for 2002 and 2.50% for 2001; volatility factors of the expected market price of our common stock of 22 for 2003, 23 for 2002 and 20 for 2001; and an expected option life of 8 years for 2003, 2002 and 2001. The weighted-average grant date fair value of options granted during 2003, 2002 and 2001 was $10.61, $5.02 and $2.81, respectively. For purposes of the pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period.

A summary of activity in our Officer Stock Option Plan during 2001, 2002 and 2003 is as follows:

| | OPTIONS | WEIGHTED-AVERAGE EXERCISE PRICE |
|---|---|---|
| **Outstanding, January 1, 2001** | 48,000 | $ 9.98 |
| Granted | 17,000 | 11.90 |
| Exercised | – | – |
| Forfeited | – | – |
| **Outstanding, December 31, 2001** | 65,000 | $10.48 |
| Granted | 18,000 | 18.98 |
| Exercised | (100) | 11.90 |
| Forfeited | – | – |
| **Outstanding, December 31, 2002** | 82,900 | $12.33 |
| Granted | 26,000 | 35.57 |
| Exercised | (5,300) | 9.97 |
| Forfeited | – | – |
| **Outstanding, December 31, 2003** | 103,600 | $18.28 |
| **Exercisable Options:** | | |
| December 31, 2003 | 49,400 | $10.94 |
| December 31, 2002 | 38,100 | $10.22 |
| December 31, 2001 | 25,200 | $10.09 |

**NOTE 14. COMMITMENTS AND CONTINGENCIES**

**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. A summary of the contractual amount of significant commitments follows:

| | DECEMBER 31, | |
|---|---|---|
| | **2003** | 2002 |
| **Commitments to extend credit:** | | |
| Revolving home equity and credit card lines | **$20,550,322** | $15,025,781 |
| Construction loans | **39,941,256** | 24,144,256 |
| Other loans | **23,626,963** | 17,499,115 |
| **Standby letters of credit** | **3,717,958** | 2,475,000 |
| **Total** | **$ 87,836,499** | $59,144,152 |

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.

**Litigation:** 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.

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 and the alleged use of trade secrets. The individual defendants have also been sued based on allegations arising out of their former employment relationship with Corinthian Mortgage and their current employment with Summit Financial, LLC.

The plaintiff seeks damages in the amount proven at trial on each claim and punitive damages in the amount of $350,000 on each claim. Plaintiff also seeks permanent and temporary injunctive relief prohibiting the alleged use of trade secrets by Summit Financial and the alleged solicitation of Corinthian's employees.

On January 22, 2004, we successfully defeated the Petition for Temporary Injunction brought against us by Corinthian Mortgage Corporation. The Circuit Court of Fairfax County, Virginia denied Corinthian's petition.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

We, after consultation with legal counsel, believe that Corinthian's claims made in its recent lawsuit arising out of the hiring of former employees of Corinthian Mortgage Corporation and the alleged use of trade secrets are without foundation and that meritorious defenses exist as to all the claims. We will continue to evaluate the claims in the Corinthian lawsuit and intend to vigorously defend against them. We believe that the lawsuit is without merit and will have no material adverse effect on us. 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.

**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. STOCK SPLIT

On February 21, 2003, our Board of Directors authorized a 2-for-1 split of our common stock to be effected in the form of a 100% stock dividend that was distributed on March 14, 2003 to shareholders of record as of March 3, 2003. All share and per share amounts included in the consolidated financial statements and the accompanying notes have been restated to give effect to the stock split.

### NOTE 16. REGULATORY MATTERS

The primary source of funds for our dividends paid to our shareholders is dividends received from our subsidiary banks. Dividends paid by the subsidiary banks are subject to restrictions by banking regulations. The most restrictive provision requires approval by their regulatory agencies if dividends declared in any year exceed the year's net income, as defined, plus the net retained profits of the two preceding years. During 2004, our subsidiaries have $11,503,000 plus net income for the interim periods through the date of declaration, available for dividends for distribution to us.

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, 2003, 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 noninterest bearing reserve balances with the Federal Reserve Bank. The required reserve balance was $3,927,000 at December 31, 2003.

Summit's and its subsidiary banks', Summit Community Bank ("SCB"), Capital State Bank, Inc.'s ("CSB") and Shenandoah Valley National Bank's ("SVNB") actual capital amounts and ratios are also presented in the following table (dollar amounts in thousands).

| | ACTUAL | | MINIMUM REQUIRED REGULATORY CAPITAL | | TO BE WELL CAPITALIZED UNDER PROMPT CORRECTIVE ACTION PROVISIONS | |
|---|---|---|---|---|---|---|
| | AMOUNT | RATIO | AMOUNT | RATIO | AMOUNT | RATIO |
| **As of December 31, 2003** | | | | | | |
| Total Capital (to risk weighted assets) | | | | | | |
| Summit | $60,092 | 11.0% | $ 43,678 | 8.0% | $54,598 | 10.0% |
| SCB | 28,449 | 10.9% | 20,791 | 8.0% | 25,989 | 10.0% |
| CSB | 12,843 | 10.7% | 9,621 | 8.0% | 12,026 | 10.0% |
| SVNB | 16,650 | 10.4% | 12,780 | 8.0% | 15,975 | 10.0% |
| Tier I Capital (to risk weighted assets) | | | | | | |
| Summit | 55,411 | 10.1% | 21,839 | 4.0% | 32,759 | 6.0% |
| SCB | 26,032 | 10.0% | 10,396 | 4.0% | 15,593 | 6.0% |
| CSB | 11,830 | 9.8% | 4,810 | 4.0% | 7,216 | 6.0% |
| SVNB | 15,399 | 9.6% | 6,390 | 4.0% | 9,585 | 6.0% |
| Tier I Capital (to average assets) | | | | | | |
| Summit | 55,411 | 7.3% | 22,692 | 3.0% | 37,820 | 5.0% |
| SCB | 26,032 | 7.0% | 11,184 | 3.0% | 18,639 | 5.0% |
| CSB | 11,830 | 7.0% | 5,064 | 3.0% | 8,440 | 5.0% |
| SVNB | 15,399 | 7.1% | 6,472 | 3.0% | 10,786 | 5.0% |
| **As of December 31, 2002** | | | | | | |
| Total Capital (to risk weighted assets) | | | | | | |
| Summit | $53,114 | 11.7% | $36,310 | 8.0% | $45,388 | 10.0% |
| SCB | 25,916 | 11.1% | 18,661 | 8.0% | 23,327 | 10.0% |
| CSB | 11,041 | 10.7% | 8,247 | 8.0% | 10,309 | 10.0% |
| SVNB | 12,816 | 11.0% | 9,304 | 8.0% | 11,630 | 10.0% |
| Tier I Capital (to risk weighted assets) | | | | | | |
| Summit | 49,043 | 10.8% | 18,155 | 4.0% | 27,233 | 6.0% |
| SCB | 23,708 | 10.2% | 9,334 | 4.0% | 14,001 | 6.0% |
| CSB | 10,146 | 9.8% | 4,124 | 4.0% | 6,187 | 6.0% |
| SVNB | 11,848 | 10.2% | 4,651 | 4.0% | 6,976 | 6.0% |
| Tier I Capital (to average assets) | | | | | | |
| Summit | 49,043 | 7.4% | 20,012 | 3.0% | 33,353 | 5.0% |
| SCB | 23,708 | 7.0% | 10,161 | 3.0% | 16,934 | 5.0% |
| CSB | 10,146 | 6.8% | 4,457 | 3.0% | 7,428 | 5.0% |
| SVNB | 11,848 | 6.7% | 5,289 | 3.0% | 8,815 | 5.0% |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 17. SEGMENT INFORMATION

We operate two business segments: community banking and mortgage banking. These segments are primarily identified by the products or services offered and the channels through which they are offered. The community banking segment consists of our full service banks which offer customers traditional banking products and services through various delivery channels. The mortgage banking segment consists of mortgage origination facilities that originate and sell mortgage products. The accounting policies for each of our business segments are the same as those described in Note 1. Information for each of our segments is included below:

| DECEMBER 31, 2003 | COMMUNITY BANKING | MORTGAGE BANKING | PARENT | ELIMINATIONS | TOTAL |
|---|---|---|---|---|---|
| Net interest income | $23,848,159 | $ 69,097 | $ (223,676) | $ – | $23,693,580 |
| Provision for loan losses | 915,000 | – | – | – | 915,000 |
| Net interest income after provision for loan losses | 22,933,159 | 69,097 | (223,676) | – | 22,778,580 |
| Other income | 2,706,245 | 3,137,702 | 3,291,622 | (3,311,180) | 5,824,389 |
| Other expenses | 13,443,687 | 3,060,882 | 3,690,299 | (3,311,180) | 16,883,688 |
| Income (loss) before income taxes | 12,195,717 | 145,917 | (622,353) | – | 11,719,281 |
| Income tax expense (benefit) | 3,655,277 | 49,798 | (194,150) | – | 3,510,925 |
| Net income | $ 8,540,440 | $ 96,119 | $ (428,203) | $ – | $ 8,208,356 |
| Average assets (in thousands) | $ 717,565 | $ 4,081 | $ 60,164 | $ (59,066) | $ 722,744 |

| DECEMBER 31, 2002 | COMMUNITY BANKING | MORTGAGE BANKING | PARENT | ELIMINATIONS | TOTAL |
|---|---|---|---|---|---|
| Net interest income | $21,982,492 | $ – | $ (135,645) | $ – | $21,846,847 |
| Provision for loan losses | 1,215,000 | – | – | – | 1,215,000 |
| Net interest income after provision for loan losses | 20,767,492 | – | (135,645) | – | 20,631,847 |
| Other income | 1,589,964 | 357,486 | 2,772,688 | (2,775,120) | 1,945,018 |
| Other expenses | 11,839,690 | 336,856 | 3,205,011 | (2,775,120) | 12,606,437 |
| Income (loss) before income taxes | 10,517,766 | 20,630 | (567,968) | – | 9,970,428 |
| Income tax expense (benefit) | 3,191,420 | 8,010 | (467,300) | – | 2,732,130 |
| Net income | $ 7,326,346 | $ 12,620 | $ (100,668) | $ – | $ 7,238,298 |
| Average assets (in thousands) | $ 625,752 | $ 1,432 | $ 51,359 | $ (49,999) | $ 628,544 |

| DECEMBER 31, 2001 | COMMUNITY BANKING | MORTGAGE BANKING | PARENT | ELIMINATIONS | TOTAL |
|---|---|---|---|---|---|
| Net interest income | $17,546,125 | $ – | $ (64,737) | $ – | $17,481,388 |
| Provision for loan losses | 830,000 | – | – | – | 830,000 |
| Net interest income after provision for loan losses | 16,716,125 | – | (64,737) | – | 16,651,388 |
| Other income | 1,736,767 | 72,783 | 2,268,600 | (2,268,600) | 1,809,550 |
| Other expenses | 10,262,980 | 96,361 | 2,646,600 | (2,268,600) | 10,737,341 |
| Income (loss) before income taxes | 8,189,912 | (23,578) | (442,737) | – | 7,723,597 |
| Income tax expense (benefit) | 2,638,164 | (5,129) | (175,900) | – | 2,457,135 |
| Net income | $ 5,551,748 | $ (18,449) | $ (266,837) | $ – | $ 5,266,462 |
| Average assets (in thousands) | $ 521,409 | $ 303 | $ 44,111 | $ (41,581) | $ 524,242 |

### NOTE 18. EARNINGS PER SHARE

The computations of basic and diluted earnings per share follow:

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | **2003** | 2002 | 2001 |
| Numerator: | | | |
| Net income | **$8,208,356** | $7,238,298 | $5,266,462 |
| Denominator | | | |
| Denominator for basic earnings per share–weighted average common shares outstanding | **3,505,003** | 3,507,964 | 3,508,898 |
| Effect of dilutive securities: | | | |
| Stock options | **31,640** | 18,116 | 1,386 |
| Denominator for diluted earnings per share–weighted average common shares outstanding and assumed conversions | **3,536,643** | 3,526,080 | 3,510,284 |
| Basic earnings per share | **$ 2.34** | $ 2.06 | $ 1.50 |
| Diluted earnings per share | **$ 2.32** | $ 2.05 | $ 1.50 |

### NOTE 19. DERIVATIVE FINANCIAL INSTRUMENTS

We use derivative instruments primarily to protect against the risk of adverse interest rate movements on the value 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.

Market risk is the risk of loss arising from an adverse change in interest rates or equity prices. Our primary market risk is interest rate risk. We use interest rate swaps to protect against the risk of interest rate movements on the value of certain funding instruments.

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.

**Fair value hedges:** We primarily use receive-fixed interest rate swaps to hedge the fair values of certain fixed rate long term FHLB advances and certificates of deposit against changes in interest rates. These hedges are 100% effective, therefore there is no ineffectiveness reflected in earnings. The net of the amounts earned on the fixed rate leg of the swaps and amounts due on the variable rate leg of the swaps are reflected in interest expense.

**Other derivative activities:** We also have other derivative financial instruments which do not qualify as SFAS 133 hedge relationships. We issue certain certificates of deposit which pay a return based upon changes in the S&P 500 equity index. Under SFAS 133, the equity index feature of these deposits is deemed to be an embedded derivative accounted for separately from the deposit. To hedge the returns paid to the depositors, we have entered into an equity swap indexed to the S&P 500. Both the embedded derivative and the equity swap are accounted for as other derivative instruments. Gains and losses on both the embedded derivative and the swap are included in other noninterest income on the income statement.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of our derivative financial instruments by type of activity follows:

| FAIR VALUE HEDGES | NOTIONAL AMOUNT | DERIVATIVE FAIR VALUE ASSET | DERIVATIVE FAIR VALUE LIABILITY | NET INEFFECTIVE HEDGE GAINS (LOSSES) |
|---|---|---|---|---|
| **DECEMBER 31, 2003** | | | | |
| FHLB advances | | | | |
| Receive-fixed interest rate swaps | $46,000,000 | $ 74,164 | $ – | $ – |
| **DECEMBER 31, 2002** | | | | |
| FHLB advances | | | | |
| Receive-fixed interest rate swaps | $10,000,000 | $ 212,401 | $ – | $ – |
| Certificates of deposit | | | | |
| Receive-fixed interest rate swaps | 2,000,000 | 67,328 | – | – |
| Total derivatives used in fair value hedges | $12,000,000 | $ 279,729 | $ – | $ – |

| OTHER DERIVATIVE INSTRUMENTS | NOTIONAL AMOUNT | DERIVATIVE FAIR VALUE ASSET | DERIVATIVE FAIR VALUE LIABILITY | NET GAINS (LOSSES) |
|---|---|---|---|---|
| **DECEMBER 31, 2003** | | | | |
| Equity index linked certificates of deposit | $ 1,211,724 | $ - | $ 86,273 | $ (31,440) |
| Equity index swap | 1,211,724 | - | 59,937 | 25,136 |
| | $ 2,423,448 | $ - | $ 146,210 | $ (6,304) |
| **DECEMBER 31, 2002** | | | | |
| Equity index linked certificates of deposit | $ 1,117,389 | $ - | $ 48,150 | $ 130,984 |
| Equity index swap | 1,117,389 | - | 129,963 | (143,973) |
| | $ 2,234,778 | $ - | $ 178,113 | $ (12,989) |

### NOTE 20. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following summarizes the methods and significant assumptions we used in estimating our fair value disclosures for financial instruments.

**Cash and due from banks:** The carrying values of cash and due from banks approximate their estimated fair value.

**Interest bearing deposits with other banks:** The fair values of interest bearing deposits with other banks are estimated by discounting scheduled future receipts of principal and interest at the current rates offered on similar instruments with similar remaining maturities.

**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.

**Derivative financial instruments:** The fair values of the interest rate swaps are valued using cash flow projection 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:

| | **2003** | | 2002 | |
|---|---|---|---|---|
| | **CARRYING VALUE** | **ESTIMATED FAIR VALUE** | CARRYING VALUE | ESTIMATED FAIR VALUE |
| **Financial assets:** | | | | |
| Cash and due from banks | **$ 14,412,120** | **$ 14,412,120** | $ 11,470,311 | $ 11,470,311 |
| Interest bearing deposits, other banks | **3,141,092** | **3,141,092** | 2,185,369 | 2,185,369 |
| Federal funds sold | **244,000** | **244,000** | 3,390,135 | 3,390,135 |
| Securities available for sale | **235,409,228** | **235,409,228** | 212,597,975 | 212,597,975 |
| Loans held for sale, net | **6,352,836** | **6,352,836** | 906,900 | 906,900 |
| Loans, net | **498,340,211** | **505,821,897** | 414,245,082 | 421,530,990 |
| Accrued interest receivable | **3,778,139** | **3,778,139** | 4,026,188 | 4,026,188 |
| Derivative financial assets | **74,164** | **74,164** | 279,729 | 279,729 |
| | **$761,751,790** | **$769,233,476** | $649,101,689 | $656,387,597 |
| **Financial liabilities:** | | | | |
| Deposits | **$511,801,420** | **$515,071,994** | $458,647,573 | $463,620,899 |
| Short–term borrowings | **49,714,246** | **49,714,246** | 20,191,103 | 20,191,103 |
| Long–term borrowings | **168,255,208** | **179,615,901** | 137,396,020 | 152,556,561 |
| Accrued interest payable | **2,012,876** | **2,012,876** | 1,827,932 | 1,827,932 |
| Derivative financial liabilities | **146,210** | **146,210** | 178,113 | 178,113 |
| | **$731,929,960** | **$746,561,227** | $618,240,741 | $638,374,608 |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 21. 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, 2003 and 2002, and the related statements of income and cash flows for the years ended December 31, 2003, 2002 and 2001, are presented as follows:

| BALANCE SHEETS | DECEMBER 31, 2003 | 2002 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | **$ 89,965** | $ 149,979 |
| Investment in subsidiaries, eliminated in consolidation | **58,537,353** | 52,238,781 |
| Securities available for sale | **175,534** | 88,348 |
| Premises and equipment | **6,160,461** | 2,199,115 |
| Accrued interest receivable | **851** | 1,021 |
| Other assets | **863,566** | 1,139,224 |
| **Total assets** | **$65,827,730** | $55,816,468 |
| **Liabilities and Shareholders' Equity** | | |
| Long–term borrowings | **$ 4,720,000** | $ – |
| Subordinated debentures owed to unconsolidated subsidiary trust | **3,609,000** | 3,609,000 |
| Other liabilities | **311,187** | 127,672 |
| Total liabilities | **8,640,187** | 3,736,672 |
| Preferred stock, $1.00 par value, authorized 250,000 shares; no shares issued | **–** | – |
| Common stock, $2.50 par value, authorized 5,000,000 shares; issued 2003 – 3,566,960 shares; 2002 – 3,561,660 shares | **8,917,400** | 8,904,150 |
| Capital surplus | **3,845,906** | 3,805,891 |
| Retained earnings | **43,427,000** | 36,726,583 |
| Less cost of shares acquired for the treasury – 57,940 shares | **(627,659)** | (619,711) |
| Accumulated other comprehensive income | **1,624,896** | 3,262,883 |
| Total shareholders' equity | **57,187,543** | 52,079,796 |
| **Total liabilities and shareholders' equity** | **$65,827,730** | $55,816,468 |

| STATEMENTS OF INCOME | FOR THE YEAR ENDED DECEMBER 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Income** | | | |
| Dividends from bank subsidiaries | **$ 2,800,000** | $ 2,400,000 | $ 2,300,000 |
| Other dividends and interest income | **8,060** | 37,486 | 14,327 |
| Management and service fees from bank subsidiaries | **3,311,180** | 2,775,120 | 2,268,600 |
| Total income | **6,119,240** | 5,212,606 | 4,582,927 |
| **Expense** | | | |
| Interest expense | **231,736** | 173,131 | 79,064 |
| Operating expenses | **3,709,857** | 3,207,443 | 2,646,600 |
| Total expenses | **3,941,593** | 3,380,574 | 2,725,664 |
| Income before income taxes and equity in undistributed income of bank subsidiaries | **2,177,647** | 1,832,032 | 1,857,263 |
| Income tax (benefit) | **(194,150)** | (467,300) | (175,900) |
| Income before equity in undistributed income of bank subsidiaries | **2,371,797** | 2,299,332 | 2,033,163 |
| Equity in (distributed) undistributed income of bank subsidiaries | **5,836,559** | 4,938,966 | 3,233,299 |
| **Net income** | **$ 8,208,356** | $ 7,238,298 | $ 5,266,462 |

| STATEMENTS OF INCOME | FOR THE YEAR ENDED DECEMBER 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | **$ 8,208,356** | $ 7,238,298 | $ 5,266,462 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Equity in (undistributed) distributed net income of bank subsidiaries | **(5,836,559)** | (4,938,966) | (3,233,299) |
| Deferred tax expense (benefit) | **219,850** | (215,300) | 34,600 |
| Depreciation | **344,546** | 327,303 | 269,083 |
| (Increase) decrease in other assets | **138,841** | (393,750) | 169,034 |
| Increase (decrease) in other liabilities | **120,210** | (43,903) | 122,035 |
| **Net cash provided by operating activities** | **3,195,244** | 1,973,682 | 2,627,915 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Investment in bank subsidiaries | **(2,100,000)** | (700,000) | (3,600,000) |
| Proceeds sales of available for sale securities | **–** | 300,000 | – |
| Purchase of available for sale securities | **(87,186)** | (81,723) | – |
| Proceeds from sales of premises and equipment | **1,000,000** | – | 14,807 |
| Purchases of premises and equipment | **(5,325,450)** | (126,811) | (891,098) |
| Purchase of life insurance contracts | **–** | (475,000) | (23,000) |
| **Net cash (used in) investing activities** | **(6,512,636)** | (1,083,534) | (4,499,291) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Dividends paid to shareholders | **(1,507,939)** | (1,315,258) | (1,228,016) |
| Exercise of stock options | **53,265** | 1,190 | – |
| Purchase of treasury stock | **(7,948)** | (87,232) | (14,754) |
| Net increase (decrease) in short–term borrowings | **–** | (1,000,000) | 1,000,000 |
| Net proceeds from long–term borrowings | **4,720,000** | 4,379,200 | 1,900,000 |
| Repayment of long–term borrowings | **–** | (2,900,000) | – |
| **Net cash provided by (used in) financing activities** | **3,257,378** | (922,100) | 1,657,230 |
| Increase (decrease) in cash | **(60,014)** | (31,952) | (214,146) |
| **Cash:** | | | |
| Beginning | **149,979** | 181,931 | 396,077 |
| Ending | **$ 89,965** | $ 149,979 | $ 181,931 |
| **SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION** | | | |
| Cash payments for: | | | |
| Interest | **$ 223,228** | $ 143,345 | $ 75,038 |

# OFFICERS AND DIRECTORS

**SUMMIT FINANCIAL GROUP**

H. Charles Maddy, III
President & CEO

Robert S. Tissue
Senior Vice President & Chief Financial Officer

Scott C. Jennings
Senior Vice President & Chief Operating Officer

Patrick N. Frye
Chief Credit Officer

Julie R. Cook
Vice President & Director of Accounting

Danyl R. Freeman
Vice President & Director of Human Resources

John A. Harper
Vice President & Director of Processing

Russell F. Ratliff, Jr.
Director of Operations

Adam T. McKenery
Director of Audit & Loan Review

Teresa D. Sherman
Shareholder Relations Coordinator

**BOARD OF DIRECTORS**

Frank Baer, III
Oscar M. Bean
Dewey F. Bensenhaver
James M. Cookman
John W. Crites
Patrick N. Frye
James P. Geary
Thomas J. Hawse, III
Phoebe Fisher Heishman
Gary L. Hinkle
Gerald W. Huffman
H. Charles Maddy, III
Duke A. McDaniel
Harold K. Michael
Ronald F. Miller
G.R. Ours, Jr.
Charles Piccirillo

**SUMMIT COMMUNITY BANK**

Patrick N. Frye
President & CEO

Russell F. Ratliff, Jr.
Senior Vice President of Retail Operations,
Cashier & Trust Officer

Mark H. Wright
Senior Vice President, Commercial Lending

Debra S. Davis
Senior Vice President, Retail Lending

Jay P. Mongold
Vice President, Commercial Lending

J. Vance Wilson
Vice President, Retail Lending

Bob A. Cooper
Vice President, Retail Lending

Barbara Gorenflo
Assistant Vice President

Jill D. Runion
Assistant Vice President

**BOARD OF DIRECTORS**

Oscar M. Bean
Dewey F. Bensenhaver
Donald W. Biller
James M. Cookman
John W. Crites
Patrick N. Frye
James P. Geary
Charles W. Halterman
Thomas J. Hawse, III
Phoebe Fisher Heishman
Gary L. Hinkle
Jeffrey E. Hott
Gerald W. Huffman
H. Charles Maddy, III
Duke A. McDaniel
Harold K. Michael
G.R. Ours, Jr.
Russell F. Ratliff, Jr.
F. Richard Thompson

David P. VanMeter, IV
Lysle T. Veach
Harry C. Welton, Jr.

**CAPITAL STATE BANK**

C. David Robertson
President & CEO

J.D. Koontz
Senior Vice President, Commercial Lending

Ann Vincent – Urling
Senior Vice President, Operations & Branch Administration

Joyce A. Neal
Assistant Vice President, Consumer Loans

Brenda Barnett
Assistant Vice President, Branch Manager – Rainelle

**BOARD OF DIRECTORS**

Frank A. Baer, III
Georgette R. George
Richard E. Heffelfinger
Richard L. Howard, DDS
H. Charles Maddy, III
Charles S. Piccirillo
C. David Robertson
Stephen D. Wehrle
Louis M. Weisberg

**SHENANDOAH VALLEY NATIONAL BANK**

Ronald F. Miller
President & CEO

Cyndie J. Layman
Senior Vice President

Steven D. Tavenner
Senior Vice President

Dawn P. Frye
Vice President & Cashier

James L. Bowman
Vice President

Dennis L. Snyder
Vice President

**BOARD OF DIRECTORS**

J. Scott Bridgeforth
George B. Caley
Randolph A. Craun
Fred Hetzel
Henry P. Kern, III
H. Charles Maddy, III
Ronald F. Miller
Larry T. Omps
George W. Pace
Douglas R. Toan

**LOUDOUN NATIONAL BANK**

*a division of Shenandoah Valley National Bank*

James L. Bowman
President

**LOCAL BOARD**

Jane Fellows
Fred Hetzel
Joel Lyles
Jeffrey Mitchell
H. Powers Thomas

**ROCKINGHAM NATIONAL BANK**

*a division of Shenandoah Valley National Bank*

Dennis L. Snyder
President

**LOCAL BOARD**

Stephanne S. Byrd
Carl B. Harman
Michael Layman
Allon H. Lefever
George W. Pace
Karl D. Stoltzfus

**SUMMIT FINANCIAL SERVICES**

Donita Stitt
Managing Director

**SUMMIT FINANCIAL, LLC**

Theresa Ritter
Managing Director

**SUMMIT INSURANCE SERVICES, LLC**

DBA Sager Insurance Agency

H. Charles Maddy, III
Managing Director

Bruce Kesner
Senior Agent

## SHAREHOLDER INFORMATION

**CORPORATE ADDRESS**

300 North Main Street
Moorefield, WV 26836
304.530.1000
www.summitfgi.com

**FORM 10-K**

Summit Financial Group, Inc. files an annual report to the Securities and Exchange Commission on Form 10-K. Copies of this report are available at www.summitfgi.com or may be obtained without charge upon written request to:

Julie R. Cook, Vice President & Director of Accounting
Summit Financial Group, Inc.
Post Office Box 179
Moorefield, West Virginia 26836
Email: jcook@summitfgi.com

**SHAREHOLDER ASSISTANCE AND GENERAL CORPORATE INFORMATION**

Summit Financial Group, Inc. acts as its own registrar and transfer agent. Shareholders seeking assistance and others seeking general corporate information should contact:

Teresa D. Sherman
Shareholder Relations Coordinator
Summit Financial Group, Inc.
Post Office Box 179
Moorefield, West Virginia 26836
Email: tsherman@summitfgi.com

**COMMON STOCK LISTING**

Current market quotations for the common stock of Summit Financial Group, Inc. are available on the OTC Bulletin Board under the symbol SMMF.

**COMMON STOCK DIVIDEND AND MARKET PRICE INFORMATION**

The following table presents cash dividends paid per share and information regarding bid prices per share of Summit's common stock for the periods indicated. The bid prices presented are based on information reported by the OTC Bulletin Board, and may reflect inter-dealer prices, without retail mark-up, mark-down or commission and not represent actual transactions.

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| **2003** | | | | |
| Dividends paid | $ – | $ 0.20 | $ – | $ 0.23 |
| High bid | 28.50 | 29.25 | 37.00 | 36.95 |
| Low bid | 19.61 | 27.00 | 28.50 | 35.00 |
| **2002** | | | | |
| Dividends paid | $ – | $ 0.185 | $ – | $ 0.19 |
| High bid | 17.50 | 19.25 | 19.50 | 20.00 |
| Low bid | 13.75 | 16.10 | 17.63 | 17.70 |

Dividends on Summit's common stock are paid on the 15th day of June and December. The record date is the 1st day of each respective month.

As of March 9, 2004, there were approximately 1,280 shareholders of record of Summit's common stock.

Design and Production: www.annualreportsinc.com

Summit Financial Group, Inc. • 300 North Main Street • Moorefield, WV  26836 • (304) 530-1000 •  www.summitfgi.com