SUMMIT FINANCIAL GROUP INC
Form 10-Q
May 03, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10 – Q

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

For the quarterly period ended March 31, 2011.
or

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

Commission File Number 0-16587

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

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filero

Non-accelerated filer o Smaller reporting companyþ

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

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

Common Stock, $2.50 par value
7,425,472 shares outstanding as of April 29, 2011

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

Dollars in thousands	March 31, 2011 (unaudited)	December 31, 2010 (*)	March 31, 2010 (unaudited)
ASSETS			
Cash and due from banks	$4,263	$4,652	$5,163
Interest bearing deposits with other banks	46,448	45,696	9,032
Securities available for sale	293,240	271,730	262,565
Other investments	21,956	22,941	24,008
Loans held for sale, net	402	343	429
Loans, net	979,387	995,319	1,112,526
Property held for sale	66,961	70,235	50,562
Premises and equipment, net	22,784	23,092	24,001
Accrued interest receivable	5,797	5,879	6,519
Intangible assets	8,914	9,002	9,265
Other assets	32,043	29,581	32,426
Total assets	$1,482,195	$1,478,470	$1,536,496
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Deposits			
Non interest bearing	$86,735	$74,604	$71,100
Interest bearing	975,384	962,335	939,936
Total deposits	1,062,119	1,036,939	1,011,036
Short-term borrowings	1,879	1,582	27,456
Long-term borrowings	283,516	304,109	361,335
Subordinated debentures	16,800	16,800	16,800
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	8,964	9,630	9,746
Total liabilities	1,392,867	1,388,649	1,445,962
Commitments and Contingencies			
Shareholders' Equity			
Preferred stock and related surplus - authorized 250,000 shares;			
Series 2009, 8% Non-cumulative convertible preferred stock,			
par value $1.00; issued 3,710 shares	3,519	3,519	3,519
Common stock and related surplus - authorized 20,000,000 shares;			
$2.50 par value; issued and outstanding 2011 and			
2010 - 7,425,472 shares	24,515	24,508	24,508
Retained earnings	60,879	61,201	63,519
Accumulated other comprehensive income (loss)	415	593	(1,012)
Total shareholders' equity	89,328	89,821	90,534
Total liabilities and shareholders' equity	$1,482,195	$1,478,470	$1,536,496

(*) - December 31, 2010 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

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

	Three Months Ended	
	March 31,	March 31,
Dollars in thousands, except per share amounts	2011	2010
Interest income		
Interest and fees on loans		
Taxable	$ 15,075	$ 16,958
Tax-exempt	65	83
Interest and dividends on securities		
Taxable	2,609	3,138
Tax-exempt	434	455
Interest on interest bearing deposits with other banks	17	11
Total interest income	18,200	20,645
Interest expense		
Interest on deposits	4,743	5,498
Interest on short-term borrowings	1	57
Interest on long-term borrowings and subordinated debentures	3,354	4,858
Total interest expense	8,098	10,413
Net interest income	10,102	10,232
Provision for loan losses	3,000	5,350
Net interest income after provision for loan losses	7,102	4,882
Other income		
Insurance commissions	1,242	1,209
Service fees	621	707
Realized securities gains (losses)	1,628	264
Gain (loss) on sale of assets	71	12
Writedown of OREO	(3,443)	-
Other	497	353
Total other-than-temporary impairment loss on securities	(1,828)	(454)
Portion of loss recognized in other comprehensive income	600	425
Net impairment loss recognized in earnings	(1,228)	(29)
Total other income	(612)	2,516
Other expense		
Salaries, commissions, and employee benefits	3,842	3,724
Net occupancy expense	509	521
Equipment expense	580	629
Supplies	78	109
Professional fees	196	274
Amortization of intangibles	88	88
FDIC premiums	693	825

OREO expense		434		232
Other		556		1,208
Total other expense		6,976		7,610
Income (loss) before income taxes		(486)		(212)
Income tax expense (benefit)		(238)		(332)
Net Income (loss)		(248)		120
Dividends on preferred shares		74		74
Net Income (loss) applicable to common shares	$	(322)	$	46
Basic earnings per common share	$	(0.04)	$	0.01
Diluted earnings per common share	$	(0.04)	$	0.01

See Notes to Consolidated Financial Statements

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

Dollars in thousands, except per share amounts	Common Stock and Related Surplus	Preferred Stock and Related Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2010	$24,508	$3,519	$61,201	$ 593	$89,821
Three Months Ended March 31, 2011					
Comprehensive income:					
Net income (loss)	-	-	(248)	-	(248)
Other comprehensive income:					
Non-credit related other-than-temporary impairment on available for sale debt securities of $594, net of deferred taxes of $226	-	-	-	(372)	(372)
Net unrealized gain on available for sale debt securities of $312 net of deferred taxes of $118 and reclassification adjustment for net realized gains included in net income of $1,628	-	-	-	194	194
Total comprehensive income					(426)
Exercise of stock options	-	-	-	-	-
Stock compensation expense	7	-	-	-	7
Preferred stock cash dividends declared ($20.00 per share)	-	-	(74)	-	(74)
Balance, March 31, 2011	$24,515	$3,519	$60,879	$ 415	$89,328
Balance, December 31, 2009	$24,508	$3,519	$63,474	$ (841)	$90,660
Three Months Ended March 31, 2010					
Comprehensive income:					
Net income (loss)	-	-	120	-	120
Other comprehensive income:					

Non-credit related other-than-temporary impairment on available for sale debt securities of $425, net of deferred taxes of $161	-	-	-	(264)	(264)
Net unrealized gain on available for sale debt securities of $150 net of deferred taxes of $57 and reclassification adjustment for net realized gains included in net income of $264	-	-	-	93	93
Total comprehensive income					(51)
Exercise of stock options	-	-	-	-	-
Stock compensation expense	-	-	-	-	-
Preferred stock cash dividends declared ($20.00 per share)	-	-	(75)	-	(75)
Balance, March 31, 2010	$24,508	$3,519	$63,519	$ (1,012)	$90,534

See Notes to Consolidated Financial Statements

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

	Three Months Ended	
Dollars in thousands	March 31, 2011	March 31, 2010
Cash Flows from Operating Activities		
Net income (loss)	$ (248)	$ 120
Adjustments to reconcile net earnings to net cash		
provided by operating activities:		
Depreciation	362	407
Provision for loan losses	3,000	5,350
Stock compensation expense	7	-
Deferred income tax (benefit)	(1,630)	(437)
Loans originated for sale	(2,715)	(1,781)
Proceeds from loans sold	2,656	1,354
Securities (gains)	(1,628)	(264)
Other-than-temporary impairment of debt securities	1,228	29
(Gain) on disposal of other repossessed assets & property held for sale	(71)	(12)
Write down of other repossessed assets & property held for sale	3,443	-
Amortization of securities premiums (accretion of discounts), net	373	(302)
Amortization of goodwill and purchase accounting		
adjustments, net	91	91
Increase (decrease) in accrued interest receivable	82	(196)
(Increase) in other assets	(973)	(1,574)
Increase (decrease) in other liabilities	(665)	739
Net cash provided by operating activities	3,312	3,524
Cash Flows from Investing Activities		
Proceeds from (purchase of) interest bearing deposits		
with other banks	(752)	25,215
Proceeds from maturities and calls of securities available for sale	2,889	6,034
Proceeds from sales of securities available for sale	13,256	4,078
Principal payments received on securities available for sale	17,311	13,144
Purchases of securities available for sale	(55,226)	(13,907)
Redemption of Federal Home Loan Bank Stock	986	-
Net principal payments received on loans	11,225	8,792
Purchases of premises and equipment	(54)	(175)
Proceeds from sales of other repossessed assets & property held for sale	1,855	462
Net cash provided by (used in) investing activities	(8,510)	43,643

Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and		
savings accounts	50,571	6,935
Net (decrease) in time deposits	(25,391)	(13,236)
Net increase (decrease) in short-term borrowings	296	(22,284)
Repayment of long-term borrowings	(20,593)	(20,158)
Dividends paid on preferred stock	(74)	(74)
Net cash provided by (used in) financing activities	4,809	(48,817)
(Decrease) in cash and due from banks	(389)	(1,650)
Cash and due from banks:		
Beginning	4,652	6,813
Ending	$ 4,263	$ 5,163

(Continued)

See Notes to Consolidated Financial Statements

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

	Three Months Ended	
	March 31,	March 31,
Dollars in thousands	2011	2010
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 8,311	$ 10,636
Income taxes	$ -	$ -
Supplemental Schedule of Noncash Investing and Financing Activities		
Other assets acquired in settlement of loans	$ 1,707	$ 10,668

See Notes to Consolidated Financial Statements

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

NOTE 1. BASIS OF PRESENTATION

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

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

The results of operations for the quarter ended March 31, 2011 are not necessarily indicative of the results to be expected for the full year. The consolidated financial statements and notes included herein should be read in conjunction with our 2010 audited financial statements and Annual Report on Form 10-K. Certain accounts in the consolidated financial statements for December 31, 2010 and March 31, 2010, as previously presented, have been reclassified to conform to current year classifications.

NOTE 2. SIGNIFICANT NEW AUTHORITATIVE ACCOUNTING GUIDANCE

ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures About Fair Value Measurements, requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements.
ASU 2010-06 further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) company's should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy is required for us beginning January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective for us on January 1, 2010. See Note 3 – Fair Value Measurements.

ASU No. 2010-20, Receivables (Topic 310) - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators.

ASU 2010-20 will be effective for our financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period were effective January 1, 2011 and had no impact on our financial statements.

ASU No. 2011-01, Receivables (Topic 310) – Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20 temporarily delayed the effective date of the disclosures regarding troubled debt restructurings in ASU No. 2010-20 for public entities. The effective date is for interim and annual reporting periods ending after June 15, 2011.

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

ASU 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring provides additional guidance to clarify when a loan modification or restructuring is considered a troubled debt restructuring (TDR) in order to address current diversity in practice and lead to more consistent application of U.S. GAAP for debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. The amendments to Topic 310 clarify the guidance regarding the evaluation of both considerations above. Additionally, the amendments clarify that a creditor is precluded from using the effective interest rate test in the debtor's guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a TDR. This amendment is effective for us July 1, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, we may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011.

ASU No. 2010-28, Intangibles – Goodwill and Other (Topic 350) – When to Perform Step 2 of the goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with the existing guidance and examples in paragraph 350-20-35-30, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This amendment was effective for us January 1, 2011 and had no impact on our financial statements.

NOTE 3. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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

Loans: We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, Accounting by Creditors for Impairment of a Loan. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At March 31, 2011, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with ASC Topic 310, impaired loans where an allowance is established based on the fair value of collateral requires classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When a current appraised value is not available and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

When a collateral-dependent loan is identified as impaired, management immediately begins the process of evaluating the estimated fair value of the underlying collateral to determine if a related specific allowance for loan losses or charge-off is necessary. Current appraisals are ordered once a loan is deemed impaired if the existing appraisal is more than twelve months old, or more frequently if there is known deterioration in value. For recently identified impaired loans, a current appraisal may not be available at the financial statement date. Until the current appraisal is obtained, the original appraised value is discounted, as appropriate, to compensate for the estimated depreciation in the value of the loan’s underlying collateral since the date of the original appraisal. Such discounts are generally estimated based upon management’s knowledge of sales of similar collateral within the applicable market area and its knowledge of other real estate market-related data as well as general economic trends. When a new appraisal is received (which generally are received within 3 months of a loan being identified as impaired), management then re-evaluates the fair value of the collateral and adjusts any specific allocated allowance for loan losses, as appropriate. In addition, management also assigns a discount of 7–10% for the estimated costs to sell the collateral. As of March 31, 2011, the appraised values of the underlying collateral for our collateral-dependent impaired loans which had a related specific allowance or prior charge-off was in excess of the total fair value by $12,107,000.

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

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

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

Dollars in thousands	Balance at March 31, 2011	Fair Value Measurements Using: Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	$ 31,389	$ -	$ 31,389	$ -
Mortgage backed securities:				
Government sponsored agencies	146,226	-	146,226	-
Nongovernment sponsored agencies	52,540	-	52,540	-
State and political subdivisions	22,168	-	22,168	-
Corporate debt securities	965	-	965	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	39,875	-	39,875	-
Total available for sale securities	$ 293,240	$ -	$ 293,240	$ -

Dollars in thousands	Balance at December 31, 2010	Fair Value Measurements Using: Level 1	Level 2	Level 3
Available for sale securities				
U.S. Government sponsored agencies	$ 30,665	$ -	$ 30,665	$ -
Mortgage backed securities:				
Government sponsored agencies	123,037	-	123,037	-
Nongovernment sponsored agencies	59,267	-	59,267	-
State and political subdivisions	22,388	-	22,388	-
Corporate debt securities	949	-	949	-
Other equity securities	77	-	77	-
Tax-exempt state and political subdivisions	35,347	-	35,347	-
Total available for sale securities	$ 271,730	$ -	$ 271,730	$ -

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended March 31, 2011.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

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

Dollars in thousands	Total at March 31, 2011	Fair Value Measurements Using: Level 1	Level 2	Level 3
Residential mortgage loans held for sale	$ 402	$ -	$ 402	$ -
Impaired loans				
Commercial	$ 1,423	$ -	$ -	$ 1,423
Commercial real estate	16,512	-	14,137	2,375
Construction and development	19,790	-	10,023	9,767
Residential real estate	20,755	-	16,608	4,147
Total impaired loans	$ 58,480	$ -	$ 40,768	$ 17,712
OREO	$ 66,961	$ -	$ 66,961	$ -

Dollars in thousands	Total at December 31, 2010	Fair Value Measurements Using: Level 1	Level 2	Level 3
Residential mortgage loans held for sale	$ 343	$ -	$ 343	$ -
Impaired loans				
Commercial	$ 630	$ -	$ -	$ 630
Commercial real estate	16,408	-	13,569	2,839
Construction and development	13,940	-	11,251	2,689
Residential real estate	21,028	-	14,836	6,192
Total impaired loans	$ 52,006	$ -	$ 39,656	$ 12,350
OREO	$ 70,235	$ -	$ 69,855	$ 380

Impaired loans, which are measured for impairment primarily using the fair value of the collateral for collateral-dependent loans, had a carrying amount at March 31, 2011 of $61,748,000, with a valuation allowance of $3,268,000, resulting in no additional provision for loan losses for the three months ended March 31, 2011.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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:

	March 31, 2011		December 31, 2010	
	Carrying	Estimated Fair	Carrying	Estimated Fair
ollars in usands	Value	Value	Value	Value
nancial assets				
Cash and due m banks	$ 4,263	$ 4,263	$ 4,652	$4,652
Interest bearing posits with other banks	46,448	46,448	45,696	45,696
Securities ilable for sale	293,240	293,240	271,730	271,730
Other estments	21,956	21,956	22,941	22,941

Loans held for e, net	402	402	343	343			
Loans, net	979,387	987,922	995,319	1,002,889			
Accrued interest eivable	5,797	5,797	5,879	5,879			
	$ 1,351,493	$ 1,360,028	$ 1,346,560	$1,354,130			
nancial liabilities							
Deposits	$ 1,062,119	$ 1,121,890	$ 1,036,939	$1,102,131			
Short-term rowings	1,879	1,879	1,582	1,582			
Long-term rowings	283,516	300,538	304,109	323,803			
Subordinated bentures	16,800	16,800	16,800	16,800			
Subordinated bentures owed to unconsolidated osidiary trusts	19,589	19,589	19,589	19,589			
Accrued interest vable	2,916	2,916	34%	350,750	33%	381,267	35%

ean freight vices and ocean vices:								
venues	464,692		576,772		918,884		1,142,489	
penses	323,699		433,356		646,719		878,812	
t revenues	140,993	26	143,416	26	272,165	25	263,677	25
stoms brokerage d other services:								
venues	428,379		420,969		831,806		825,334	
penses	194,929		199,068		384,535		388,651	
t revenues	233,450	42	221,901	40	447,271	42	436,683	40
tal net revenues	553,117	100	552,141	100	1,070,186	100	1,081,627	100
erhead expenses:								
aries and related sts	293,532	53	287,065	52	576,887	54	565,943	52
her	80,721	15	82,360	15	162,609	15	164,085	15
tal overhead penses	374,253	68	369,425	67	739,496	69	730,028	67
erating income	178,864	32	182,716	33	330,690	31	351,599	33
her income, net	4,493	1	6,440	1	8,151	1	9,206	1
rnings before ome taxes	183,357	33	189,156	34	338,841	32	360,805	34
ome tax expense	66,918	12	70,827	13	125,355	12	135,144	13
t earnings	116,439	21	118,329	21	213,486	20	225,661	21
ss net earnings ributable to the ncontrolling erest	387	—	569	—	850	—	1,197	—
t earnings ributable to areholders	$116,052	21 %	$117,760	21 %	$ 212,636	20 %	$224,464	21

Airfreight services:

Airfreight services revenues decreased 16% and 18%, respectively in the three and six-month periods ended June 30, 2016, as compared with the same periods for 2015, primarily as a result of lower average sell rates in response to competitive market conditions across all regions. Airfreight tonnage increased 2% in the second quarter of 2016 and decreased 4% in the first half of 2016. Airfreight services expenses decreased 20% and 22%, respectively, in the three and six-month periods of 2016 as a result of favorable buying opportunities throughout all regions, due primarily to excess available carrier capacity, and changes in tonnage. While not possible to quantify, sell rates and tonnage were favorably impacted in the first half of 2015 by customers converting a portion of their ocean freight shipments to airfreight due to port disruptions on the U.S. West Coast.

Airfreight services net revenues decreased 4% for the three-month period ended June 30, 2016, as compared with the same period for 2015. This was principally due to a 10% decrease in net revenue per kilo, partially offset by a 2% increase in tonnage. North America net revenues decreased by 5% due to a 4% decrease in tonnage and competitive conditions that led to lower net revenue per kilo. North Asia, South Asia and Europe net revenues decreased 4%, 7% and 2%, respectively, primarily due to competitive market conditions that resulted in lower net revenue per kilo, partially offset by 5%, 4% and 3% increases in tonnage.

Airfreight services net revenues decreased 8% for the six-month period ended June 30, 2016, as compared with the same period for 2015. This decrease was principally due to a 4% decline in airfreight tonnage and a 6% decrease in net revenue per kilo. North America, South Asia and Europe net revenues decreased by 10%, 7% and 1%, respectively, due principally to 9%, 5% and 2% decreases in tonnage. North Asia net revenues decreased 10% primarily due to competitive market conditions that resulted in lower net revenue per kilo while tonnage remained constant.

Aside from temporary disruptions such as those experienced with U.S. West Coast ports in 2015, the Company expects the global airfreight market to continue to be affected by carrier overcapacity and the timing of new product launches. Customers remain focused on improving supply-chain efficiency, reducing overall logistics costs by negotiating lower rates and utilizing ocean freight whenever possible. The Company expects these trends to continue in conjunction with carriers' efforts to manage available capacity. However, this could be affected by new product launches during periods that have historically experienced higher demands. These events, should they occur, could create a higher degree of volatility in volumes and ultimately buy and sell rates.

Ocean freight and ocean services:

Ocean freight consolidation, direct ocean forwarding and order management are the three basic services that constitute and are collectively referred to as ocean freight and ocean services. Ocean freight and ocean services revenues decreased 19% and 20%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods in 2015, as the Company continued to lower average sell rates to customers in response to competitive market conditions and lower available buy rates from carriers. The Company experienced 1% and 2% declines in container volume in the second quarter and first half of 2016, respectively. Ocean freight and ocean services expenses decreased 25% and 26%, respectively, for the three and six-month periods ended June 30, 2016, due to lower average buy rates, resulting from carrier overcapacity, and declines in volume.

Ocean freight and ocean services net revenues decreased 2% and increased 3%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods for 2015. The largest component of the Company's ocean freight net revenue was derived from ocean freight consolidation, which represented 51% of ocean freight net revenue for both six-month periods ended June 30, 2016 and 2015, respectively.

Ocean freight consolidation net revenues decreased 3% in the second quarter of 2016, as compared with the same period in 2015, due primarily to a 2% decrease in net revenue per container and a 1% decrease in volume. Ocean freight consolidation net revenues increased 3% for the six-month period ended June 30, 2016, as compared with the same period in 2015. This increase was due primarily to a 5% increase in net revenue per container, while volume decreased 2%. Direct ocean freight forwarding net revenues decreased 8% and 2%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods in 2015, due to lower volumes principally in North America. Order management net revenues increased 10% for both the three and six-month periods ended June 30, 2016, mostly resulting from higher volumes with new and existing customers, primarily in North Asia and South Asia.

North America ocean freight and ocean services net revenues decreased 3% in the second quarter of 2016 due to lower direct ocean forwarding volumes. In the first half of 2016, ocean freight and ocean services net revenues in North America increased 2%, primarily due to improved margins. North Asia net revenues decreased 6% and remained constant, respectively, for the three and six-month periods of 2016. Lower volumes in the second quarter fully offset the increase achieved in the first quarter of 2016. Europe net revenues decreased 4% in the second quarter as lower direct ocean forwarding volumes more than offset growth from ocean freight consolidation and order management. In the first half of 2016, Europe increased 3% primarily as a result of growth in volume and higher margins, partially offset by lower direct ocean forwarding volumes.

The Company expects pricing volatility to continue as customers and carriers react to current market conditions, including carrier liquidity challenges and the recent expansion of the Panama Canal. Additionally, customers continue to solicit bids from competitors. These conditions could result in lower revenues and yields.

Customs brokerage and other services:

Customs brokerage and other services revenues increased 2% and 1%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods in 2015, as a result of increased volumes from existing and new road freight customers. Customs brokerage and other services expenses decreased 2% and 1%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods for 2015, principally as a result of reduced import services costs partially offset by an increase in road freight volumes.

Customs brokerage and other services net revenues increased 5% and 2%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods in 2015, primarily as a result of an increase in road freight volumes. North America net revenues increased 6% and 5%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods for 2015, primarily as a result of volumes from existing and new customers in road freight and lower import service costs. Europe net revenues increased 7% in the second quarter due to higher road freight services and decreased 1% for the six-month period. North Asia net revenues increased 20% and 11% in the three and six-month periods, respectively, due to growth in warehouse and distribution services.

Overhead expenses:

Salaries and related costs increased 2% for both the three and six-month periods ended June 30, 2016, as compared with the same periods in 2015, principally as a result of an increase in the number of employees, primarily in North America and Europe, partially offset by reduced bonuses from lower operating income.

Historically, the relatively consistent relationship between salaries and net revenues is the result of a compensation philosophy that has been maintained since the inception of the Company: offer a modest base salary and the opportunity to share in a fixed and determinable percentage of the operating profit of the business unit controlled by each key employee. Using this compensation model, changes in individual incentive compensation will occur in proportion to changes in Company operating income, creating a direct alignment between corporate performance and shareholder interests. Bonuses to field and executive management for the six-month period ended June 30, 2016 were down 6% as compared with the same period for 2015, primarily as a result of a 6% decrease in operating income and reduced executive bonuses in 2015 to recoup the retirement bonus to the Company's former chief executive officer. The Company’s management incentive compensation programs have always been incentive-based and performance driven and there is no built-in bias that favors or enriches management in a manner inconsistent with overall corporate performance. Salaries and related costs as a percentage of net revenues increased 1% and 2%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same periods for 2015.

Because the Company’s management incentive compensation programs are also cumulative, no management bonuses can be paid unless the relevant business unit is, from inception, cumulatively profitable. Any operating losses must have been offset in their entirety by operating profits before management is eligible for a bonus. Executive management, in limited circumstances, makes exceptions at the branch operating unit level. Since the most significant portion of management compensation comes from the incentive bonus programs, the Company believes that this cumulative feature is a disincentive to excessive risk taking by its managers. Due to the nature of the Company’s services, it has a short operating cycle. The outcome of most higher risk transactions, such as overriding established credit limits, would be known in a relatively short time frame. Management believes that when the potential and certain impact on the bonus is fully considered in light of this short operating cycle, the potential for short term gains that could be generated by engaging in risky business practices is sufficiently mitigated to discourage excessive and inappropriate risk taking. Management believes that both the stability and the long term growth in revenues, net

revenues and net earnings are a result of the incentives inherent in the Company’s compensation program.
Other overhead expenses decreased 2% and 1%, respectively, for the three and six-month periods ended June 30, 2016, as compared with the same period in 2015. Higher rent and maintenance costs were offset by recovery of legal and related costs. Other overhead expenses remained constant as a percentage of net revenues for both the three and six-month periods ended June 30, 2016, when compared with the same periods in 2015.
Income tax expense:
The Company pays income taxes in the United States and other jurisdictions. The Company’s consolidated effective income tax rate was 36.5% and 37.0%, respectively, for the three and six-month periods ended June 30, 2016, and 37.4% and 37.5% for the same periods in 2015. The Company's effective tax rate is subject to variation and the rate can be more or less volatile based on the amount of pre-tax income or loss. For example, the impact of discrete items and non-deductible expenses on the effective tax rate is greater when pre-tax income is lower.

Currency and Other Risk Factors

The nature of the Company's worldwide operations necessitates the Company dealing with a multitude of currencies other than the U.S. dollar. This results in the Company being exposed to the inherent risks of volatile international currency markets and governmental interference. Some of the countries where the Company maintains offices and/or agency relationships have strict currency control regulations which influence the Company's ability to hedge foreign currency exposure. The Company tries to compensate for these exposures by accelerating international currency settlements among its offices or agents. The Company may enter into foreign currency hedging transactions where there are regulatory or commercial limitations on the Company's ability to move money freely around the world or the short-term financial outlook in any country is such that hedging is the most time-sensitive way to mitigate short-term exchange losses. Any such hedging activity during the three and six months ended June 30, 2016 and 2015 was insignificant. The Company had no foreign currency derivatives outstanding at June 30, 2016 and December 31, 2015. During the second quarter of 2016 total net foreign currency gains, including amounts recorded in revenues, operating expenses and other income, net, were approximately $2 million. For the six months ended June 30, 2016, total net foreign currency losses were approximately $2 million. During the three and six months ended June 30, 2015, total net foreign currency gains were less than $1 million and $3 million, respectively.

International air and ocean freight forwarding and customs brokerage are intensively competitive and are expected to remain so for the foreseeable future. There are a large number of entities competing in the international logistics industry, many of which have significantly more resources than the Company; however, the Company’s primary competition is confined to a relatively small number of companies within this group. The industry continues to experience consolidations into larger firms striving for stronger and more complete multinational and multi-service networks. However, regional and local brokers and forwarders remain a competitive force.

The primary competitive factors in the international logistics industry continue to be price and quality of service, including reliability, responsiveness, expertise, convenience, and scope of operations. The Company emphasizes quality customer service and believes that its prices are competitive with those of others in the industry. Customers regularly solicit bids from competitors in order to improve service, pricing and contractual terms such as seeking longer payment terms, higher or unlimited liability limits and performance penalties. Increased competition and competitors' acceptance of less favorable contractual terms could result in reduced revenues, reduced margins, higher operating costs or lower volumes, any of which would damage the Company's results of operations and financial condition.

Larger customers utilize more sophisticated and efficient procedures for the management of their logistics supply chains by embracing strategies such as just-in-time inventory management. The Company believes that this trend has resulted in customers using fewer service providers with greater technological capability and more consistent global coverage. Accordingly, sophisticated computerized customer service capabilities and a stable worldwide network have become significant factors in attracting and retaining customers. Developing and maintaining these systems and a worldwide network has added a considerable indirect cost to the services provided to customers. Smaller and middle-tier competitors, in general, do not have the resources available to develop customized systems and a worldwide network.

Liquidity and Capital Resources

The Company’s principal source of liquidity is cash and cash equivalents, short-term investments and cash generated from operating activities. Net cash provided by operating activities for the three and six months ended June 30, 2016 was $105 million and $341 million, as compared with $182 million and $316 million for the same periods in 2015. The decrease of $77 million in the second quarter of 2016 is primarily due to changes in working capital accounts. The increase of $25 million for the six-month period ended June 30, 2016 is primarily due to changes in working capital accounts, partially offset by lower earnings. At June 30, 2016, working capital was $1,233 million, including cash and cash equivalents of $980 million. The Company had no long-term debt at June 30, 2016. Management believes that the Company’s current cash position and operating cash flows will be sufficient to meet its capital and liquidity requirements for at least the next 12 months and thereafter for the foreseeable future, including meeting any contingent liabilities related to standby letters of credit and other obligations.

As a customs broker, the Company makes significant cash advances for a select group of its credit-worthy customers. These cash advances are for customer obligations such as the payment of duties and taxes to customs and tax authorities in various countries throughout the world. Cash advances are a “pass through” and are not recorded as a component of revenue and expense. The billings of such advances to customers are accounted for as a direct increase in accounts receivable from the customer and a corresponding increase in accounts payable to governmental authorities. As a result of these “pass through” billings, the conventional Days Sales Outstanding or DSO calculation does not directly measure collection efficiency. For customers that meet certain criteria, the Company has agreed to extend payment terms beyond its customary terms. Management believes that the Company has effective credit control procedures, and historically has experienced relatively insignificant collection problems.

The Company’s business is subject to seasonal fluctuations. Cash flow fluctuates as a result of this seasonality. Historically, the first quarter shows an excess of customer collections over customer billings. This results in positive cash flow. The increased activity associated with peak season (typically commencing late second or early third quarter and continuing well into the fourth quarter) causes an excess of customer billings over customer collections. This cyclical growth in customer receivables consumes available cash.

Cash used in investing activities for the three and six months ended June 30, 2016 was $9 million and $23 million, respectively, compared to $60 million and $29 million in the same periods of 2015. The Company made minor net investments in short-term investments for both the three and six months ended June 30, 2016 compared to net investments of $47 million and $7 million for the same periods in 2015. The Company had capital expenditures of $13 million and $27 million, respectively, for the three and six-month periods ended June 30, 2016, as compared with capital expenditures of $13 million and $22 million for the same periods in 2015. Capital expenditures in the three and six months ended June 30, 2016 related primarily to investments in technology, office and warehouse furniture and equipment and building and leasehold improvements. The Company does have need, on occasion, to purchase buildings to house staff and to facilitate the staging of customers’ freight. Total capital expenditures in 2016 are currently estimated to be $90 million. This includes routine capital expenditures plus additional real estate development.

Cash used in financing activities during the three and six months ended June 30, 2016 was $120 million and $149 million, respectively, as compared with $172 million and $213 million for the same periods in 2015. The Company uses the proceeds from stock option exercises, employee stock purchases and available cash to repurchase the Company’s common stock on the open market to reduce outstanding shares. During the three and six months ended June 30, 2016, the Company used cash to repurchase 1.9 million and 3.4 million shares, respectively, to reduce the number of total outstanding shares, compared to 2.7 million and 4.3 million shares in the same periods in 2015.

The Company follows established guidelines relating to credit quality, diversification and maturities of its investments to preserve principal and maintain liquidity. The Company’s investment portfolio has not been adversely impacted by the disruption in the credit markets. However, there can be no assurance that the Company’s investment portfolio will not be adversely affected in the future.

The Company maintains international unsecured bank lines of credit. At June 30, 2016, the Company was contingently liable for $76 million from standby letters of credit and guarantees. The standby letters of credit and guarantees relate to obligations of the Company’s foreign subsidiaries for credit extended in the ordinary course of business by direct carriers, primarily airlines, and for duty and tax deferrals available from governmental entities responsible for customs and value-added-tax (VAT) taxation. The total underlying amounts due and payable for transportation and governmental excises are properly recorded as obligations in the books of the respective foreign subsidiaries, and there would be no need to record additional expense in the unlikely event the parent company is required to perform.

The Company's foreign subsidiaries regularly remit dividends to the U.S. parent company after evaluating their working capital requirements and needs to finance local capital expenditures. In some cases, the Company’s ability to repatriate funds from foreign operations may be subject to foreign exchange controls. At June 30, 2016, cash and cash equivalent balances of $531 million were held by the Company’s non-United States subsidiaries, of which $55 million was held in banks in the United States. Earnings of the Company's foreign subsidiaries are not considered to be indefinitely reinvested outside of the United States and, accordingly, a deferred tax liability has been accrued for all undistributed earnings, net of foreign related tax credits that are available to be repatriated.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to market risks in the ordinary course of its business. These risks are primarily related to foreign exchange risk and changes in short-term interest rates. The potential impact of the Company's exposure to these risks is presented below:

Foreign Exchange Risk

The Company conducts business in many different countries and currencies. The Company's business often results in billings issued in a country and currency which differs from that where the expenses related to the service are incurred. In the ordinary course of business, the Company creates numerous intercompany transactions and may have receivables, payables and currencies that are not denominated in the local functional currency. This brings foreign exchange risk to the Company's earnings. The principal foreign exchange risks to which the Company is exposed are in Chinese Yuan, Euro, Mexican Peso, Canadian Dollar and British Pound.

Foreign exchange rate sensitivity analysis can be quantified by estimating the impact on the Company's earnings as a result of hypothetical changes in the value of the U.S. dollar, the Company's functional currency, relative to the other currencies in which the Company transacts business. All other things being equal, an average 10% weakening of the U.S. dollar, throughout the six months ended June 30, 2016, would have had the effect of raising operating income approximately $24 million. An average 10% strengthening of the U.S. dollar, for the same period, would have the effect of reducing operating income approximately $20 million. This analysis does not take into account changes in shipping patterns based upon this hypothetical currency fluctuation. For example, a weakening in the U.S. dollar would be expected to increase exports from the United States and decrease imports into the United States over some relevant period of time, but the exact effect of this change cannot be quantified without making speculative assumptions.

The Company currently does not use derivative financial instruments to manage foreign currency risk and only enters into foreign currency hedging transactions in limited locations where regulatory or commercial limitations restrict the Company's ability to move money freely. Any such hedging activity during the three and six months ended June 30, 2016 and 2015 was insignificant. During the second quarter of 2016 total net foreign currency gains, including amounts recorded in revenues, operating expenses and other income, net, were approximately $2 million. For the six months ended June 30, 2016, total net foreign currency losses were approximately $2 million. During the three and six months ended June 30, 2015, total net foreign currency gains were and less than $1 million and $3 million, respectively. The Company had no foreign currency derivatives outstanding at June 30, 2016 and December 31, 2015. The Company instead follows a policy of accelerating international currency settlements to manage foreign exchange risk relative to intercompany billings. As of June 30, 2016, the Company had approximately $2 million of net unsettled intercompany transactions. The majority of intercompany billings are resolved within 30 days.

Interest Rate Risk

At June 30, 2016, the Company had cash and cash equivalents and short term investments of $980 million, of which $529 million was invested at various short-term market interest rates. The Company had no long-term debt at June 30, 2016. A hypothetical change in the interest rate of 10 basis points at June 30, 2016 would not have a significant impact on the Company's earnings. In management's opinion, there has been no material change in the Company's interest rate risk exposure in the second quarter of 2016.

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report at the reasonable assurance level.

Changes in Internal Controls

There were no changes in the Company's internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company is developing a new accounting system which it is implementing on a worldwide basis over the next several years. This system is expected to improve the efficiency of certain financial and transactional processes and reporting. This transition is affecting the processes that constitute the Company's internal control over financial reporting. Prior to implementing new functionalities, applicable controls are tested for operating effectiveness.
The Company's management has confidence in the Company's internal controls and procedures. Nevertheless, the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, does not expect that the Company's disclosure controls and procedures or the Company's internal controls will prevent all errors or intentional fraud. An internal control system, no matter how well-conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of such internal controls are met. Further, the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all internal control systems, no evaluation of controls can provide absolute assurance that all the Company's control issues and instances of fraud, if any, have been detected.

PART II. OTHER INFORMATION
Item 1. Legal Proceedings
The Company is involved in claims, lawsuits, government investigations and other legal matters that arise in the ordinary course of business and are subject to inherent uncertainties. Currently, in management's opinion and based upon advice from legal advisors, none of these matters are expected to have a significant effect on the Company's operations or financial position. As of June 30, 2016, the amounts accrued for these claims, lawsuits, government investigations and other legal matters are not significant to the Company's operations or financial position. At this time, the Company is unable to estimate any additional loss or range of reasonably possible losses, if any, beyond the amounts recorded, that might result from the resolution of these matters.
Item 1A. Risk Factors
There have been no material changes in the Company's risk factors from those disclosed in the Company's annual report on Form 10-K filed on February 25, 2016.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs
April 1-30, 2016	—	$ —	—	11,390,165
May 1-31, 2016	—	—	—	21,836,489
June 1-30, 2016	1,942,952	49.47	1,942,952	18,955,712
Total	1,942,952	$ 49.47	1,942,952	18,955,712

In November 1993, the Company's Board of Directors authorized a Non-Discretionary Stock Repurchase Plan for the purpose of repurchasing the Company's common stock in the open market with the proceeds received from the exercise of stock options. On February 9, 2009, the Plan was amended to increase the authorization to repurchase up to 40 million shares of the Company's common stock. This authorization has no expiration date. This plan was disclosed in the Company's annual report on Form 10-K filed on March 31, 1995. In the second quarter of 2016, 1,231,745 shares of common stock were repurchased under the Non-Discretionary Stock Repurchase Plan.
In November 2001, under a Discretionary Stock Repurchase Plan, the Company's Board of Directors authorized the repurchase of the Company's common stock in the open market to reduce the issued and outstanding stock down to 200 million shares. In February 2014, the Board of Directors authorized repurchases down to 190 million shares of common stock. In February and August 2015 and May 2016, the Board of Directors further authorized repurchases down to 188 million, 180 million and 170 million, respectively. The maximum number of shares available for

repurchase under this plan will increase as the total number of outstanding shares increases. This authorization has no expiration date. In the second quarter of 2016, 711,207 shares of common stock were repurchased under the Discretionary Stock Repurchase Plan. These discretionary repurchases included 211,207 shares that were made to limit the growth in the number of issued and outstanding shares resulting from stock option exercises and 500,000 shares to reduce the number of total shares outstanding.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

(a) Not applicable

(b) In connection with the implementation of proxy access, the Nominating and Corporate Governance Committee (Governance Committee) of the Board amended the Policy on Director Nominations (Policy) to eliminate the stockholding amount and duration requirements for recommending a nominee to the Board. Under the prior Policy, only shareholders who had held at least 5% of the Company stock for at least one year were eligible to make director candidate recommendations to the Governance Committee. The Policy is available on the Company's website at http://investor.expeditors.com/committees/policy-on-director-nominations.asp.

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Item 6. Exhibits

Exhibits required by Item 601 of Regulation S-K.

Exhibit Number	Description
3.2	The Company's Amended and Restated Bylaws (Incorporated by reference to Exhibit 3.2 to Form 8-K filed on or about May 6, 2016.)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

	EXPEDITORS INTERNATIONAL OF WASHINGTON, INC.
August 4, 2016	/s/ JEFFREY S. MUSSER Jeffrey S. Musser, President, Chief Executive Officer and Director
August 4, 2016	/s/ BRADLEY S. POWELL Bradley S. Powell, Senior Vice President and Chief Financial Officer

EXPEDITORS INTERNATIONAL OF WASHINGTON, INC.
AND SUBSIDIARIES
Form 10-Q Index and Exhibits
June 30, 2016

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101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document