

POTOMAC BANCSHARES INC
Form 10KSB
March 29, 2004

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

FORM 10-KSB

(Mark one)

Annual Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2003

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 0-24958

Potomac Bancshares, Inc.

(Name of Small Business Issuer in Its Charter)

West Virginia
(State or Other Jurisdiction of
Incorporation or Organization)

111 East Washington Street

55-0732247
(I.R.S. Employer
Identification No.)

25414-0906

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PO Box 906, Charles Town WV
(Address of Principal Executive Offices)

(Zip Code)

304-725-8431

(Issuer's Telephone Number, Including Area Code)

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of Each Exchange on Which Registered
NONE	

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, \$1.00 Par Value

(Title of Class)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 past 90 days.

Yes No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

State issuer's revenues for its most recent fiscal year. \$13,629,758

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of a specified date within the past 60 days.
\$38,666,147 as of March 10, 2004

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ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS

DURING THE PAST FIVE YEARS

Check whether the issuer has filed all documents and reports required by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.

Yes x No " Not Applicable "

(APPLICABLE ONLY TO CORPORATE REGISTRANTS)

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

1,698,817 as of March 10, 2004

DOCUMENTS INCORPORATED BY REFERENCE

The following lists the documents that are incorporated by reference in the Form 10-KSB Annual Report, and the Parts and Items of the Form 10-KSB into which the documents are incorporated.

<u>Document</u>	<u>Part of the Form 10-KSB Into Which the Document is Incorporated</u>
Portions of Potomac Bancshares, Inc.'s 2003 Annual Report to Shareholders for the year ended December 31, 2003	Part II, Items 6 and 7
Portions of Potomac Bancshares, Inc.'s Proxy Statement for the 2004 Annual Meeting of Shareholders	Part III, Items 9, 10, 11, 12 and 14

Transitional Small Business Disclosure Format (check one):

Yes "No x

PART I

Item 1. Description of Business.

History and Operations

The Board of Directors of Bank of Charles Town (the bank) caused Potomac Bancshares, Inc. (Potomac) to be formed on March 2, 1994, as a single-bank holding company. To date, Potomac's only activities have involved the acquisition of the bank. Potomac acquired all of the shares of the bank's common stock on July 29, 1994.

Bank of Charles Town is a West Virginia state-chartered bank that formed and opened for business in 1871. The Federal Deposit Insurance Corporation insures the bank's deposits. The bank engages in general banking business primarily in Jefferson County and Berkeley County, West Virginia. The bank also provides services to Washington County and Frederick County, Maryland and Loudoun County, Frederick County and Clarke County, Virginia. The main office is in Charles Town, West Virginia at 111 East Washington Street, with branch offices in

Harpers Ferry, West Virginia,
Kearneysville, West Virginia,
Martinsburg, West Virginia and
Hedgesville, West Virginia.

The bank provides individuals, businesses and local governments with a broad range of banking services. These services include

Commercial credit lines,
Real estate loans, secondary and adjustable rate mortgages,
Equipment loans and retail loan products,
Checking and savings accounts,
Certificates of deposit, and
Individual retirement accounts.

Automated teller machines located at each of the five offices and Touchline 24, an interactive voice response system available at 1-304-728-2424, provide certain services to customers on a twenty-four hour basis. Bill paying and certain other banking services are available through the Internet. The trust and financial services department provides financial management, investment and trust services.

Lending Activities. The bank offers installment, term, and real estate loans for consumer and commercial purposes. These loans can be unsecured, secured by collateral being purchased or secured by other collateral.

Underwriting standards for all lending include

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Sound credit analysis,
Proper documentation according to the bank's loan policy standards,
Promotion of profitable customer relationships with cross-selling of bank services,
Avoidance of loan concentrations to a single industry or with a single class of collateral, and
Diligent maintenance of past due and nonaccrual loans.

It is management's goal to maintain a relatively equal lending distribution among the following loan categories:

Commercial,
Commercial real estate,
Residential real estate and
Consumer or retail.

The lending policies of the bank address the importance of a diversified portfolio and of a balance between maximum yield and minimum risk. It is the bank's policy to avoid concentrations of loans such as loans to one industry, loans to one borrower or guarantor or loans secured by similar collateral.

The bank's loan policy designates particular loan-to-value limits for real estate loans in accordance with recommendations in Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991. As stated in the loan policy, there may be certain lending situations not subject to these loan-to-value limits and from time to time the Board of Directors may permit exceptions to the established limits. Any exceptions are sufficiently documented.

Loans secured by real estate are made to individuals and businesses for

The purchase of raw land and land development,
 Commercial, multi-family and other non-residential construction,
 Purchase of improved property,
 Purchase of owner occupied one to four family residential property,
 Lines of credit, and
 Home equity loans.

Approximately 74% of the bank's loans are secured by real estate. These loans had an average delinquency rate of .65% and a loss rate of .01% during 2003. The average delinquency rate and loss rate are based on comparisons to 2003 average total loans.

As of December 31, 2003, aggregate dollar amounts in loan categories secured by real estate are as follows:

Construction and land development	\$ 13,956,590
Secured by farmland	3,711,332
Secured by 1-4 family residential	60,903,351
Other	25,313,790
	<hr/>
	\$ 103,885,063
	<hr/>

Commercial loans not secured by real estate with an aggregate balance of \$17,649,329 at December 31, 2003 make up approximately 13% of the total loan portfolio. The bank's loan policy for commercial loans including those commercial loans secured by real estate is to

Grant loans on a sound and collectible basis,
 Invest the bank's funds profitably for the benefit of shareholders and the protection of depositors and
 Serve the legitimate credit needs of the community in which the bank is located.

Average delinquency for commercial loans not secured by real estate was 0% and the loss rate was 0% during 2003.

Retail loans to individuals for personal expenditures are approximately 12% of the bank's total loans at December 31, 2003. The aggregate balance of these loans was \$17,549,454 at December 31, 2003. The majority of these loans are installment loans with the remainder made as term loans.

There is some risk in every retail loan transaction. The bank accepts moderate levels of risk while minimizing retail loan losses through careful investigation into the character of each borrower, determining the source of repayment before closing each loan, collateralizing most loans, exercising care in documentation procedures, administering an aggressive retail loan collection program, and following the retail loan policies. Loans to individuals for personal expenditures had an average delinquency rate of .23% and a loss rate of .79% in 2003 (based on comparisons to 2003 average total loans).

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The remaining aggregate dollar amount of the bank's loans is \$973,978 (less than 1% of total loans) at December 31, 2003. This amount includes:

Obligations of states and political subdivisions secured by real estate	\$ 590,294
Loans for agricultural purposes	257,000
Other loans	126,684

These categories of loans had a 0% average delinquency rate and a 0% average loss rate in 2003 compared to 2003 average total loans.

Investment Activities. The bank's investment policy governs its investment activities.

The policy states that excess daily funds are to be invested in federal funds sold and securities purchased under agreements to resell. The daily funds are used to cover deposit draw downs by customers, to fund loan commitments and to help maintain the bank's asset/liability mix.

According to the policy, funds in excess of those invested in federal funds sold and securities purchased under agreements to resell are to be invested in U.S. Treasury bills, notes or bonds, obligations of U.S. Government agencies, obligations of political subdivisions of the State of West Virginia with a rating of not less than AAA and, with prior approval of the Board of Directors, bank qualified local industrial revenue bonds to be carried in the bank's loan portfolio.

The policy governs various other factors including maturities, the closeness of purchase price to par, amounts that may be purchased and percentages of the various types of investments that may be held.

Deposit Activities. The bank offers noninterest-bearing and interest-bearing checking accounts and statement savings accounts. The bank offers automatically renewable certificates of deposit in various terms from 91 days to five years. Individual retirement accounts in the form of certificates of deposit are also available.

To open a deposit account, the depositor must meet the following requirements for low risk individuals:

- Present a valid identification,
- Have a social security number,
- Must be a U.S. citizen or possess evidence of legal alien status, and
- Must be at least 18 years of age or share account with a person at least 18 years of age.

Depositors who are considered medium or high risk (i.e. out-of-state driver's license and/or resident), additional verification requirements apply. The bank fully complies with the Patriot Act.

Competition

As of March 3, 2004, there were 65 bank holding companies (including multi-bank and one bank holding companies) operating in the State of West Virginia. These holding companies are headquartered in various West Virginia cities and control banks throughout the State of West Virginia, including banks that compete with the bank in its market area.

The bank's market area is generally defined as Jefferson County and Berkeley County, West Virginia. As of June 30, 2003, there were six banks in Jefferson County with 13 banking offices. The total deposits of these commercial banks as of June 30, 2003 were \$533.4 million, and the bank ranked number one with \$156.4 million or 29% of the total deposits in the market at that time. The bank has two branch offices in Berkeley County at this time. Opening in July 2001 and June 2003, these branches have less than 1% of the market share of deposits in Berkeley County where there are nine banks with 27 banking offices.

For most of the services that the bank performs, there is also competition from financial institutions other than commercial banks. For instance, credit unions, some insurance companies, and issuers of commercial paper and money market funds actively compete for funds and for various types of loans. In addition, personal and corporate trust and investment counseling services are offered by insurance companies, investment counseling firms and other business firms and individuals. Due to the geographic location of the bank's primary market area, the existence of larger financial institutions in Maryland, Virginia and Washington, D.C. influences the competition in the market area. In addition, larger regional and national corporations continue to be increasingly visible in offering a broad range of financial services to all types of commercial and consumer customers. The principal competitive factors in the markets for deposits and loans are interest rates, either paid or charged. The chartering of numerous new banks in West Virginia and the opening of numerous federally chartered savings and loan associations have increased competition for the bank. The 1986 legislation passed by the West Virginia Legislature allowing statewide branch banking provided increased opportunities for the bank, but it also increased competition for the bank in its service area. With the beginning of reciprocal interstate banking in 1988, bank holding companies (such as Potomac Bancshares, Inc.) also face additional competition in efforts to acquire other subsidiaries throughout West Virginia.

In 1994, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act. Under this Act, bank holding companies are permitted to acquire banks located in states other than the bank holding company's home state without regard to whether the transaction is permitted under state law. Commencing on June 1, 1997, the Act allowed national banks and state banks with different home states to merge across state lines, unless the home state of a participating bank enacted legislation prior to May 31, 1997, that expressly prohibits interstate mergers. Additionally, the Act allows banks to branch across state lines, unless the state where the new branch will be located enacted legislation restricting or prohibiting de novo interstate branching on or before May 31, 1997. West Virginia adopted legislation, effective May 31, 1997, that allowed for interstate branch banking by merger across state lines and allowed for de novo branching and branching by purchase and assumption on a reciprocal basis with the home state of the bank in question. The effect of this legislation has been increased competition for West Virginia banks, including the bank.

Employees

Potomac currently has no employees.

As of March 10, 2004, the bank had 80 full-time employees and 16 part-time employees.

Supervision and Regulation

Introduction. Potomac is a bank holding company within the provisions of the Bank Holding Company Act of 1956, is registered as such, and is subject to supervision by the Board of Governors of the Federal Reserve System (Board of Governors). The Bank Holding Company Act requires Potomac to secure the prior approval of the Board of Governors before Potomac acquires ownership or control of more than five percent (5%) of the voting shares or substantially all of the assets of any institution, including another bank.

As a bank holding company, Potomac is required to file with the Board of Governors annual reports and such additional information as the Board of Governors may require pursuant to the Bank Holding Company Act. The Board of Governors may also make examinations of Potomac and its banking subsidiaries. Furthermore, under Section 106 of the 1970 Amendments to the Bank Holding Company Act and the regulations of the Board of Governors, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or any provision of credit, sale or lease of property or furnishing of services.

Potomac's depository institution subsidiaries are subject to affiliate transaction restrictions under federal law that limit the transfer of funds by the subsidiary banks to their respective parents and any nonbanking subsidiaries, whether in the form of loans, extensions of credit, investments or asset purchases. Such transfers by any subsidiary bank to its parent corporation or any nonbanking subsidiary are limited in an amount to 10% of the institution's capital and surplus and, with respect to such parent and all such nonbanking subsidiaries, to an aggregate of 20% of any such institution's capital and surplus.

Potomac is required to register annually with the Commissioner of Banking of West Virginia (Commissioner) and to pay a registration fee to the Commissioner based on the total amount of bank deposits in banks with respect to which it is a bank holding company. Although legislation allows the Commissioner to prescribe the registration fee, it limits the fee to ten dollars per million dollars of deposits rounded off to the nearest million dollars. Potomac is also subject to regulation and supervision by the Commissioner.

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Potomac is required to secure the approval of the West Virginia Board of Banking before acquiring ownership or control of more than five percent of the voting shares or substantially all of the assets of any institution, including another bank. West Virginia banking law prohibits any West Virginia or non-West Virginia bank or bank holding company from acquiring shares of a bank if the acquisition would cause the combined deposits of all banks in the State of West Virginia, with respect to which it is a bank holding company, to exceed 25% of the total deposits of all depository institutions in the State of West Virginia.

Depository Institution Subsidiaries. The bank is subject to FDIC deposit insurance assessments. As of January 1, 2003, FDIC set the Financing Corporation (FICO) Bank Insurance Fund (BIF) premium for the bank at the annual rate of 1.540 basis points or .0001540 times the total deposits of the bank. This premium is not tied to the bank's risk classification. The rate of the premium based on the bank's risk classification is at 0.00%. It is possible that BIF insurance assessments will be changed, and it is also possible that there may be a special additional assessment. A large special assessment could have an adverse impact on Potomac's results of operations.

Capital Requirements. The Federal Reserve Board has issued risk-based capital guidelines for bank holding companies, such as Potomac. The guidelines establish a systematic analytical framework that makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations, takes off-balance sheet exposures into explicit account in assessing capital adequacy, and minimizes disincentives to holding liquid, low-risk assets. Under the guidelines and related policies, bank holding companies must maintain capital sufficient to meet both a risk-based asset ratio test and leverage ratio test on a consolidated basis. The risk-based ratio is determined by allocating assets and specified off-balance sheet commitments into four weighted categories, with higher levels of capital being required for categories perceived as representing greater risk. The leverage ratio is determined by relating core capital (as described below) to total assets adjusted as specified in the guidelines. Bank is subject to substantially similar capital requirements adopted by applicable regulatory agencies.

Generally, under the applicable guidelines, the financial institution's capital is divided into two tiers. Tier 1, or core capital, includes common equity, noncumulative perpetual preferred stock (excluding auction rate issues) and minority interests in equity accounts or consolidated subsidiaries, less goodwill. Bank holding companies, however, may include cumulative perpetual preferred stock in their Tier 1 capital, up to a limit of 25% of such Tier 1 capital. Tier 2, or supplementary capital, includes, among other things, cumulative and limited-life preferred stock, hybrid capital instruments, mandatory convertible securities, qualifying subordinated debt, and the allowance for loan losses, subject to certain limitations, less required deductions. Total capital is the sum of Tier 1 and Tier 2 capital.

Financial institutions are required to maintain a risk-based ratio of 8%, of which 4% must be Tier 1 capital. The appropriate regulatory authority may set higher capital requirements when an institution's particular circumstances warrant.

Financial institutions that meet certain specified criteria, including excellent asset quality, high liquidity, low interest rate exposure and the highest regulatory rating, are required to maintain a minimum leverage ratio of 3%. Financial institutions not meeting these criteria are required to maintain a leverage ratio which exceeds 3% by a cushion of at least 100 to 200 basis points, and, therefore, the ratio of Tier 1 capital to total assets should not be less than 4%.

The guidelines also provide that financial institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets. Furthermore, the Federal Reserve Board's guidelines indicate that the Federal Reserve Board will continue to consider a tangible Tier 1 leverage ratio in evaluating proposals for expansion or new activities. The tangible Tier 1 leverage is the ratio of an institution's Tier 1 capital, less all intangibles, to total assets, less all intangibles.

Failure to meet applicable capital guidelines could subject the financial institution to a variety of enforcement remedies available to the federal regulatory authorities, including limitations on the ability to pay dividends, the issuance by the regulatory authority of a capital directive to increase capital and the termination of deposit insurance by the FDIC, as well as to the measures described in the Federal Deposit Insurance Corporation Improvement Act of 1991 as applicable to undercapitalized institutions.

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The Federal Reserve Board, as well as the FDIC, has adopted changes to their risk-based and leverage ratio requirements that require that all intangible assets, with certain exceptions, be deducted from Tier 1 capital. Under the Federal Reserve Board's rules, the only types of intangible assets that may be included in (i.e., not deducted from) a bank holding company's capital are readily marketable purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs), provided that, in the aggregate, that total amount of PMSRs and PCCRs included in capital does not exceed 50% of Tier 1 capital. PCCRs are subject to a separate limit of 25% of Tier 1 capital. The amount of PMSRs and PCCRs that a bank holding company may include in its capital is limited to the lesser of (i) 90% of such assets' fair market value (as determined under the guidelines), or (ii) 100% of such assets' book value, each determined quarterly. Identifiable intangible assets (i.e., intangible assets other than goodwill) other than PMSRs and PCCRs, including core deposit intangibles, acquired on or before February 19, 1992 (the date the Federal Reserve Board issued its original proposal for public comment), generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for purposes of evaluating applications filed by bank holding companies.

As of December 31, 2003, Potomac had capital in excess of all applicable requirements as shown below:

	<u>Actual</u>	<u>Required</u>	<u>Excess</u>
(Amounts in thousands)			
Tier 1 capital:			
Common stock	\$ 1,800		
Surplus	4,200		
Retained earnings	16,543		
	<u>22,543</u>		
Less cost of shares acquired for the treasury	1,709		
	<u>20,834</u>	<u>5,679</u>	<u>15,155</u>
Tier 2 capital:			
Allowance for loan losses (1)	1,724		
Total risk-based capital	<u>\$ 22,558</u>	<u>\$ 11,358</u>	<u>\$ 11,200</u>
Risk-weighted assets	<u>\$ 141,978</u>		
Tier 1 capital	<u>\$ 20,834</u>	<u>\$ 6,129</u>	<u>\$ 14,705</u>
Average total assets	<u>\$ 204,287</u>		
Capital ratios:			
Tier 1 risk-based capital ratio	14.67%	4.00%	10.67%
Total risk-based capital ratio	15.89%	8.00%	7.89%
Tier 1 capital to average total assets (leverage)	10.20%	4.00%	6.20%

(1) Limited to 1.25% of gross risk-weighted assets.

Gramm-Leach-Bliley Act of 1999. On November 4, 1999, Congress adopted the Gramm-Leach-Bliley Act of 1999. This Act, also known as the Financial Modernization Law, repealed a number of federal limitations on the powers of banks and bank holding companies originally adopted in the 1930s. Under the Act, banks, insurance companies, securities firms and other service providers may now affiliate. In addition to broadening the powers of banks, the Act created a new form of entity, called a financial holding company, which may engage in any activity that is financial in nature or incidental or complimentary to financial activities.

The Federal Reserve Board provides the principal regulatory supervision of financial services permitted under the Act. However, the Securities and Exchange Commission and state insurance and securities regulators also assume substantial supervisory powers and responsibilities.

The Act addresses a variety of other matters, including customer privacy issues. The obtaining of certain types of information by false or fraudulent pretenses is a crime. Banks and other financial institutions must notify their customers about their policies on sharing information with certain third parties. In some instances, customers may refuse to permit their information to be shared. The Act also requires disclosures of certain automatic teller machine fees and contains certain amendments to the federal Community Reinvestment Act.

Permitted Non-Banking Activities. Under the Gramm-Leach-Bliley Act, bank holding companies may become financial holding companies and engage in certain non-banking activities. Potomac has not yet filed to become a financial holding company and presently does not engage in, nor does it have any immediate plans to engage in, any such non-banking activities.

A notice of proposed non-banking activities must be furnished to the Federal Reserve and the Banking Board before Potomac engages in such activities, and an application must be made to the Federal Reserve and Banking Board concerning acquisitions by Potomac of corporations engaging in those activities. In addition, the Federal Reserve may, by order issued on a case-by-case basis, approve additional non-banking activities.

The Bank. The bank is a state-chartered bank that is not a member of the Federal Reserve system and is subject to regulation and supervision by the FDIC and the Commissioner.

Compliance with Environmental Laws. The costs and effects of compliance with federal, state and local environmental laws will not have a material effect or impact on Potomac or the bank.

Available Information. The company files annual, quarterly and current reports, proxy statements and other information with the SEC. The company's SEC filings are filed electronically and are available to the public through the Internet at the SEC's website at <http://www.sec.gov>. In addition, any document filed by the company with the SEC can be read and copied at the SEC's public reference facilities at 450 Fifth Street, NW, Washington, DC 20549. Copies of documents can be obtained at prescribed rates by writing to the Public Reference Section of the SEC at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Copies of documents can also be obtained free of charge by any shareholder by writing to Gayle Marshall Johnson, Vice President and Chief Financial Officer, Potomac Bancshares, Inc., PO Box 906, Charles Town, WV 25414.

Item 2. Description of Property.

Potomac currently has no property.

The bank owns the land and buildings of the main office and the branch office facilities in Harpers Ferry, Kearneysville and Hedgesville.

The main office property is located at 111 East Washington Street, Charles Town, West Virginia. This property consists of two separate two story buildings located side by side with adjoining corridors. During 2000, the construction of the newer of these two buildings was completed. The first floor of the new building houses the Trust and Financial Services Division. The second floor of the new building houses certain administrative and loan offices. Both of these floors open into the older bank premises. The basement of the new building is currently being remodeled for use as offices and a board/conference room. Record storage formerly kept in the basement is now held offsite.

The older premise, constructed in 1967, was renovated at the same time the new building was constructed. The renovation includes all new lighting, new ceilings, new floor and wall coverings as well as some minor structural changes for more efficient operations.

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The Harpers Ferry branch office is located at 1318 Washington Street, Bolivar, West Virginia. The office is a one story brick building constructed in 1975. There is another building on this property that existed at the time of the bank's purchase. This separate building is rented to an outside party by the bank.

The branch facility in Kearneysville, West Virginia was erected in 1985. This one story brick building opened for business in April of 1985. During 1993, an addition was constructed, doubling the size of this facility.

The branch facility in Hedgesville, West Virginia was erected in 2003. This one story brick building opened for business in June of 2003.

The bank leases the facilities housing the branch office in Martinsburg, West Virginia that opened in July 2001. The amended lease expires in February 2008. The bank has an additional lease for property adjoining the original leased property. This property will be used for construction of a new Martinsburg branch office building. Construction should begin mid 2004 and be completed in late 2004.

There are no encumbrances on any of these properties. In the opinion of management, these properties are adequately covered by insurance.

Item 3. Legal Proceedings.

Currently Potomac is involved in no legal proceedings.

The bank is involved in various legal proceedings arising in the normal course of business, and in the opinion of the bank, the ultimate resolution of these proceedings will not have a material effect on the financial position or operations of the bank.

Item 4. Submission of Matters to a Vote of Security Holders.

Not Applicable.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

The following information reflects comparative per share data for the periods indicated for Potomac common stock for (a) trading values, and (b) dividends. This information has been restated to reflect a 200% stock dividend declared on February 11, 2003. As of March 15, 2004, there were approximately 1,100 shareholders.

Potomac's common stock is not traded on any stock exchange or over the counter. Potomac (symbol PTBS) is on the OTC Bulletin Board, a network available to brokers. Scott and Stringfellow, Inc., Koonce Securities Inc. and Ferris, Baker Watts, Inc. are market makers for Potomac common stock. A market maker is one who makes a market for a particular stock. Information about sales (but not necessarily all sales) of Potomac common stock is available on the Internet through many of the stock information services using Potomac's symbol. Shares of Potomac common stock are occasionally bought and sold by private individuals, firms or corporations, and, in many instances, Potomac does not have knowledge of the purchase price or the terms of the purchase. The trading values for 2002 and 2003 are based on information available as a result of our participation on the Bulletin Board described above and information gathered on the Internet. **No attempt was made by Potomac to verify or determine the accuracy of the representations made to Potomac or gathered on the Internet.**

Price Range		Cash Dividends Paid per Share
High	Low	

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2002	First Quarter	\$ 12.78	\$ 11.75	\$	N/A
	Second Quarter	13.66	12.17		23
	Third Quarter	14.17	13.37		N/A
	Fourth Quarter	15.50	13.92		25
2003	First Quarter	\$ 19.00	\$ 15.50	\$	1300
	Second Quarter	20.00	18.30		1325
	Third Quarter	25.00	19.00		1350
	Fourth Quarter	23.75	22.10		1375

Beginning in 2003 common stock dividends are paid on a quarterly basis. Prior to 2003 the company had paid dividends on a semi-annual basis.

The primary source of funds for dividends paid by Potomac is the dividend income received from the bank. The bank's ability to pay dividends is subject to restrictions under federal and state law, and under certain cases, approval by the FDIC and the Commissioner could be required. Management of Potomac anticipates that the dividends paid by Potomac will likely be similar to those paid in the past, but dividends will only be paid when and as declared by the board of directors.

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The information contained on pages 6-14 of the Annual Report to Shareholders for the year ended December 31, 2003, is incorporated herein by reference.

Financial Instruments With Off-Balance-Sheet Risk. The company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. Those financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the company has in particular classes of financial instruments.

The company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of the contract or notional amount of the company's exposure to off-balance-sheet risk as of December 31, 2003 and 2002, is as follows:

	<u>2003</u>	<u>2002</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 24,847,726	\$ 19,990,685
Standby letters of credit	5,006,967	1,638,028

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and may not be drawn upon to the extent to which the company is committed.

Standby letters of credit are conditional commitments issued by the company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar

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transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The company generally holds collateral supporting those commitments if deemed necessary.

At December 31, 2003, the company had rate lock commitments to originate mortgage loans amounting to \$976,088 and loans held for sale of \$564,213. The company has entered into corresponding mandatory commitments, on a best-efforts basis, to sell these loans. These commitments to sell loans are designed to eliminate the company's exposure to fluctuations in interest rates in connection with rate lock commitments and loans held for sale.

Short-Term Borrowings. Short-term borrowings consist of securities sold under agreements to repurchase, which are secured transactions with customers and generally mature the day following the day sold. Balances outstanding under repurchase agreements were \$9.1 million on December 31, 2003 and \$6.1 million on December 31, 2002.

The table below presents selected information on these short-term borrowings:

	December 31	
	2003	2002
Balance outstanding at year end	\$ 9,199,345	\$ 6,102,441
Maximum balance at any month-end during the year	\$ 9,518,662	\$ 6,244,907
Average balance for the year	\$ 8,549,015	\$ 4,196,410
Weighted average rate for the year	2.01%	2.35%
Weighted average rate at year end	2.00%	2.15%
Estimated fair value	\$ 9,199,345	\$ 6,102,441

Item 7. Financial Statements.

The information contained on pages 15-35 of the Annual Report to Shareholders for the year ended December 31, 2003, is incorporated herein by reference.

Item 8. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.

Not Applicable.

Item 8A. Controls and Procedures.

The company's chief executive officer and chief financial officer, based on their evaluation as of the date of this report of the company's disclosure controls and procedures (as defined in Rule 13(a)-14(e) of the Securities Exchange Act of 1934), have concluded that the company's disclosure controls and procedures are adequate and effective for purposes of Rule 13(a)-14(c) and timely, alerting them to material information relating to the company required to be included in the company's filings with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

There were no significant changes in the company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation.

Appearing immediately following the signatures of this annual report on Form 10-KSB, certificates of the chief executive officer and chief financial officer appear. This form of certification is required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002. This section of the annual report on Form 10-KSB is the information concerning the controls evaluation referred to in the Section 302 certifications. This information should be read in conjunction with those certifications for a more complete understanding of the topics presented. Disclosure

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controls are procedures that a company designs with the objective of ensuring that information required to be disclosed in their reports filed under the Securities Exchange Act of 1934 (such as this Form 10-KSB), is recorded, processed, summarized and reported within the time period specified under the SEC's rules and forms.

Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure. Internal controls are procedures that a company designs with the objective of providing reasonable assurance that transactions are properly authorized, assets are safeguarded against unauthorized or improper use and transactions are properly recorded and reported all to permit the preparation of a company's financial statements in conformity with generally accepted accounting principles.

The company's management, including the CEO and CFO, does not expect that our disclosure controls or internal controls will prevent all error and fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a 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 control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments and decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of control also is based in part upon certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

Based upon the controls evaluation conducted by our CEO and CFO, they have concluded that, subject to the limitations noted above, the company's disclosure controls are effective to ensure that material information relating to Potomac and its subsidiaries is made known to management, including the CEO and CFO, particularly during the period when our periodic reports are being prepared, and that our internal controls are effective to provide reasonable assurance that our financial statements are fairly presented in conformity with generally accepted accounting principles.

PART III

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act.

The information contained on pages 8-10 and 17 of the Proxy Statement dated March 30, 2004, for the April 27, 2004 Annual Meeting under the captions "Management Nominees to the Board of Potomac" and "Directors Continuing to Serve Unexpired Terms," and page 17 under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" is incorporated herein by reference.

The Executive Officers are as follows:

<u>Name</u>	<u>Position Since</u>	<u>Age</u>	<u>Principal Occupation</u>
Robert F. Baronner, Jr.	President & CEO 2001	45	Employed by bank as of 1/1/01 as President & CEO; former Senior Credit Officer BB&T Northern West Virginia May 2000 - December 2000; former Executive Vice President One Valley Bank East September 1997 - April 2000.
William R. Harner	Sr. Vice President 1994	63	Employed at bank from 1967 to 2004; Sr. Vice President & Cashier 1988-2004 (retired).
Gayle Marshall Johnson	Vice President & Chief Financial Officer 1994	54	Employed with the bank 1977-1985 and 1988-present; Vice President and Chief Financial Officer since 1990.
Donald S. Smith	Assistant Secretary 1994	75	Employed at bank 1947 to 1991; President 1979 to 1991 (retired).

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The bank has adopted a Code of Ethics that applies to all employees, including Potomac's and the bank's chief executive officer and chief financial officer and other senior officers. The Code of Ethics is attached to this document as Exhibit 14.1. If we make any substantive amendments to this code or grant any waiver from a provision of the code to our chief executive officer or chief financial officer, we will disclose the amendment or waiver in a report on Form 8-K.

Item 10. Executive Compensation.

The information contained on pages 12-13 and 15-16 of the Proxy Statement dated March 30, 2004, for the April 27, 2004 Annual Meeting under the captions Executive Compensation, Employee Benefit Plans, Employment Agreement, and Compensation of Directors is incorporated herein by reference.

Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information contained on pages 10-12 of the Proxy Statement dated March 30, 2004, for the April 27, 2004 Annual Meeting under the captions Principal Holders of Voting Securities and Ownership of Securities by Nominees, Directors and Officers is incorporated herein by reference.

Item 12. Certain Relationships and Related Transactions.

The information contained on page 16 of the Proxy Statement dated March 30, 2004, for the April 27, 2004 Annual Meeting under the caption Certain Transactions with Directors, Officers and Their Associates is incorporated herein by reference.

Item 13. Exhibits List and Reports on Form 8-K.

(a) 2.1 Agreement and Plan of Merger dated March 8, 1994, by and between Potomac Bancshares, Inc., and Bank of Charles Town filed with and incorporated by reference from the Registration on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

3.1 Articles of Incorporation of Potomac Bancshares, Inc. filed with and incorporated by reference from the Registration on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

3.2 Amendments to Articles of Incorporation of Potomac Bancshares, Inc. adopted by shareholders on April 25, 1995 and filed with the West Virginia Secretary of State on May 23, 1995, and incorporated by reference from Potomac's Form 10-KSB for the year ended December 31, 1995 and filed with the Securities and Exchange Commission, File No. 0-24958.

3.3 Bylaws of Potomac Bancshares, Inc. filed with and incorporated by reference from the Registration on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

3.4 Amended and Restated Bylaws of Potomac Bancshares, Inc. adopted by shareholders April 25, 1995 and incorporated by reference from Potomac's Form 10-KSB for the year ended December 31, 1995, and filed with the Securities and Exchange Commission, File No. 0-24958.

10.1 2003 Stock Incentive Plan adopted by the Potomac Board February 20, 2003 and approved by the Company's shareholders on May 13, 2003.

10.2 Employment Agreement of Mr. Robert F. Baronner, Jr., filed with and incorporated by reference from Form 10-KSB for the year ended December 31, 2001, and filed with the Securities and Exchange Commission, File No. 0-24958.

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13 2003 Annual Report to Shareholders, portions are incorporated by reference in Form 10KSB Annual Report*

14.1 Code of Ethics

21 Subsidiaries of the Registrant

23.1 Consent of Independent Accountants

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer

32.2 Section 1350 Certification of Chief Financial Officer

99.1 Proxy Statement for the 2004 Annual Meeting for Potomac, portions are incorporated by reference in Form 10KSB Annual Report*

* Filed herewith.

(b) A Form 8-K report was filed on November 4, 2003. The report was to announce the 2003 fourth quarter dividend of \$.1375 cents per share. The dividend was payable on December 1, 2003 to shareholders of record November 15, 2003. There were no financial statements filed with the report.

Item 14. Principal Accountant Fees and Services.

The information contained on page 7-8 of the Proxy Statement dated March 30, 2004, for the April 27, 2004 Annual Meeting under the caption Audit Committee Report is incorporated herein by reference.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

POTOMAC BANCSHARES, INC.

By /s/ Robert F. Baronner, Jr. March 29, 2004

Robert F. Baronner, Jr.

President & Chief Executive Officer

By /s/ Gayle Marshall Johnson March 29, 2004

Gayle Marshall Johnson

Vice President & Chief Financial Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature & Title

Date

By /s/ J. Scott Boyd March 29, 2004

J. Scott Boyd, Director

By /s/ John P. Burns, Jr. March 29, 2004

John P. Burns, Jr., Director

By /s/ Guy Gareth Chicchirichi March 29, 2004

Guy Gareth Chicchirichi, Director

By /s/ Margaret Cogswell March 29, 2004

Margaret Cogswell, Director

By /s/ Thomas C. G. Coyle March 29, 2004

Thomas C. G. Coyle, Director

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By /s/ William R. Harner

March 29, 2004

William R. Harner, Director and Secretary

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<u>Signature & Title</u>	<u>Date</u>
By <u>/s/ E. William Johnson</u> E. William Johnson, Director	March 29, 2004
By <u>/s/ Barbara H. Pichot</u> Barbara H. Pichot, Director	March 29, 2004
By <u>/s/ John C. Skinner, Jr.</u> John C. Skinner, Jr., Director	March 29, 2004
By <u>/s/ Donald S. Smith</u> Donald S. Smith, Director	March 29, 2004
By <u>/s/ C. Larry Togans</u> C. Larry Togans, Director	March 29, 2004