

POTOMAC BANCSHARES INC
Form 10-Q
November 14, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007

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.

(Exact Name of Registrant as Specified in Its Charter)

West Virginia
(State or Other Jurisdiction of

Incorporation or Organization)

111 East Washington Street

PO Box 906, Charles Town WV

55-0732247
(I.R.S. Employer

Identification No.)

25414-0906

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(Address of Principal Executive Offices)

(Zip Code)

Registrant's telephone number, including area code 304-725-8431

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

3,410,000 as of November 2, 2007

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 evidences Congress' determination that the disclosure of forward-looking information is desirable for investors and encourages such disclosure by providing a safe harbor for forward-looking statements by corporate management. This Form 10Q, including Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements that involve risk and uncertainty. Forward-looking statements are easily identified by the use of words such as "could," "anticipate," "estimate," "believe," and similar words that refer to a future outlook. To comply with the terms of the safe harbor, the company notes that a variety of factors could cause the company's actual results and experiences to differ materially from the anticipated results or other expectations expressed in the company's forward-looking statements.

The risks and uncertainties that may affect the operations, performance, development and results of the company's business include, but are not limited to, the growth of the economy, interest rate movements, the impact of competitive products, services and pricing, customer business requirements, Congressional legislation and similar matters as well as the occurrence of the events described in the "Risk Factors" section of the December 31, 2006 Form 10-K. We caution readers of this report not to place undue reliance on forward-looking statements which are subject to influence by the named risk factors and unanticipated future events. Actual results, accordingly, may differ materially from management expectations.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(In thousands)

	(Unaudited) September 30 2007	December 31 2006
Assets:		
Cash and due from banks	\$ 4,161	\$ 6,214
Interest-bearing deposits in financial institutions	47	367
Securities purchased under agreements to resell and federal funds sold	6,773	345
Securities available for sale, at fair value	40,386	42,706
Loans held for sale	698	405
Loans, net of allowance for loan losses of \$2,405 and \$2,423 respectively	223,285	227,646
Bank premises and equipment, net	6,242	6,421
Accrued interest receivable	1,371	1,431
Other assets	9,945	7,214
Total Assets	\$ 292,908	\$ 292,749
Liabilities and Stockholders' Equity:		
Liabilities:		
Deposits		
Noninterest-bearing	\$ 27,571	\$ 29,873
Interest-bearing	221,025	221,905
Total Deposits	248,596	251,778
Accrued interest payable	637	672
Securities sold under agreements to repurchase and federal funds purchased	12,373	10,526
Federal Home Loan Bank advances	316	620
Other liabilities	2,409	2,436
Total Liabilities	\$ 264,331	\$ 266,032
Stockholders' Equity:		
Common stock, \$1 per share par value; 5,000,000 shares authorized; 3,671,691 shares issued	\$ 3,672	\$ 3,672
Surplus	3,778	3,661
Undivided profits	24,609	22,677
Accumulated other comprehensive (loss), net	(837)	(1,014)
	\$ 31,222	\$ 28,996
Less cost of shares acquired for the treasury, 2007, 261,691 shares; 2006, 238,108 shares	2,645	2,279
Total Stockholders' Equity	\$ 28,577	\$ 26,717
Total Liabilities and Stockholders' Equity	\$ 292,908	\$ 292,749

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(In thousands except per share data)

(Unaudited)

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2007	2006	2007	2006
Interest and Dividend Income:				
Interest and fees on loans	\$ 4,272	\$ 4,346	\$ 12,871	\$ 12,325
Interest on securities available for sale - taxable	469	558	1,451	1,575
Interest on securities available for sale - nontaxable	19	15	54	41
Interest on securities purchased under agreements to resell and federal funds sold	88	3	345	36
Other interest and dividends	52	39	149	127
Total Interest and Dividend Income	\$ 4,900	\$ 4,961	\$ 14,870	\$ 14,104
Interest Expense:				
Interest on deposits	\$ 1,951	\$ 1,675	\$ 5,843	\$ 4,352
Interest on securities sold under agreements to repurchase and federal funds purchased	125	151	330	444
Federal Home Loan Bank advances	5	100	20	159
Total Interest Expense	\$ 2,081	\$ 1,926	\$ 6,193	\$ 4,955
Net Interest Income	\$ 2,819	\$ 3,035	\$ 8,677	\$ 9,149
Provision for Loan Losses	100	104	100	179
Net Interest Income after Provision for Loan Losses	\$ 2,719	\$ 2,931	\$ 8,577	\$ 8,970
Noninterest Income:				
Trust and financial services	\$ 300	\$ 225	\$ 826	\$ 819
Service charges on deposit accounts	567	459	1,517	1,297
BCT Visa/MC Fees	116	96	328	265
Other operating income	202	156	551	472
Total Noninterest Income	\$ 1,185	\$ 936	\$ 3,222	\$ 2,853
Noninterest Expenses:				
Salaries and employee benefits	\$ 1,363	\$ 1,296	\$ 3,826	\$ 3,926
Net occupancy expense of premises	148	138	424	411
Furniture and equipment expenses	237	225	698	658
Advertising and marketing	67	81	180	232
ATM and check card expenses	73	84	254	236
Other operating expenses	554	532	1,757	1,571
Total Noninterest Expenses	\$ 2,442	\$ 2,356	\$ 7,139	\$ 7,034
Income before Income Tax Expense	\$ 1,462	\$ 1,511	\$ 4,660	\$ 4,789
Income Tax Expense	524	542	1,674	1,696

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Net Income	\$	938	\$	969	\$	2,986	\$	3,093
Earnings Per Share, basic	\$.27	\$.28	\$.87	\$.89
Earnings Per Share, diluted	\$.27	\$.28	\$.87	\$.89

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006

(In thousands)

(Unaudited)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive (Loss)	Comprehensive Income	Total
Balances, December 31, 2005	\$ 3,600	\$ 2,400	\$ 21,158	\$ (1,850)	\$ (276)		\$ 25,032
Comprehensive income							
Net income			3,093			\$ 3,093	3,093
Other comprehensive gain: unrealized holding gain arising during the period (net of tax, \$10)					20	20	20
Total comprehensive income						\$ 3,113	
2% stock dividend	72	1,149	(1,221)				
Purchase of treasury shares: 11,426 shares				(184)			(184)
Stock compensation expense		98					98
Cash dividends (\$.28 per share)			(958)				(958)
Balances, September 30, 2006	\$ 3,672	\$ 3,647	\$ 22,072	\$ (2,034)	\$ (256)		\$ 27,101
Balances, December 31, 2006	\$ 3,672	\$ 3,661	\$ 22,677	\$ (2,279)	\$ (1,014)		\$ 26,717
Comprehensive income							
Net income			2,986			\$ 2,986	2,986
Other comprehensive gain: unrealized holding gain arising during the period (net of tax, \$91)					177	177	177
Total comprehensive income						\$ 3,163	
Purchase of treasury shares: 23,583 shares				(366)			(366)
Stock compensation expense		117					117
Cash dividends (\$.31 per share)			(1,054)				(1,054)
Balances, September 30, 2007	\$ 3,672	\$ 3,778	\$ 24,609	\$ (2,645)	\$ (837)		\$ 28,577

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	For the Nine Months Ended	
	September	September
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,986	\$ 3,093
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	100	179
Depreciation	425	427
Discount accretion and premium amortization on securities, net	(56)	(95)
(Gain) on call of securities available for sale	(1)	
Stock compensation expense	117	98
Proceeds from sale of loans	8,197	5,341
Origination of loans for sale	(8,490)	(5,669)
Changes in assets and liabilities:		
Decrease (increase) in accrued interest receivable	60	(316)
(Increase) in other assets	(2,438)	(797)
(Decrease) increase in accrued interest payable	(35)	169
(Decrease) in other liabilities	(41)	(575)
Net cash provided by operating activities	\$ 824	\$ 1,855
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from maturity of securities available for sale	\$ 10,470	\$ 7,500
Proceeds from call of securities available for sale	7,035	
Purchase of securities available for sale	(14,860)	(11,437)
Net decrease (increase) in loans	3,891	(19,526)
Purchases of bank premises and equipment	(246)	(864)
Net cash provided by (used in) investing activities	\$ 6,290	\$ (24,327)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (decrease) in noninterest-bearing deposits	\$ (2,302)	\$ (1,619)
Net (decrease) increase in interest-bearing deposits	(880)	27,455
Net proceeds (repayment) of securities sold under agreements to repurchase and federal funds purchased	1,847	(7,889)
Net (repayment) proceeds of Federal Home Loan Bank advances	(304)	2,713
Purchase of treasury shares	(366)	(184)
Cash dividends	(1,054)	(958)
Net cash (used in) provided by financing activities	\$ (3,059)	\$ 19,518
Increase (decrease) in cash and cash equivalents	\$ 4,055	\$ (2,954)
CASH AND CASH EQUIVALENTS		
Beginning	6,926	8,472
Ending	\$ 10,981	\$ 5,518

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments for:

Interest	\$ 6,228	\$ 4,786
Income taxes	\$ 1,801	\$ 2,333

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES

Unrealized gain on securities available for sale	\$ 268	\$ 30
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See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2007 (UNAUDITED) AND DECEMBER 31, 2006

1. In the opinion of management, the accompanying financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of September 30, 2007, and December 31, 2006, the results of operations for the three months and nine months ended September 30, 2007 and 2006, and cash flows and statements of changes in stockholders' equity for the nine months ended September 30, 2007 and 2006. The statements should be read in conjunction with Notes to Consolidated Financial Statements included in the Potomac Bancshares, Inc. annual report for the year ended December 31, 2006. The results of operations for the three month and nine month periods ended September 30, 2007 and 2006 are not necessarily indicative of the results to be expected for the full year.

The consolidated financial statements of Potomac Bancshares, Inc. (the company) and its wholly-owned subsidiary, Bank of Charles Town (the bank), include the accounts of both companies. All material intercompany balances and transactions have been eliminated in consolidation.

Certain reclassifications have been made to prior period amounts to conform to the current year presentation.

2. The 2003 Stock Incentive Plan was approved by stockholders on May 13, 2003 which authorized up to 183,600 shares of common stock to be used in the granting of incentive options to employees and directors. This is the first stock incentive plan adopted by the company. On April 24, 2007 the shareholders authorized an additional 250,000 shares of common stock to be used in the granting of incentive options to employees and directors. Under the plan, the option price cannot be less than the fair market value of the stock on the date granted. An option's maximum term is ten years from the date of grant. The company granted 36,723 options in the first quarter of 2007 and 45,889 options in the first quarter of 2006. Options granted under the plan may be subject to a graded vesting schedule. In December 2004, The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R). SFAS 123R requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, such as stock options and restricted stock, based on the fair value of those awards at the date of grant and eliminates the choice to account for employee stock options under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). The company adopted SFAS 123R effective January 1, 2006 using the modified prospective method and as such, results for prior periods have not been restated. Prior to January 1, 2006, no compensation expense was recognized for stock option grants as all such grants had an exercise price not less than fair market value on the date of grant.

Incremental stock-based compensation expense recognized for the nine month period ending September 30, 2007 was \$117 thousand.

Stock option compensation expense is the estimated fair value of options granted and amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award. The weighted average estimated fair value of stock options granted in the nine months ended September 30, 2007 and 2006 was \$3.76 and \$3.88, respectively. Fair value is estimated using the Black-Scholes option-pricing model with the following assumptions for grants during 2007 and 2006: option term until exercise 10 years, expected volatility of 19.56% and 17.86%, risk-free interest rates of 4.66% and 4.43%, and expected dividend yields of 2.74% and 2.66%, respectively.

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Stock option plan activity for the nine months ended September 30, 2007 is summarized below:

	Shares (in thousands)	Weighted Average Exercise Price (Dollars in thousands, except per share amounts)	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Options outstanding, January 1	116	\$ 14		
Granted	37	16		
Exercised				
Canceled or expired				
Options outstanding, September 30	153	15	8	\$ 968
Options exercisable, September 30	84	14	8	\$ 643

As of September 30, 2007 there was \$195 thousand of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period.

- On March 14, 2006 the Board of Directors of Potomac Bancshares, Inc. declared a 2% stock dividend payable on June 1, 2006. Shares issued increased from 3,600,000 to 3,671,691. All per share information for all periods presented has been restated to reflect this dividend.
- The amortized cost and fair value of securities available for sale as of September 30, 2007 and December 31, 2006 (in thousands) are as follows:

	Amortized Cost	September 30, 2007 Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U. S. Government agencies	\$ 38,463	\$ 107	\$ (65)	\$ 38,505
State and municipal obligations	1,887	2	(8)	1,881
	\$ 40,350	\$ 109	\$ (73)	\$ 40,386

	Amortized Cost	December 31, 2006 Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U. S. Government agencies	\$ 41,213	\$ 16	\$ (242)	\$ 40,987
State and municipal obligations	1,725	3	(9)	1,719
	\$ 42,938	\$ 19	\$ (251)	\$ 42,706

The primary purpose of the investment portfolio is to generate income and meet liquidity needs of the company through readily saleable financial instruments. The portfolio is made up of fixed rate bonds, whose prices move inversely with rates. At the end of any accounting period, the investment portfolio has unrealized gains and losses. The company monitors the portfolio which is subject to liquidity needs, market rate changes and credit risk changes to see if adjustments are needed. The primary concern in a loss situation is the credit quality of the business

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behind the instrument. The primary cause of impairments is the decline in the prices of the bonds as rates have risen. There are approximately 15 accounts in the consolidated portfolio that have losses. These securities have not suffered credit deterioration and the company has the ability and intent to hold these issues to maturity; therefore, the gross unrealized losses are considered temporary as of September 30, 2007.

The following table summarizes the fair value and gross unrealized losses for securities aggregated by investment category and length of time that individual securities have been in a continuous gross unrealized loss position as of September 30, 2007 and December 31, 2006 (in thousands).

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	Less than 12 months		September 30, 2007		Total	
	Gross		More than 12 months		Gross	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies	\$ 998	\$ (2)	\$ 13,916	\$ (63)	\$ 14,914	\$ (65)
State and municipal obligations	470	(1)	560	(7)	1,030	(8)
Total	\$ 1,468	\$ (3)	\$ 14,476	\$ (70)	\$ 15,944	\$ (73)

	Less than 12 months		December 31, 2006		Total	
	Gross		More than 12 months		Gross	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies	\$ 6,753	\$ (11)	\$ 20,733	\$ (231)	\$ 27,486	\$ (242)
State and municipal obligations			731	(9)	731	(9)
Total	\$ 6,753	\$ (11)	\$ 21,464	\$ (240)	\$ 28,217	\$ (251)

5. The loan portfolio, stated at face amount, is composed of the following:

	September 30 2007	December 31 2006
	(in thousands)	
Mortgage loans on real estate:		
Construction, land development and other land	\$ 55,961	\$ 53,801
Secured by farmland	1,452	1,557
Secured by 1-4 family residential	98,284	103,983
Secured by multifamily residential	3,655	3,733
Secured by nonfarm nonresidential	46,537	46,367
Commercial and industrial loans (except those secured by real estate)	4,449	4,247
Consumer loans	15,166	16,089
All other loans	186	292
Total loans	\$ 225,690	\$ 230,069
Less: allowance for loan losses	2,405	2,423
	\$ 223,285	\$ 227,646

6. The following is a summary of transactions (in thousands) in the allowance for loan losses:

	September 2007	December 2006	September 2006
Balance at beginning of period	\$ 2,423	\$ 2,161	\$ 2,161
Provision charged to operating expense	100	331	179
Recoveries added to the allowance	131	138	96

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Loan losses charged to the allowance	(249)	(207)	(148)
Balance at end of period	\$ 2,405	\$ 2,423	\$ 2,288

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7. There were no impaired loans at September 30, 2007 and at December 31, 2006. Nonaccrual loans amounted to \$161 thousand and \$144 thousand at September 30, 2007 and December 31, 2006, respectively
8. Components of net periodic benefit cost for the pension and postretirement benefit plans are shown below:

Components of Net Periodic Benefit Cost	Pension Benefits Nine Months Ended		Postretirement Benefits Nine Months Ended	
	September 30 2007	September 30 2006	September 30 2007	September 30 2006
	(In thousands)		(In thousands)	
Service cost	\$ 206	\$ 170	\$ 7	\$ 5
Interest cost	242	236	23	23
Expected return on plan assets	(248)	(236)		
Amortization of net obligation (asset) at transition		(12)	14	13
Recognized net actuarial (gain) loss	26	20		(2)
Net periodic benefit cost	\$ 226	\$ 178	\$ 44	\$ 39

Employer Contribution

Through the nine months ended September 30, 2007, the company has contributed \$485,000 to the pension plan. The company has made payments of \$16,084 for the postretirement benefits plan for the first nine months of 2007 and anticipates remaining payments for 2007 to total \$6,856.

9. Weighted Average Number of Shares Outstanding and Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential diluted common stock had no effect on earnings per share available to shareholders.

	Nine Months Ended		Nine Months Ended	
	September 30, 2007		September 30, 2006	
	Average Shares	Per Share Amount	Average Shares	Per Share Amount
Basic earnings per share	3,427,795	\$.87	3,457,862	\$.89
Effect of dilutive securities:				
Stock options	8,295		14,895	
Diluted earnings per share	3,436,090	\$.87	3,472,757	\$.89

As of September 30, 2007 stock options representing 79,960 shares were not included in the calculation of earnings per share as their effect would have been anti-dilutive.

Average shares outstanding for all periods presented have been restated to reflect the 2% stock dividend discussed in Note 3.

10. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may

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change current practice for some entities. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

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In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses in earnings on items for which the fair value option has been elected at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The company is in the process of evaluating the impact SFAS 159 may have on its consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations **CRITICAL ACCOUNTING POLICIES**

General

The company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimatable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

Our allowance for loan losses has two basic components: the formula allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in the formula allowance.

FINANCIAL OVERVIEW

The bank continues to experience a decrease in loan demand, which continues to affect our deposit strategy. We are not offering any CD specials to increase deposits in an attempt to keep interest expense under control until loan demand begins to increase. The effect on the balance sheet and income statement are outlined below.

Total assets have increased slightly from the December 2006 total of \$292.7 million to \$292.9 million at September 30, 2007. There were, however, some changes within categories in the assets. Due to payoff of several large loans and slow loan demand extra funds were invested in federal funds. The securities portfolio decreased because we invested some maturity funds in federal funds hoping to satisfy loan demand which has never materialized.

Total deposits have decreased \$3.2 million or 1.3% at September 30, 2007 compared to December 31, 2006. The decrease in noninterest-bearing deposits is 7.7% at September 30, 2007 compared to December 31, 2006. Interest-bearing deposits other than time deposits have decreased 1.7% during the same time period while time deposits have increased 1.1% over the December 31, 2006 balance.

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The September 30, 2007 annualized return on average assets is 1.33% compared to 1.39% at December 31, 2006. At September 30, 2007 the annualized return on average equity is 14.26% compared to 15.15% at December 31, 2006. The leverage capital (equity to assets) ratio is 10.05% at September 30, 2007 compared to 9.34% at December 31, 2006. The Tier 1 capital (equity to total risk weighted assets) ratio is 13.26% compared to 12.71% at December 31, 2006. The total capital (total equity to risk weighted assets) ratio is 14.34% compared to 13.82% at December 31, 2006.

The following table is an analysis of the company's allowance for loan losses with amounts shown in thousands. Net charge-offs for the company have been very low when compared with the size of the total loan portfolio. Management monitors the loan portfolio on a continual basis with procedures that allow for problem loans and potential problem loans to be highlighted and watched. Written reports are prepared on a quarterly basis for all loans and information on commercial loans graded below a certain level are reported to the Board of Directors on a monthly basis. Based on experience, these loan policies and the bank's grading and review system, management believes the loan loss allowance is adequate.

	September 30, 2007	September 30, 2006
Balance at beginning of period	\$ 2,423	\$ 2,161
Charge-offs:		
Commercial, financial and agricultural	14	
Real estate - construction		
Real estate - mortgage	80	
Consumer	155	148
Total charge-offs	249	148
Recoveries:		
Commercial, financial and agricultural	30	
Real estate - construction		
Real estate - mortgage		
Consumer	101	96
Total recoveries	131	96
Net charge-offs	118	52
Additions charged to operations	100	179
Balance at end of period	\$ 2,405	\$ 2,228
Ratio of net charge-offs during the period to average loans outstanding during the period	.052%	.023%

Loans are placed on nonaccrual status when principal or interest is delinquent for 90 days or more. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received. Following is a table showing the risk elements in the loan portfolio with amounts in thousands.

	September 30, 2007	September 30, 2006
Nonaccrual loans	\$ 161	\$ 129
Restructured loans		
Foreclosed properties	370	
Total nonperforming assets	\$ 531	\$ 129
Loans past due 90 days accruing interest	\$	\$ 10

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Allowance for loan losses to period end loans	1.07%	1.00%
Nonperforming assets to period end loans and foreclosed properties	.235%	.056%

The percentage increase in the allowance for loan losses to period end loans can be explained by two trends in the housing market. Currently new and existing home sales are below prior year levels which have affected the new loan volume in our portfolio as well as affecting our customers trying to sell their homes. In addition, foreclosures are up and, unfortunately, we have begun to see some in our own portfolio.

At September 30, 2007, other potential problem loans (excluding impaired loans) totaled \$1.7 million. Loans are viewed as potential problem loans according to the ability of such borrowers to comply with current repayment terms. These loans are subject to constant management attention, and their status is reviewed on a regular basis.

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The details of the income statements for the three months and nine months ended September 30, 2007 and 2006 are presented below.

Year to date net income at September 30, 2007 is 3.5% less than 2006 net income for the same period. Net income for the quarter ended September 30, 2007 is 3.2% below the same quarter in 2006.

At September 30, 2007 total interest and dividend income year to date is up 5.4% compared to September 30, 2006 due to higher rates in 2007 for securities and fed funds and higher volumes for loans rates. However, comparisons of the September 30, 2007 quarter to date interest and dividend income to the same period ended September 30, 2006 and quarter to date ended June 30, 2007 show decreases in interest and dividend income of 1.2% and 2.3%, respectively.

The income on the securities portfolio for the nine months ended September 30, 2007 has decreased approximately 6.9% from the same period in 2006. As securities have matured we have invested in fed funds since bond rates have been about the same as fed funds rates. We followed this strategy in order to have more easily accessible funds in anticipation of increased loan demand. Of course, loan demand has not increased as we expected.

Interest income on fed funds sold has increased exponentially over the three months and nine months ended September 30, 2007 compared to the same periods in 2006. The bank has continued to invest more in fed funds due to low loan demand, competitive rates compared to other investments and the liquidity of fed funds compared to other investment options. However, interest on federal funds has decreased 32.8% in the quarter ended September 30, 2007 compared to the quarter ended June 30, 2007. The cause is the anticipated and actual reduction in federal funds rate by the Federal Reserve. We anticipate, as do most economists, that the Federal Reserve will either reduce or maintain the current federal funds rate through the June quarter of 2008. We will adjust our investment strategy accordingly.

Interest expense continues to increase. At September 30, 2007, year to date interest expense was 25.0% above 2006. The third quarter 2007 interest expense is 8% greater than the third quarter of 2006. The increase is due to overall higher interest rates for year to date 2007 compared to year to date 2006. We expect interest expense to gradually decrease as the Federal Reserve is expected to decrease rates at one or more meetings over the next three quarters.

Net interest income through September 30, 2007 is down 5.2% compared to September 30, 2006. The quarterly net interest income as of September 30, 2007 shows a 7.1% decrease over the same quarter in 2006.

Net interest margin at September 30, 2007 is 4.13%, down from the December 31, 2006 figure of 4.45%. During the first nine months of 2007, the overall average rate on loans has remained approximately 7.6%, the same overall average rate as December 31, 2006. During this same year to date September 30, 2007 period, the overall average rate being paid on deposits has increased to 3.4% compared to 2.9% at December 31, 2006.

Noninterest income increased 12.9% for the nine months ended September 30, 2007 compared to September 30, 2006 and has increased 26.6% in the quarter ended September 30, 2007 over the same quarter in 2006. Some significant income items are listed here.

Service charges on deposit accounts have increased 17.0% in 2007 over 2006. The majority of these fees are overdraft related.

Credit and debit card fees have increased 23.8% at September 30, 2007 compared to the same time in 2006. Increased use and additional card holders have contributed to the increase.

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Other noninterest income has increased 23.8% as of September 30, 2007 compared to September 30, 2006. Significant factors include increases in secondary market fee income and income on bank owned life insurance due to additional purchases of the product.

Noninterest expense increased 1.5% for the nine months ended September 30, 2007 compared to the same period in 2006. The September 2007 quarterly total shows a 3.7% increase compared to the third quarter of 2006. Some details of this increase are listed below.

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Salaries and employee benefits for the first nine months of 2007 are actually down 2.5% compared to the first nine months of 2006 for a combination of reasons including the effect of FASB 91 adoption for the entire year in 2007 which reduces salary expense, decreased group insurance costs (though we feel by year end these will probably be comparable to 2006 costs), and increases in pension and other post retirement benefits expense related to fully funding these benefits. In comparing salaries and employee benefits for the quarter ended September 30, 2007 to the quarter ended June 30, 2007 the expense has increased by about 14.7%. This increase is due in large part to additional pension expense as discussed in the previous sentence.

Advertising and marketing expenses have decreased 22.4% in 2007 compared to 2006 due to a more targeted marketing approach. Collaboration with our outside marketing agency has allowed us to cut costs without reducing our market reach.

Auditing and accounting expenses have increased 43.1% in 2007 compared to 2006. In order to accommodate the increased requirements of regulation including the Sarbanes-Oxley Act, the bank has outsourced internal auditing tasks and some testing related to compliance with the Sarbanes-Oxley Act. We face our first level of compliance with the act this year.

Other noninterest expenses have increased 11.8% at September 30, 2007 compared to September 30, 2006. Significant increases and decreases in this category include the following.

Correspondent bank fees have decreased 20.6 % in 2007 over 2006 due in large part to increased use of check imaging and less use of paper.

Other taxes which include a local business and occupation tax, sales tax and purchaser's use tax have increased 15.8%. The local tax is based on gross income and the company's gross income continues to grow so the taxes will increase. Business growth also requires more items that are taxable so sales and purchaser's use taxes can be expected to increase.

Pinnacle fee expense has decreased 85.8% in 2007 compared to 2006. This was the fee paid to vendor for the overdraft protection program based on the increase in our income over former levels. The five year contract for payment of this fee ended.

Printing, stationery and supplies expense is 27.1% greater in 2007 than in 2006. Increased costs in this area account for a large part of this increase. In addition we continue to have mailings to customers in regard to regulatory issues and education.

Legal fees and miscellaneous expenses have increased due to a one time expense in settlement of litigation associated with customer fraud.

We have had foreclosures for the first time in a number of years and expenses related to these foreclosures. We expect that we will have additional foreclosures as we continue through the housing slowdown.

Officers and directors liability and errors and omissions liability insurance increased 55% due to updating policy parameters as part of an annual review and due to the current environment.

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The bank's charge-offs for ATM fraud and other check fraud schemes have increased 67% year to date at September 30, 2007 compared to 2006 for the same period.

Home equity closing costs have decreased 22% due to slow down in loan demand.

LIQUIDITY

Liquid assets of the company include cash and due from banks, securities purchased under agreements to resell, federal funds sold, securities available for sale, and loans and investments maturing within one year. The company's statement of cash flows details this liquidity since January 1, 2007.

Operating Activities. The company's net income provides cash from the bank's operating activities. The net income figure is adjusted for certain noncash transactions, such as depreciation expense, that reduce net income but do not require a cash outlay. Through September 30, 2007 net income as adjusted has provided cash of \$0.8 million. Interest income earned on loans and investments is the company's major income source.

Investing Activities. Customer deposits and company borrowings provide the funds used to invest in loans and securities investments. In addition, the principal portion of loan payments and payoffs and funds from maturing investments provide cash flow. Purchases of bank premises and equipment are an investing activity. The net amount of cash provided by investing activities through September 30, 2007 is \$6.3 million.

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Financing Activities. Customer deposits and company borrowings provide the financing for the investing activities as stated above. If the company has an excess of funds on any given day, the bank will sell these funds to make additional interest income to fund activities. Likewise, if the company has a shortage of funds on any given day it will purchase funds and pay interest for the use of these funds. Financing activities also include payment of dividends, purchase of shares of the company's common stock for the treasury and repayment of any borrowed or purchased funds. The net amount of cash used in financing activities in 2007 through September 30 is \$3.0 million.

The company has additional funding sources in the Federal Home Loan Bank, The Bankers Bank and PNC Bank. Management believes liquidity of the company is adequate to meet present and future financial obligations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no significant changes during the first nine months of 2007 to the quantitative and qualitative disclosures about market risk as discussed in the annual report of Form 10-K as of December 31, 2006.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the date of this quarterly report. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

There are no material legal proceedings to which the Registrant or its subsidiary, directors or officers is a party or by which they, or any of them, are threatened. All legal proceedings presently pending or threatened against Potomac Bancshares, Inc. and its subsidiary involve routine litigation incidental to the business of the company or the subsidiary and are either not material in respect to the amount in controversy or fully covered by insurance.

Item 1A. Risk Factors.

There has been one significant change during the first nine months of 2007 to the risk factors as discussed in the annual report on Form 10-K as of December 31, 2006.

Our market area has encountered a measurable decline in real estate prices due to inflated housing inventories. This increase in inventory was caused, in part, by unregulated mortgage products and overly aggressive national builders which have migrated into this market during the previous five years. Falling real estate prices have the potential to affect loan demand and credit quality within the bank.

Table of Contents**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds.**

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Programs	(d) Maximum Number of Shares that May Yet be purchased under the Program
January 1 through January 31	NONE			107,960
February 1 through February 28	NONE			107,960
March 1 through March 31	NONE			107,960
April 1 through April 30	NONE			107,960
May 1 through May 31	NONE			107,960
June 1 through June 30	NONE			107,960
July 1 through July 31	23,583	15.50	261,691	84,377
August 1 through August 31	NONE			84,377
September 1 through September 30	NONE			84,377

On February 12, 2002, the company's Board of Directors originally authorized the repurchase program. The program authorized the repurchase of up to 10% of the company's stock over the next twelve months. The stock may be purchased in the open market and/or in privately negotiated transactions as management and the board of directors determine prudent. The program has been extended on annual basis.

Item 5. Other Information

- (b) There have been no changes to the procedures by which security holders may recommend nominees to the registrant's board of directors since the registrant last provided disclosure in response to Item 7(d)(2)(ii)(G) of Schedule 14A.

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Item 6. Exhibits

- 31.1 Certification Under Exchange Act Rule 13a-14, Chief Executive Officer (and Section 302 of Sarbanes-Oxley Act of 2002)
- 31.2 Certification Under Exchange Act Rule 13a-14, Chief Financial Officer (and Section 302 of Sarbanes-Oxley Act of 2002)
- 32 Certification Pursuant to 18 U.S.C. Section 1350, Chief Executive Officer and Chief Financial Officer (pursuant to Section 906 of Sarbanes-Oxley Act of 2002)

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

POTOMAC BANCSHARES, INC.

Date November 13, 2007

/s/ Robert F. Baronner, Jr.
Robert F. Baronner, Jr.
President & CEO

Date November 13, 2007

/s/ Gayle Marshall Johnson
Gayle Marshall Johnson
Sr. Vice President and Chief Financial Officer