POTOMAC BANCSHARES INC
Form 10-K
March 29, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

ANNUAL REPORT
PURSUANT TO SECTIONS 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark one)

XXX	**ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended December 31, 2011
	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)	**55-0732247** (I.R.S. Employer Identification No.)
111 East Washington Street **PO Box 906, Charles Town WV** (Address of Principal Executive Offices)	**25414-0906** (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

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

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $1.00 Par Value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No XX

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No XX

Indicate by check mark whether the registrant: (l) 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 XX No

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

Yes XX No

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K (§ 228.405) is not contained herein, and will not 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-K or any amendment to this Form 10-K.

XX

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company XX

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

Yes No XX

State the aggregate market value of the voting and non-voting common equity held by nonaffiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter. $19,207,285 as of June 30, 2011

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

3,390,178 as of March 20, 2012

DOCUMENTS INCORPORATED BY REFERENCE

The following lists the document that is incorporated by reference in the Form 10-K Annual Report, and the Parts and Items of the Form 10-K into which the document is incorporated.

Document	Part of the Form 10-K into Which the Document is Incorporated
Portions of Potomac Bancshares, Inc. s Proxy Statement for the 2012 Annual Meeting of Shareholders which proxy statement will be filed on or about March 30, 2012.	Part III, Items 10, 11, 12, 13 and 14

Potomac Bancshares, Inc.
Annual Report on Form 10-K
For the Year Ended December 31, 2011

* The information required by Items 10, 11, 12, 13 and 14, to the extent not included in this document, is incorporated herein by reference to the information included under the captions Management Nominees to the Board of Potomac, Directors Continuing to Serve Unexpired Terms, Section 16(a) Beneficial Ownership Reporting Compliance, Executive Compensation, Employee Benefit Plans, Compensation of Directors, Ownership of Securities by Nominees, Directors and Officers, Certain Transactions with Directors, Officers and Their Associates and Audit Committee Report in the registrant s definitive proxy statement which is expected to be filed on or about March 30, 2012.

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 10-K, including the President s letter and the 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, confident, and similar words that refer to a future outlook. To comply with the terms of th 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, unemployment, pricing in the real estate market, interest rate movements, the impact of competitive products, services and pricing, customer business requirements, the current economic environment posing significant challenges and affecting our financial condition and results of operations, lack of loan growth, the possibility of future FDIC assessments, Congressional legislation and similar matters (including changes as a result of rules and regulations adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act). The downgrade of U.S. government securities by one of the credit rating agencies could have a material adverse effect on the company s operations, earnings and financial condition. We caution readers of this report not to place undue reliance on forward-looking statements which are subject to influence by unanticipated future events. Actual results, accordingly, may differ materially from management expectations.

PART I

Item 1. Business.

History and Operations

The Board of Directors of Bank of Charles Town (the "bank") caused Potomac Bancshares, Inc. ("Potomac" or the company) 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, Berkeley and Morgan Counties of West Virginia; Clarke, Frederick and Loudoun Counties of Virginia, and Washington and Frederick Counties of Maryland. 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, equipment loans, and construction financing,
- Real estate loans, secondary market and adjustable rate mortgages,
- Retail loan products including home equity lines of credit,
- Checking and savings accounts for businesses and individuals and
- Certificates of deposit and individual retirement accounts.

Online banking with bill pay, electronic statements and other services are available through BCT NetTeller 24 hours a day, 7 days a week. ATMs located at each of the five offices and Touchline 24, an interactive voice response system available at 1-304-728-2424, are also available to customers 24/7. The bank initiated in 2005 the formation of an ATM network with two banks in the community to provide customers of all three banks the use of 17 ATM locations free of charge in the eastern panhandle of West Virginia. Use of ATMs at all Sheetz (a regional convenience store franchise) locations is also free of charge. The bank s One Financial Center encompasses the trust and financial services department and BCT Investments. The trust department provides financial management, investment and trust services. BCT Investments provides financial management, investment and brokerage services.

Lending Activities

Credit Policies

The bank offers a variety of loans for consumer and commercial purposes. Underwriting standards for all lending include

- Sound credit analysis,
- Proper documentation according to the bank's loan policy and compliance standards,
- Management of loan concentrations to a single industry or with a single class of collateral, where applicable,
- Diligent maintenance of past due, nonaccrual loans, and problem loans,
- A risk grading system that assists us in managing deteriorating credits on a proactive basis.

The lending policies of the bank address the importance of a diversified portfolio and a balance between maximum yield and minimum risk. It is the bank s policy to manage 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 senior management of the bank may permit exceptions to the established limits. Any exceptions are sufficiently documented.

Real Estate Lending

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

- Purchase/refinance of owner occupied and investment of one to four family residential property,
- Home equity loans, lines of credit and construction loans,
- Non-owner occupied and owner occupied commercial real estate
- Commercial, multi-family and other non-residential construction,

Approximately 93% of the bank's loans are secured by real estate. These loans had a delinquency rate of 3.86% and a loss rate of 1.82% during 2011. The delinquency rate and loss rate are based on comparisons to 2011 period end loans and average loans, respectively. The delinquent rate to total real estate lending portfolio was 4.16% at December 31, 2011.

As of December 31, 2011, aggregate dollar amounts (in thousands) in loan categories secured by real estate are as follows:

Construction and land development	$	19 179
Secured by farmland		598
Secured by 1-4 family residential		92 856
Secured by multifamily residential		3 088
Commercial real estate owner occupied		61 086
Commercial real estate non-owner occupied		15 796
	$	192 603

Commercial Lending

Commercial loans not secured by real estate with an aggregate balance of $8.4 million at December 31, 2011 make up approximately 4.03% 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 credit needs of the community in which the bank is located.

The delinquency rate for commercial loans not secured by real estate was ..03% during 2011 and the portfolio had net recoveries for the year. The delinquency rate and loss rate are based on comparisons to 2011 period end total loans and average total loans, respectively. The delinquency rate to total commercial loans was .072% at December 31, 2011.

Consumer Lending

Retail loans to individuals for personal expenditures are approximately 2.97% of the bank's total loans at December 31, 2011. The aggregate balance of these loans was $6.2 million at December 31, 2011. The majority of these loans are installment 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 0.02% and a loss rate of 0.02% in 2011. The delinquency rate and loss rate are based on comparisons to 2011 period end total loans and average total loans, respectively. The delinquency rate to total consumer loans was .50% at December 31, 2011.

All other loans total $116 thousand (0.06% of total loans) at December 31, 2011. These loans had no delinquency rate and no loss rate in 2011.

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 withdrawals 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 (1) U.S. Treasury bills, notes or bonds, (2) obligations of U.S. Government agencies or (3) obligations of the State of West Virginia and political subdivisions thereof with a rating of not less than A or fully insured bonds or (4) obligations of states other than West Virginia and political subdivisions thereof with a rating of not less than A or fully insured bonds.

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 savings accounts. The bank offers automatically renewable certificates of deposit in various terms from 91 days to five years. The bank is also a participant in the CDARS and ICS programs. The CDARS program offers certificates of deposit in various terms from four weeks to five years. The ICS program offers money market accounts with increased FDIC protection. 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 an account with a person at least 18 years of age.

When depositors are considered medium or high risk (i.e. out-of-state driver s license and/or resident), additional verification requirements apply.

Competition

As of February 16, 2012, there were 58 bank holding companies headquartered in West Virginia (including multi-bank and one bank holding companies) operating in the State of West Virginia. These holding companies 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. The bank has three branch locations in Jefferson County, WV. As of June 30, 2011, there were six banks in Jefferson County with 15 banking offices. The total deposits of these commercial banks as of June 30, 2011 were $673 million, and the bank ranked number one in total deposits with three branch offices with $209 million or 30.98% of the total deposits in Jefferson County at that time. The bank has two branch offices in Berkeley County. Opening in July 2001 and June 2003, these branches have 4.48% of the market share of deposits in Berkeley County where there are 12 banks with 32 banking offices and total deposits in the Berkeley County market of $1.12 billion.

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. 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.

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 1, 2012, the bank had 83 full-time employees and 10 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 subsidiary is subject to affiliate transaction restrictions under federal law that limit the transfer of funds by the subsidiary bank to its respective parent 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.

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 Subsidiary. The bank is subject to FDIC deposit insurance assessments. In addition to the normal FDIC insurance rates, during 2009, the FDIC imposed a 7 basis point special assessment based on June 30, 2009 deposits due on or before September 30, 2009, which amounted to $138,090 for Bank of Charles Town. In November of 2009, the FDIC required all banks to prepay premiums for the next three years, which was due on or before December 30, 2009. As a result, Bank of Charles Town has prepaid the FDIC insurance premiums of $1,661,631 for the years of 2010, 2011, and 2012. It is possible that the FDIC will impose additional assessments in the future, and the amount of these assessments could be material.

The deposits of Bank of Charles Town are insured by the FDIC up to the limits set forth under applicable law. The deposits of Bank of Charles Town subsidiary are subject to the deposit insurance assessments of the Deposit Insurance Fund (DIF) of the FDIC.

The FDIC has implemented a risk-based deposit insurance assessment system under which the assessment rate for an insured institution may vary according to regulatory capital levels of the institution and other factors, including supervisory evaluations. In addition to being influenced by the risk profile of the particular depository institution, FDIC premiums are also influenced by the size of the FDIC insurance fund in relation to total deposits in FDIC insured banks. Beginning April 1, 2011, an institution s assessment base will be its consolidated total assets less its average tangible equity as defined by the FDIC. The FDIC has authority to impose special assessments from time to time.

The maximum deposit insurance amount per depositor has been increased from $100,000 to $250,000. Also, all funds in a noninterest-bearing transaction account are insured in full by the FDIC from December 31, 2010, through December 31, 2012. This temporary unlimited coverage is in addition to, and separate from, the coverage of at least $250,000 available to depositors under the FDIC s general deposit insurance rules. The FDIC issued a rule including Interest on Lawyers Trust Accounts (IOLTAs) in the temporary unlimited coverage for noninterest-bearing transaction accounts.

The FDIC is authorized to prohibit any DIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution s primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. The company is not aware of any existing circumstances that could result in termination of any of the bank s deposit insurance.

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. The 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 and after tax unrealized gain or loss on available for sale debt securities. Tier 1 capital may also be affected by a limitation on the recorded deferred tax assets. 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.

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, the 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.

Payment of Dividends. The majority of the company s revenues are from dividends paid to the company by its subsidiary bank. The bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both the company and the bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. The FDIC has the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. The FDIC has indicated that paying dividends that deplete a bank s capital base to an inadequate level would be an unsound and unsafe banking practice. During the year ended December 31, 2011, the company paid $67 thousand in dividends to its shareholders.

As of December 31, 2011, Potomac had capital in excess of all applicable requirements as shown below:

	Actual	Required (in thousands)	Excess
Tier 1 capital (to risk-weighted assets)	$ 24 842	$ 8 391	$ 16 451
Total capital (to risk-weighted assets)	$ 27 487	$ 16 782	$ 10 705
Tier 1 capital (to average assets)	$ 24 842	$ 11 602	$ 13 240
Capital ratios:			
Tier 1 risk-based capital ratio	11.84%	4.00%	7.84%
Total risk-based capital ratio	13.10%	8.00%	5.10%
Tier 1 capital to average total assets (leverage)	8.56%	4.00%	4.56%

Community Reinvestment Act. Under the Community Reinvestment Act and related regulations, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. The Community Reinvestment Act requires the adoption by each institution of a Community Reinvestment Act statement for each of its market areas describing the depository institution s efforts to assist in its community s credit needs. Depository institutions are periodically examined for compliance with the Community Reinvestment Act and are periodically assigned ratings in this regard. Banking regulators consider a depository institution s Community Reinvestment Act rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries.

The Gramm-Leach-Bliley Act and federal bank regulators have made various changes to the Community Reinvestment Act. Among other changes, Community Reinvestment Act agreements with private parties must be disclosed and annual reports must be made to a bank s primary federal regulator. A bank holding company will not be permitted to become a financial holding company and no new activities authorized under the GLBA may be commenced by a holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a satisfactory rating in its latest Community Reinvestment Act examination.

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 1930 s. 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 complementary 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.

International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (USA Patriot Act). The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the Patriot Act) was adopted in response to the September 11, 2001 terrorist attacks. The Patriot Act provides law enforcement with greater powers to investigate terrorism and prevent future terrorist acts. Among the broad-reaching provisions contained in the Patriot Act are several designed to deter terrorists ability to launder money in the United States and provide law enforcement with additional powers to investigate how terrorists and terrorist organizations are financed. The Patriot Act creates additional requirements for banks, which were already subject to similar regulations. The Patriot Act authorizes the Secretary of the Treasury to require financial institutions to take certain special measures when the Secretary suspects that certain transactions or accounts are related to money laundering. These special measures may be ordered when the Secretary suspects that a jurisdiction outside of the United States, a financial institution operating outside of the United States, a class of transactions involving a jurisdiction outside of the United States or certain types of accounts are of primary money laundering concern. The special measures include the following: (a) require financial institutions to keep records and report on the transactions or accounts at issue; (b) require financial institutions to obtain and retain information related to the beneficial ownership of any account opened or maintained by foreign persons; (c) require financial institutions to identify each customer who is permitted to use a payable-through or correspondent account and obtain certain information from each customer permitted to use the account; and (d) prohibit or impose conditions on the opening or maintaining of correspondent or payable-through accounts.

Sarbanes-Oxley Act of 2002. On July 30, 2002, the Senate and the House of Representatives of the United States enacted the Sarbanes-Oxley Act of 2002, a law that addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information.

Effective August 29, 2002, as directed by Section 302(a) of Sarbanes-Oxley, Potomac s chief executive officer and chief financial officer are each required to certify that Potomac s Quarterly and Annual Reports do not contain any untrue statement of a material fact. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of Potomac s internal controls; they have made certain disclosures to Potomac s auditors and the audit committee of the Board of Directors about Potomac s internal controls; and they have included information in Potomac s Quarterly and Annual Reports about their evaluation and whether there have been significant changes in Potomac s internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

American Recovery and Reinvestment Act of 2009. On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA), more commonly known as the economic stimulus or economic recovery package. ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. In addition, ARRA imposes certain new executive compensation and corporate expenditure limits on all current and future TARP recipients that are in addition to those previously announced by the U.S. Treasury, until the institution has repaid the U.S. Treasury, which is now permitted under ARRA without penalty and without the need to raise new capital, subject to the U.S. Treasury s consultation with the recipient s appropriate regulatory agency.

Dodd-Frank Act. On July 21, 2010, sweeping financial regulatory reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law. Generally, the Dodd-Frank Act is effective the day after it was signed into law, but different effective dates apply to specific sections of the law. The Dodd-Frank Act implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- Centralize responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau, which will have rulemaking authority for a wide range of consumer protection laws that would apply to all banks and have broad powers to supervise and enforce consumer protection laws;
- After a three-year phase-in period which begins January 1, 2013, removes trust preferred securities as a permitted component of a holding company s tier 1 capital;
- Requires financial holding companies to be well-capitalized and well-managed as of July 21, 2011. Bank holding companies and banks must also be both well-capitalized and well-managed in order to acquire banks located outside their domiciled state;
- Provides for an increase in the FDIC assessment for depository institutions with assets of $10 billion or more, increases in the minimum reserve ratio for the deposit insurance fund from 1.15% to 1.35% and changes in the basis for determining FDIC premiums from deposits to assets;
- Provides for new disclosure and other requirements relating to executive compensation and corporate governance. These disclosures and requirements apply to all public companies, not just financial institutions;
- Permanently increases the limit for federal deposit insurance, increases the cash limit of Securities Investor

  Protection Corporation protection from $100,000 to $250,000 and provides unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions;
- Repeals the federal prohibitions on the payment of interest on demand deposits;
- Amends the Electronic Fund Transfer Act (EFTA) to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer; and
- The Federal Reserve adopted rules effective October 1, 2011, establishing standards for assessing whether the interchange fees that may be charged with respect to electronic debit transactions are reasonable and proportional to the costs incurred by issuers for such transactions. The ultimate impact to the bank is not known.

The Dodd-Frank Act created a new, independent federal agency, the CFPB, which was granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the laws referenced above and certain other statutes, effective July 21, 2011. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, the Dodd-Frank Act will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Uncertainty remains as to the ultimate impact of the Act, which could have a material adverse impact either on the financial services industry as a whole, or on our business. Provisions in the legislation that affect deposit insurance assessments, payment of interest on demand deposits and interchange fees could increase the costs associated with deposits as well as place limitations on certain revenues those deposits may generate. Provisions in the legislation that revoke the Tier 1 capital treatment of trust preferred securities and otherwise require revisions to the capital requirements of the company and the bank could require the company and the bank to seek other sources of capital in the future.

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 100 F Street, NE, Washington, DC 20549. Copies of documents can be obtained at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, NE, 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 Dean Cognetti, Sr. Vice President and Chief Financial Officer, Potomac Bancshares, Inc., PO Box 906, Charles Town, WV 25414.

Item 2. Properties.

The bank owns the land and buildings of the main office and the branch office facilities in Harpers Ferry, Kearneysville, Martinsburg and Hedgesville. The bank also owns a lot at the corner of Route 340 and Washington Street in Bolivar that will most likely be sold when a suitable buyer is identified.

In addition to land specifically purchased for use by the bank, the bank owns, by process of foreclosure, properties in which the customer could no longer meet their obligation to the bank.

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 bank s One Financial Center (trust and financial services). The second floor of the new building houses certain administrative and loan offices. Both of these floors open into the older bank premises, constructed in 1967. In July of 2006, the bank completed the purchase of a property adjacent to the main office for future expansion. In early 2008, construction began on an addition to the main office facilities which was completed in 2009. The new addition houses a new drive through with five lanes (one ATM/night deposit lane and four transaction lanes), the call center, the Information Technology and Deposit Operations departments and certain administrative offices. Renovations to the existing two buildings were completed along with the addition.

In October 2005 to provide additional office and storage areas, the bank leased space in Kearneysville, West Virginia at the Burr Industrial Park. Currently, the leased space provides record storage facilities and a business recovery site for the bank.

The Harpers Ferry branch office is located at 1366 W. Washington Street, Bolivar, West Virginia. The office is a one story brick building constructed in 1975 and renovated in 2005. 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 at 5480 Charles Town Road, 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. Renovation of these facilities was completed in 2006.

The branch facility at 119 Cowardly Lion Drive, Hedgesville, West Virginia was erected in 2003. This one story brick building opened for business in June of 2003.

The branch office at 9738 Tuscarora Pike in Martinsburg, West Virginia opened for business in July of 2001. Originally housed in a leased facility on the property, the one story brick building was completed in January 2005.

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. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

The following information reflects comparative per share data for the periods indicated for Potomac common stock for (a) trading values and (b) dividends. As of March 20, 2012, there were approximately 1,100 shareholders.

Trading of Potomac Bancshares, Inc. common stock is not extensive and cannot be described as a public trading market. Potomac Bancshares, Inc. is on the OTC Bulletin Board Market. To gather information about Potomac in this market use Potomac s symbol PTBS.OB. Scott and Stringfellow, Inc., and Koonce Securities Inc. are market makers for Potomac s stock. Market makers are firms that maintain a firm bid and ask price for a given number of shares at a given point in time in a given security by standing ready to buy or sell at publicly quoted prices. Information about sales of Potomac s 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 most instances, Potomac does not have knowledge of the purchase price or the terms of the purchase. The trading values for 2010 and 2011 are based on information available through 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	
2011	First Quarter	$ 6.00	$ 4.65	$ .0100
	Second Quarter	6.00	5.25	.0100

	Third Quarter	5.95	4.20	.0000
	Fourth Quarter	5.00	3.51	.0000
2010	First Quarter	$ 6.10	$ 4.63	$ .0000
	Second Quarter	6.34	4.50	.0000
	Third Quarter	5.84	4.30	.0000
	Fourth Quarter	5.25	4.30	.0000

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. Dividends will only be paid when and as declared by the board of directors.

Performance Graph

The following graph compares the yearly percentage change in Potomac s cumulative total shareholder return on common stock for the five-year period ending December 31, 2011, with the cumulative total return of the Bank Holding Companies Index (SIC Code 6712) and the Market Value Index. There is no assurance that Potomac s stock performance will continue in the future with the same or similar trends as depicted in the graph.

The graph shall not be deemed incorporated by reference by any general statement into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that Potomac specifically incorporates this graph by reference, and shall not otherwise be filed under such Acts.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN

Among Potomac Bancshares, Inc., Market Value Index, and Bank Holding Companies Index

ASSUMES $100 WAS INVESTED ON JANUARY 1, 2007 AND ASSUMES
DIVIDENDS WERE REINVESTED THROUGH FISCAL YEAR ENDING
DECEMBER 31, 2011

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
October 1 through October 31	NONE	$ - -	283 553	83 617
November 1 through November 30	NONE	- -	283 553	83 617
December 1 through December 31	NONE	- -	283 553	83 617

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 an annual basis at Potomac s reorganization meeting.

Summary of Equity Compensation Plans

	Equity Compensation Plan Information		
Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plan
Equity compensation plans approved by Stockholders	119,908	$ 14.76	311,652
Equity compensation plans not approved by Stockholders	-	$ -	-
	119,908	$ 14.76	311,652

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 and non-qualified options to employees and directors. On April 24, 2007, the stockholders approved an additional 250,000 shares of common stock to be used in the granting of incentive and non-qualified options to employees and directors. This is the first and only stock incentive plan adopted by the company. 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. Employee options granted under the plan are subject to a five year graded vesting schedule. Director options immediately vest.

For additional information regarding our equity compensation plans, refer to the discussion in Note 10 to the audited consolidated financial statements included in Item 15 of this Annual Report on Form 10-K.

Item 6. Selected Financial Data.

	2011	2010	2009	2008	2007
	(Dollars in Thousands Except Per Share Data)				
Summary of Operations					
Interest income	$ 12 571	$ 13 904	$ 14 913	$ 17 358	$ 19 691
Interest expense	2 900	4 143	5 121	6 477	8 161
Net interest income	9 671	9 761	9 792	10 881	11 530
Provision for loan losses	3 343	1 599	6 690	2 934	678
Net interest income after provision for loan losses	6 328	8 162	3 102	7 947	10 852
Noninterest income	4 368	4 076	4 281	4 540	4 379
Noninterest expense	12 956	9 764	11 059	9 772	9 703
(Loss) income before income taxes	(2 260)	2 474	(3 676)	2 715	5 528
Income tax (benefit) expense	(1 250)	680	(1 436)	853	1 998
Net (loss) income	$ (1 010)	$ 1 794	$ (2 240)	$ 1 862	$ 3 530
Per Share Data					
Net (loss) income, basic	$ (.30)	$ .53	$ (.66)	$ .55	$ 1.03
Net (loss) income, diluted	(.30)	.53	(.66)	.55	1.03
Cash dividends declared	.02	.00	.27	.46	.42
Book value at period end	7.51	7.90	7.54	8.19	8.52
Weighted-average shares outstanding, basic	3 390 178	3 390 178	3 390 516	3 401 717	3 423 239
Weighted-average shares outstanding, diluted	3 390 178	3 390 178	3 390 516	3 403 265	3 430 764
Average Balance Sheet Summary					
Assets	$ 299 759	$ 303 998	$ 304 739	$ 303 749	$ 297 716
Loans	210 817	227 113	239 175	232 894	226 773
Securities	47 090	39 388	32 841	34 178	42 040
Deposits	260 766	263 534	261 233	259 536	252 908
Stockholders equity	27 167	26 780	26 266	30 118	28 207
Performance Ratios					
(Loss) return on average assets	(0.34)%	0.59%	(0.74)%	0.61%	1.19%
(Loss) return on average equity	(3.72)%	6.70%	(8.53)%	6.18%	12.51%
Dividend payout ratio	N/A	N/A	N/A	83.64%	40.78%
Capital Ratios					
Leverage ratio	8.56%	9.36%	8.75%	9.85%	9.99%
Risk-based capital ratios					
Tier 1 capital	11.84%	12.97%	11.65%	12.37%	13.01%
Total capital	13.10%	14.24%	12.92%	13.63%	14.23%

Item 7. 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 U. S. generally accepted accounting principles. 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, U. S. generally accepted accounting principles 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: (1) losses be accrued when they are probable of occurring and are capable of estimation and (2) losses be accrued based on the differences between the margin value of collateral and the loan balance.

The allowance consists of specific and general components. The specific component relates to loans (other than consumer and residential mortgage loans) that are classified as substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for environmental factors such as economic, concentration and growth trends. The historical period used in calculating the loss factor has changed. Prior to August 2011 the bank used a thirty six month rolling average to calculate the historical loss factor in the loan portfolio. In August 2011 bank management changed to a twelve month rolling average. The change was made due to management s belief that the twelve month average more accurately compares with the current economic environment. The impact of the change was an increase in the allowance of $476 thousand at December 31, 2011.

GENERAL

The year ended December 31, 2011 was a mix of challenges and opportunities. 2011 results were dominated by credit loss provisions, and foreclosed property expenses. These items were the principal drivers of the loss for the year as these were over 2010 amounts by $1.7 million and $2.6 million, respectively. As noted in the table below, the primary charges occurred in the third quarter. The net loss in the third quarter was $1.8 million due to two charges posted in that quarter. First, we reduced the value of our foreclosed property assets by some $1.85 million upon obtaining updated appraisals on foreclosed property carried on our balance sheet. We evaluate these assets on an ongoing basis especially in a declining real estate market which our area continues to experience. About two thirds of the write-down involved residential lot developments foreclosed upon and charged down in 2009. These properties have continued to lose value due to very weak demand by consumers for new housing and little demand from builders for lots. A surplus of foreclosed properties on the market continues to keep prices low, so until new and existing housing values reach some sort of price equilibrium, there will be little demand for both lots and new construction. A second charge of $2.1 million involved additions to our loan loss reserve as businesses and consumers continue to struggle because of the sluggish economy. In conjunction with our ongoing loan review process, an analysis of both primary and secondary sources of repayment including an assessment of the current value of collateral is performed. Again, most of the collateral that secures our loans is real estate and those values are down significantly. Management continues to pursue potential loan relationships and is vigilantly marketing our current inventory of foreclosed properties.

It is management s opinion that one of the key elements to improving our situation and that of the local economy is to reduce this housing inventory currently owned by financial institutions. We expect economic growth to be slow and do not expect the real estate market to return to pre-recession levels. Partly mitigating these increased expenses were continued strength in net interest income and noninterest income, both of which remained consistent with prior year levels.

Bank management is ending the year still hopeful that sustainable growth is closer than it has been for some time while also being aware that the pace will continue to be slow. During the year, unemployment began to improve slightly along with a further stabilization in local housing values took place. However in the near term the focus will continue to be on asset quality, management of capital levels, and continued efforts to differentiate ourselves from our competition. The company plans continued focus on reducing interest cost, efficiency improvements, and moderate loan growth utilizing current liquidity with an expectation of minimal overall asset growth in 2012.

Capital levels as of year-end continued to be in excess of required minimum regulatory levels.

The debate in Congress regarding the national debt ceiling, federal budget deficit concerns and overall weakness in the economy resulted in a downgrade of U.S. government securities by one of the three major credit rating agencies. This downgrade and the possible future downgrade by one or both of the other two major ratings agencies could create uncertainty in the U.S. and global financial markets. These actions could cause other events which, directly or indirectly, may adversely affect the company s operations, earnings and financial condition.

The following table sets forth selected quarterly results (with dollars in thousands) of the company for 2011 and 2010.

	2011 Three Months Ended				2010 Three Months Ended			
	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31
Interest income	$ 3 047	$ 3 162	$ 3 138	$ 3 224	$ 3 380	$ 3 459	$ 3 539	$ 3 526
Interest expense	557	634	784	925	948	993	1 058	1 144
Net interest income	2 490	2 528	2 354	2 299	2 432	2 466	2 481	2 382
Provision for loan losses	617	2 128	175	423	615	213	461	310
Net interest income after provision for loan losses	1 873	400	2 179	1 876	1 817	2 253	2 020	2 072
Noninterest income	1 268	1 054	1 071	975	1 051	1 022	1 063	940
Noninterest expense	2 659	4 674	3 071	2 552	2 430	2 506	2 431	2 397
Income (loss) before taxes	482	(3 220)	179	299	438	769	652	615
Income tax expense (benefit)	120	(1 418)	6	42	32	241	214	193
Net income (loss)	$ 362	$ (1 802)	$ 173	$ 257	$ 406	$ 528	$ 438	$ 422
Earnings (loss) per share, basic and diluted	$ .11	$ (.53)	$ .05	$ .08	$ .12	$ .16	$ .13	$ .12

NET INTEREST INCOME

Interest and dividend income was 10% lower in 2011 when compared with 2010 results. The particular reasons for the reduction in interest income are (1) an approximately 10% decrease in interest and fees on loans, (2) a 13% decrease in interest on taxable securities and (3) a 14% increase in interest on non-taxable securities. The decrease in loan interest is due primarily to a reduction in average loan values of $16.3 million and, to a lesser degree, a decrease in the average yield for the year. The decrease in security interest is caused by lower interest securities replacing higher interest securities at both maturity and call date. Other earning assets have changed by varying degrees but have not significantly affected interest income.

Management counteracted the reduction in interest income in 2011 by reducing interest expense and in particular interest paid on deposits. As a result, total interest expense decreased 30% in 2011 compared to 2010. There have been no significant adverse effects to deposit balances.

AVERAGE BALANCES, INCOME/EXPENSE AND AVERAGE YIELD/RATE

This schedule is a comparison of interest earning assets and interest-bearing liabilities showing average yields or rates derived from average balances and actual income and expenses. Income and rates on tax exempt loans and securities are computed on a tax equivalent basis using a federal tax rate of 34%. Loans placed on nonaccrual status are reflected in the balances.

	2011 Average Balances (in thousands)	Income/ Expense	Average Yield/Rate	2010 Average Balances (in thousands)	Income/ Expense	Average Yield/Rate	2009 Average Balances (in thousands)	Income/ Expense	Av Yie
ASSETS									
Loans									
Taxable	$ 210 382	$ 11 618	5.52%	$ 226 192	$ 12 875	5.69%	$ 238 489	$ 13 759	
Tax exempt	435	45	10.34%	921	73	7.93%	686	64	9.3
Total loans	210 817	11 663	5.53%	227 113	12 948	5.70%	239 175	13 823	5.7
Taxable securities	41 015	660	1.61%	34 372	755	2.20%	29 084	933	
Nontaxable securities	6 075	350	5.76%	5 016	306	6.10%	3 757	224	
Federal funds sold	1 506	1	0.07%	3 291	3	0.09%	4 049	7	
Other earning assets	15 705	31	0.20%	10 668	21	0.20%	2 905	24	
Total earning assets	**275 118**	**$ 12 705**	**4.62%**	**280 460**	**$ 14 033**	**5.00%**	**278 970**	**$ 15 011**	
Allowance for loan losses	(4 568)			(5 335)			(4 776)		
Cash and due from banks	1 687			1 862			6 850		
Premises and equipment, net	8 106			8 510			8 650		
Other assets	19 416			18 501			15 045		
Total assets	$ 299 759			$ 303 998			$ 304 739		
LIABILITIES AND STOCKHOLDERS EQUITY									
Deposits									
Savings and interest-bearing demand deposits	$ 139 678	$ 666	0.48%	$ 126 035	$ 838	0.66%	$ 119 504	$ 1 016	
Time deposits	91 690	2 138	2.33%	109 902	3 134	2.85%	115 239	3 756	
Total interest-bearing deposits	231 368	2 804	1.21%	235 937	3 972	1.68%	234 743	4 772	
Securities sold under agreements to repurchase and federal funds purchased	7 189	59	0.82%	8 372	84	1.00%	9 212	148	
Advances from FHLB and FRB	2 153	37	1.72%	3 333	87	2.61%	4 336	201	
Total interest bearing liabilities	**240 710**	**$ 2 900**	**1.20%**	**247 642**	**$ 4 143**	**1.67%**	**248 291**	**$ 5 121**	
Noninterest-bearing demand deposits	29 398			27 597			26 490		
Other liabilities	2 484			1 979			3 692		
Stockholders equity	27 167			26 780			26 266		
Total liabilities and stockholders equity	$ 299 759			$ 303 998			$ 304 739		
Net interest income		**$ 9 805**			**$ 9 890**			**$ 9 890**	
Net interest spread			**3.42%**			**3.33%**			
Interest expense as a percent of average earning assets			**1.05%**			**1.48%**			
Net interest margin			**3.56%**			**3.53%**			

VOLUME AND RATE ANALYSIS

This schedule analyzes the change in net interest income attributable to changes in volume of the various portfolios and changes in interest rates. The change due to both rate and volume variances has been allocated between rate and volume based on the percentage relationship of such variances to each other. Income on tax exempt loans and securities are computed on a tax equivalent basis using a federal tax rate of 34%.

	2011 Compared to 2010 (in thousands)			2010 Compared to 2009 (in thousands)		
	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect
INTEREST INCOME						
Taxable loans	$ (1 257)	$ (881)	$ (376)	$ (884)	$ (697)	$ (187)
Tax exempt loans	(28)	(46)	18	9	20	(11)
Taxable securities	(95)	130	(225)	(178)	150	(328)
Nontaxable securities	44	62	(18)	82	77	5
Federal funds sold	(2)	(1)	(1)	(4)	(1)	(3)
Other earning assets	10	9	1	(3)	26	(29)
TOTAL	$ (1 328)	$ (727)	$ (601)	$ (978)	$ (425)	$ (553)
INTEREST EXPENSE						
Savings and interest-bearing demand deposits	$ (172)	$ 80	$ (252)	$ (178)	$ 54	$ (232)
Time deposits	(996)	(474)	(522)	(622)	(167)	(455)
Securities sold under agreements to repurchase and federal funds purchased	(25)	(11)	(14)	(64)	(13)	(51)
Advances from FHLB and FRB	(50)	(25)	(25)	(114)	(39)	(75)
TOTAL	$ (1 243)	$ (430)	$ (813)	$ (978)	$ (165)	$ (813)
NET INTEREST INCOME	$ (85)	$ (297)	$ 212	$ - -	$ (260)	$ 260

NONINTEREST INCOME

Service charges on deposit accounts continue to be the largest single contributor to the bank s noninterest income. These fees totaled $1.8 million for 2011, $1.9 million for 2010 and $2.2 million for 2009. The primary driver in each of these years is overdraft and return check charges. Trust and financial services income, generally the second largest single contributor to noninterest income, increased in 2011 compared to 2010 due to an increase in market values, an increase in new account activity and a fee increase in 2010. VISA/MC fees increased 12% in 2011 compared to 2010 due to continuing consumer comfort with electronic transactions and an increase in consumer spending throughout 2011. The miscellaneous income increase was related to the termination of part of other post-retirement benefits. All other non-interest income changed to varying degrees, but no significant changes occurred in any one particular income category.

	2011	2010	2009
Trust and financial services	$ 894	$ 842	$ 758
Service charges on deposit accounts	1 831	1 854	2 205
Visa/MC Fees	759	676	563
Cash surrender value of life insurance	234	235	238
Miscellaneous income	287	38	4
Gain on sale of securities	- -	- -	42
Other operating income	363	431	471
Total Noninterest Income	$ 4 368	$ 4 076	$ 4 281

NONINTEREST EXPENSE

Salaries and employee benefits of $5 million are about 38% of the total noninterest expense for 2011, about a 10% decrease when compared to 2010. This decrease in salaries and benefits as a percentage of total noninterest expense is due to the increase in total noninterest expense. During the past few years, full utilization of personnel has continued to allow the bank to hold down salaries and benefit costs by holding down the increase in personnel.

Expenses related to premises have decreased and expenses related to furniture and equipment has increased. The increase in furniture, fixture and equipment expense is primarily caused by the outsourcing of our core banking system and increases in general repairs and maintenance. During 2011, accounting, audit and compliance expense increased 30%. Computer services increased 80%. This too is related to costs of services now performed by an outside vendor. The FDIC assessment has steadily decreased since 2009. The decrease is due to several factors: including assessment base, and the size of the FDIC insurance fund in relation to total deposits in FDIC insured banks. Total costs associated with real estate owned increased by $2.6 million from 2010 to 2011. These expenses include loss (gain) on sale of other real estate, foreclosed property expense, and write down of other real estate. Additional write downs of other real estate increased significantly due to falling property values. The majority of the write down of other real estate occurred in the third quarter of 2011.

The other operating expense category is the total of approximately 60 separate expense accounts. None of the account balances in this category exceed 1% of gross revenue of the company for any of the three years presented. Increases are due to the growth in the bank s customer base and some inflationary increases.

	2011	2010	2009
Salaries and employee benefits	$ 4 980	$ 4 731	$ 5 351
Net occupancy expense of premises	629	648	570
Furniture and equipment expenses	912	783	948
Accounting, audit and compliance	189	145	194
Computer services and online banking	331	184	91
Loss (gain) on sale of other real estate	343	(223)	(776)
FDIC assessment	453	563	711
Printing, stationery and supplies	195	182	207
Communications	187	183	184
Foreclosed property expense	551	677	1 272
Write down of other real estate	2 182	17	303
ATM and check card expense	344	291	326
Other operating expenses	1 660	1 583	1 678
Total Noninterest Expenses	$ 12 956	$ 9 764	$ 11 059

LOAN PORTFOLIO

Loans at December 31 (in thousands) for each of the five years in the period ended 2011.

	2011	2010	2009	2008	2007
Commercial, financial and agricultural	$ 8 361	$ 7 920	$ 9 700	$ 9 671	$ 4 987
Mortgage loans on real estate:					
Construction and land development	19 179	24 174	38 083	55 843	55 042
Secured by farm land	598	792	1 419	1 380	1 328
Secured by 1-4 family residential	92 856	97 537	102 290	101 253	98 864
Secured by multifamily residential	3 088	1 976	2 070	1 937	1 749
Secured by nonfarm nonresidential	76 882	79 615	71 916	63 943	47 726
Consumer loans	6 165	6 800	9 011	11 970	14 718
All other loans	116	436	222	457	193
	$ 207 245	$ 219 250	$ 234 711	$ 246 454	$ 224 607

Due in large part to the state of the real estate market and the resulting economic conditions, the loan portfolio continued to decrease in 2011 compared to the balance at the end of 2010 as it did in 2010 compared to 2009. Continued foreclosures, charge offs and a very tentative buyers market have all contributed to the decline in loans.

The bank is projecting and thus has budgeted for an increase in loans during 2012. The largest expected increase will be in the residential mortgage and commercial loan portfolio with smaller increases in the other retail loan portfolios.

There were no categories of loans that exceeded 10% of outstanding loans at December 31, 2011 that were not disclosed in the table above.

REMAINING MATURITIES OF SELECTED LOANS (in thousands)

At December 31, 2011	Commercial, Financial and Agricultural	Construction and land Development
Loans maturing within one year	$ 4 806	$ 6 019
Variable rate loans due after one year through five years	125	626
Variable rate loans due after five years	96	2 980
Fixed rate loans due after one year through five years	2 524	4 809
Fixed rate loans due after five years	810	4 745
Total maturities	$ 8 361	$ 19 179

ALLOWANCE FOR LOAN LOSSES

The table shown below is an analysis of the company s allowance for loan losses. Prior to 2008, net charge-offs (loans charged off as uncollectible less any amounts recovered on these loans) for the company have been very low when compared with the size of the total loan portfolio. Management continually monitors the loan portfolio with procedures that allow for problem loans and potentially problem loans to be highlighted and watched. Beginning in 2008 with the collapse of the economy and real estate market, both net charge offs and the provision charges to operations increased significantly. Increases to the allowance were made based on the increased risks assessed in the loan portfolio as a result of the housing market conditions and the economic slowdown. During 2011, 2010, and 2009 management has monitored the risk in the portfolio continually with reporting on a monthly basis compared to the quarterly reporting done previously. Based on experience, the loan policies and the current monitoring program, management believes the allowance for loan losses is adequate but continues to monitor closely and to prepare reporting monthly.

	2011 (in thousands)	2010	2009	2008	2007
Balance at beginning of period	$ 5 012	$ 5 718	$ 4 079	$ 2 779	$ 2 423
Charge-offs:					
Commercial, financial and agricultural	20	313	23	21	14
Real estate construction	1 673	775	3 957	269	32
Real estate mortgage	2 189	1 245	920	1 102	206
Consumer	172	293	383	441	252
Total charge-offs	4 054	2 626	5 283	1 833	504
Recoveries:					
Commercial, financial and agricultural	30	25	5	- -	30
Real estate construction	5	- -	- -	- -	- -
Real estate mortgage	17	95	2	17	- -
Consumer	131	201	225	182	152
Total recoveries	183	321	232	199	182
Net charge-offs	3 871	2 305	5 051	1 634	322
Additions charged to operations	3 343	1 599	6 690	2 934	678
Balance at end of period	$ 4 484	$ 5 012	$ 5 718	$ 4 079	$ 2 779
Ratio of net charge-offs during the period to average loans outstanding during the period	1.84%	1.01%	2.11%	0.70%	0.14%

ALLOCATION OF ALLOWANCE FOR LOAN LOSSES

The following table shows an allocation of the allowance among loan categories based upon analysis of the loan portfolio s composition, historical loan loss experience, and other factors, and the ratio of the related outstanding loan balances to total loans.

	2011		2010		2009		2008		2007	
	Allowance (in thousands)	% Loans in Category to Total Loans	Allowance (in thousands)	% Loans in Category to Total Loans	Allowance (in thousands)	% Loans in Category to Total Loans	Allowance (in thousands)	% Loans in Category to Total Loans	Allowance (in thousands)	% Loans in Category to Total Loans
Commercial, financial and agricultural	$ 156	4.03%	$ 239	3.61%	$ 425	4.13%	$ 69	3.92%	$ 35	2.22%
Mortgage loans on real estate:										
Construction and land development	506	9.25%	2 022	11.03%	2 328	16.23%	2 182	26.63%	1 025	24.50%
Secured by farm land	17	.29%	166	.36%	107	.60%	76	.56%	9	.59%
Secured by 1-4 family residential	2 754	44.80%	1 666	44.49%	1 255	43.58%	845	39.38%	924	44.02%
Secured by multi-family residential	85	1.49%	25	.90%	20	.88%	16	.79%	13	.78%
Secured by nonfarm nonresidential	882	37.10%	859	36.31%	1 275	30.64%	727	23.67%	661	21.25%
Consumer loans	84	2.98%	20	3.10%	146	3.84%	90	4.86%	111	6.55%
All other loans	- -	.06%	1	.20%	- -	.10%	4	.19%	1	.09%
Unallocated	- -	- -	14	- -	162	- -	70	- -	- -	- -
	$ 4 484	100.00%	$ 5 012	100.00%	$ 5 718	100.00%	$ 4 079	100.00%	$ 2 779	100.00%

RISK ELEMENTS IN THE LOAN PORTFOLIO

	2011 (in thousands)	2010	2009	2008	2007
Nonperforming assets					
Nonaccrual loans (1)	$ 7 243	$ 2 233	$ 3 819	$ 2 669	$ 1 584
Foreclosed properties	6 393	6 563	5 632	1 644	430
Total nonperforming assets	$ 13 636	$ 8 796	$ 9 451	$ 4 313	$ 2 014
Performing troubled debt restructures (2)	$ 9 078	$ 7 321	$ 3 345	$ - -	$ - -
Loans past due 90 days accruing interest	$ 204	$ - -	$ - -	$ 1 263	$ 21
Allowance for loan losses to period end loans	2.16%	2.29%	2.44%	1.66%	1.24%
Nonperforming assets to period end loans and foreclosed properties, net	6.38%	3.90%	3.93%	1.74%	.89%
Performing troubled debt restructures to period end loans	4.38%	3.33%	1.43%	N/A	N/A

(1) Currently there are 5 TDRs in non-performing assets with a balance of $2.9 million at December 31, 2011.
(2) Within this amount are two TDRs with balances totaling $107K and both are 30 or more days past due at December 31, 2011.

Loans are placed on nonaccrual status when the loan officer or collections officer who is supervising a particular loan determines that it is no longer prudent for a loan to continue to accrue interest, the loan is to be placed on nonaccrual status.

Generally it is the policy of this bank to stop accruing interest when principal or interest is greater than 90 days past due based upon the loan s contractual terms, unless the loan is well secured and in the process of collection. Furthermore, should the bank become aware of events which have occurred or are expected to occur which causes doubt as to the full collectability of principal or interest in the future, even though the loan is currently less than 90 days past due, the loan is considered for nonaccrual status.

In order to justify the continuation of the accrual of interest on a loan which is greater than 90 days past due, the loan must be well secured and in the process of collection. In order to determine whether the loan is well secured, the loan officer shall obtain an appraisal of the collateral establishing a value at least equal to principal and accrued interest for all loans with an aggregate borrower liability to the bank greater than $100,000. For all loans greater than 90 days past due which fall below this threshold, the bank may complete its own appraisal or valuation of the collateral as long as its methodology is documented and consistently applied. For a loan to be considered in the process of collection, there must be corrective action contemplated by the borrower, such as payment of all past due amounts, or the bank must be ready to liquidate the underlying collateral within a relatively short time frame such as 30 days.

Approval by the Chief Lending Officer or President is required of all loans greater than 90 days past due which are not placed on nonaccrual status.

SECURITIES PORTFOLIO

Currently the company classifies all securities as available for sale and records these securities at fair value. If the company classified any securities as held to maturity, held to maturity securities would be recorded at amortized cost. The effect of unrealized gains and losses on securities available for sale, net of tax effects, is recognized in stockholders equity.

The schedule below summarizes the carrying value of the portfolio by maturity classifications and shows the weighted average yield in each group. The rates on the tax exempt obligations are computed on a tax equivalent basis using a federal tax rate of 34%.

	2011 Carrying Value (in thousands)	Weighted Average Yield	2010 Carrying Value (in thousands)	Weighted Average Yield	2009 Carrying Value (in thousands)	Weighted Average Yield
Securities available for sale						
Obligations of U.S. Government sponsored agencies:						
Maturing within one year	$ 3 029	1.21%	$ 4 587	3.01%	$ 1 005	1.25%
Maturing after one year but within five years	31 794	1.35%	31 701	1.65%	27 418	2.69%
Municipal obligations:						
Maturing within one year	332	4.80%	616	6.03%		- -
Maturing after one year but within five years	663	5.42%	671	5.09%	999	5.65%
Maturing after five years	5 720	5.74%	4 237	6.09%	3 791	6.27%
Equity securities with no stated maturity	793	.01%	878	.02%	1 100	.46%
Total securities available for sale	$ 42 331		$ 42 690		$ 34 313	

DEPOSITS

Deposits decreased $4.3 million or 1.67% at December 31, 2011 compared to December 31, 2010. The net decrease was primarily in interest-bearing deposits of $14.6 million offset by increases in non-interest bearing deposits of $10.4 million. Consistent with the bank s efforts to reduce deposit interest expense as noted in the table below the reduction within interest-bearing deposits was centered in higher rate time deposits. Partly offsetting the net decrease in deposits was a transfer of balances from securities sold under agreements to repurchase for those balances under $250 thousand that now have FDIC insurance available and our ability by law to now be able to pay interest on the accounts. Total transferred during 2011 was approximately $5 million. The bank s noncore funding in the form of brokered deposits was $13 million and $14.9 million at December 31, 2011 and 2010, respectively. Included in these totals are brokered certificates of deposit through the bank s participation in the CDARS program of $6.7 million at December 31, 2011 and $7.5 million at December 31, 2010. Also included in brokered deposits are brokered money market ICS of $4.7 million and $126 thousand as of December 31, 2011 and 2010, respectively. Both of these programs allow for us to place our own customer funds over $250 thousand on a reciprocal basis with other institutions. The bank s market share percentage decreased slightly in both Jefferson and Berkeley county as of June 30, 2011 compared to June 30, 2010. We have 30.98% of the total deposits in Jefferson County compared to 31.41% in 2010 and 4.48% of the total deposits in Berkeley County compared to 4.94% in 2010.

Schedule of Average Deposits and Average Rates Paid

	Year Ended December 31 (average balances in thousands) 2011		2010		2009	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing demand deposits	$ 29 398		$ 27 597		$ 26 490	
Interest-bearing demand deposits	87 063	0.50%	85 654	0.73%	80 842	0.94%
Savings deposits	52 615	0.44%	40 381	0.53%	38 662	0.65%
Time deposits	91 690	2.33%	109 902	2.85%	115 239	3.26%
Total interest-bearing deposits	231 368	1.21%	235 937	1.68%	234 743	2.03%
Total deposits	$ 260 766		$ 263 534		$ 261 233	

At December 31, 2011, time deposits of $100 thousand or more were 13.29% of total deposits compared with 17.50% at December 31, 2010. Maturities of time deposits of $100 thousand or more (in thousands) at December 31, 2011 are as follows:

Within three months	$	8 456
Over three through six months		3 566
Over six months through twelve months		2 603
Over twelve months		19 010
Total	$	33 635

ANALYSIS OF CAPITAL

The adequacy of the company s capital is reviewed by management on an ongoing basis in terms of the size, composition, and quality of the company s asset and liability levels, and consistency with regulatory requirements and industry standards. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and absorb potential losses.

The Federal Reserve, the Comptroller of the Currency and the Federal Deposit Insurance Corporation have adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.0%, of which at least 4.0% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. All capital ratios are within the regulatory guidelines for a well capitalized institution as noted below.

	2011 (In thousands)		2010		2009	
Tier 1 capital:						
Common stock	$	3 672	$	3 672	$	3 672
Surplus		3 943		3 932		3 898
Retained earnings		22 648		23 725		21 931
		30 263		31 329		29 501
Less:						
Cost of shares acquired for the treasury		2 866		2 866		2 866
Disallowed deferred tax asset		2 555		398		- -
Total Tier 1 capital	$	24 842	$	28 065	$	26 635
Tier 2 capital:						
Allowance for loan losses (1)		2 645		2 733		2 893
Total risk-based capital	$	27 487	$	30 798	$	29 528
Risk-weighted assets	$	209 774	$	216 322	$	228 607
Capital ratios:						
Tier 1 risk-based capital ratio		11.84%		12.97%		11.65%
Total risk-based capital ratio		13.10%		14.24%		12.92%
Leverage ratio		8.56%		9.36%		8.75%

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

LIQUIDITY

Liquidity is a measure of the Bank s ability to respond to sudden changes in funding needs or funding sources. Examples of sudden changes could involve a sudden increase in loan demand, a funding need, or it might involve a large decrease in deposited funds, a funding source. The role of cash management is to manage assets and liabilities so that the Bank can respond to such fluctuations in sources and uses of cash. Management spends much of its time assessing our liquidity position.

Management is informed of the liquidity information via reports and committee discussion. The President is provided a weekly dashboard report of our liquidity information. The Asset/Liability Committee reviews and discusses our liquidity position on a quarterly basis. The committee has set a benchmark minimum liquidity ratio of 15%. Management implemented a strategy to free up some pledged assets for liquidity purposes during 2011.

Public funds are required to have collateral pledged against their balances above the FDIC insurance limits. Generally the bank has pledged securities or obtained letters of credit from the Federal Home Loan Bank of Pittsburgh to cover public funds. Two additional strategies to cover these funds are now being used. In the case of public funds in the form of CDs, the bank is utilizing the CDARS network to insure their funds. We are also using the Insured Cash Sweep (ICS) product to secure public funds. Both of the programs provide complete coverage through FDIC insurance. Most importantly, the securities that had been pledged against the public funds can be used as a source of cash if the need would arise. The securities are effectively converted from a non liquid asset to a liquid asset.

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, 2011.

Operating Activities. The company s net income usually provides cash from the bank s operating activities. The net income figure is adjusted for certain noncash transactions such as depreciation expense that reduces net income but does not require a cash outlay. During 2011, the net income as adjusted has provided cash of $4.5 million. Interest income earned on loans and investment securities is the company s major income source.

Investing Activities. Customer core deposits and company noncore funding provide the funds used to invest in loans and investment securities. In addition, the principal portion of loan payments, loan payoffs and maturity of investment securities provide cash flow. Purchases of bank premises and equipment are an investing activity. We have taken advantage of our noncore funding capabilities since deposit growth is not always sufficient. The net amount of cash provided by investing activities in 2011 is $5.9 million.

Financing Activities. Customer core deposits and company noncore funding 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 to shareholders, purchase of shares of the company s common stock for the treasury and repayment of any noncore funding. The net amount of cash used in financing activities in 2011 is $9.5 million.

At December 31, 2011, cash and due from banks, interest-bearing deposits in financial institutions, federal funds sold and loans and securities maturing within one year were $33.4 million.

Noncore funding capabilities, including borrowings, provide additional liquidity. The subsidiary bank maintains a federal funds line with one financial institution and is a member of the Federal Home Loan Bank of Pittsburgh. In July 2009 the subsidiary bank secured a credit line with the Federal Reserve discount window. At December 31, 2011, the subsidiary bank has total credit available through these institutions of approximately $87.2 million.

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 company s exposure to credit loss in the event of nonperformance by the borrowers 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 amount of the company s exposure to off-balance-sheet risk as of December 31, 2011 and 2010 is as follows (in thousands):

	2011	2010
Financial instruments whose amounts represent credit risk:		
Commitments to extend credit	$ 27 466	$ 28 050
Standby letters of credit	2 382	2 225

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 borrower. Collateral held varies but typically is cash or real estate.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. The majority of these lines of credit are collateralized and usually contains a specified maturity date.

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 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, 2011, the company had no rate lock commitments to originate mortgage loans.

Short-Term Borrowings. At December 31, 2011 and 2010, short-term borrowings consist of securities sold under agreements to repurchase that are secured transactions with customers. The total of short-term borrowings was $3.4 million on December 31, 2011 and $7.4 million on December 31, 2010.

The table below presents selected information on these short-term borrowings (in thousands):

	December 31	
	2011	2010
Balance outstanding at year end	$ 3 415	$ 7 382
Maximum balance at any month-end during the year	$ 10 339	$ 10 023
Average balance for the year	$ 7 189	$ 8 372
Weighted average rate for the year	0.82%	1.00%
Weighted average rate at year end	0.75%	1.00%
Estimated fair value	$ 3 415	$ 7 382

Contractual Obligations. The table below presents the contractual obligations of the company as of December 31, 2011:

Payments (in thousands) Due By Period			
	Less than	Over 1 Year through	Over 3 Years through
Total	1 Year	3 Years	5 Years

Long-Term Debt Obligations	$ 1 523	$ 1 215	$ 308	$ - -
Lease Obligations for Real Estate	$ 71	$ 40	$ 31	$ - -
Lease Obligations for Equipment	$ 98	$ 29	$ 59	$ 10

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. The company s market risk is composed primarily of interest rate risk. The company s Asset and Liability Management Committee (ALCO) is responsible for reviewing the interest rate sensitivity position and establishing policies to monitor and limit exposure to this risk. The Board of Directors reviews and approves the guidelines established by ALCO.

Interest rate risk is monitored through the use of three complimentary modeling tools: static gap analysis, earnings simulation modeling and economic value simulation (net present value estimation). Each of these models measure changes in a variety of interest rate scenarios. While each of the interest rate risk measures has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the company, the distribution of risk along the yield curve, the level of risk through time, and the amount of exposure to changes in certain interest rate relationships. Static gap, which measures aggregate repricing values, is less utilized since it does not effectively measure the investment options risk impact on the company and is not addressed here. But earnings simulation and economic value models, which more effectively measure the cash flow impacts, are utilized by management on a regular basis and are explained below.

Earnings Simulation Analysis

Management uses simulation analysis to measure the sensitivity of net income to change in interest rates. The model calculates an earnings estimate based on current and projected balances and rates. This method is subject to the accuracy of the assumptions that underlie the process, but it provides a better analysis of the sensitivity of earnings to changes in interest rates than other analysis such as the static gap analysis.

Assumptions used in this model, including loan and deposit growth rates, are derived from seasonal trends, economic forecasts and management s outlook, as are the assumptions used to project yields and rates for new loans and deposits. Maturities, calls and prepayments in the securities portfolio are assumed to be reinvested in like instruments. Mortgage loans and mortgage backed securities prepayment assumptions are based on industry estimates of repayment speeds for portfolios with similar coupon ranges and seasoning. Different interest rate scenarios and yield curves are used to measure the sensitivity of earnings to changing interest rates. Interest rates on different asset and liability accounts move differently when the prime rate changes and are accounted for in the different rate scenarios.

The most likely scenario represents the rate environment as management forecasts it to occur. From this base, rate shocks in 100 basis point increments are applied to see the impact on the company s earnings. The following tables represent the interest rate sensitivity on net income (fully tax equivalent basis) for the company using different rate scenarios as of December 31, 2011:

One Year Simulation

Change in Yield Curve		% Change in Net Interest Income	
+	200 basis points	+	7.8%
+	100 basis points	+	4.4%
	Most likely		0
-	100 basis points	-	1.5%
-	200 basis points	-	4.0%

Two Year Simulation

Change in Yield Curve		% Change in Net Interest Income	
+	200 basis points	+	12.1%
+	100 basis points	+	6.8%
	Most likely		0
-	100 basis points	-	4.4%
-	200 basis points	-	9.7%

Economic Value Simulation

Economic value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Economic values are calculated based on discounted cash flow analysis. The economic value of equity is the economic value of all assets minus the economic value of all liabilities. The change in economic value of equity over different rate environments is an indication of the longer term repricing risk in the balance sheet. The same assumptions are used in the economic value simulation as in the earnings simulation.

The following chart reflects the change in net market value over different rate environments as of December 31, 2011:

Change in Yield Curve	Change in Economic Value of Equity (dollars in thousands)	
+ 200 basis points	$	-1,344
+ 100 basis points	$	- 303
Most likely	$	0
- 100 basis points	$	+ 614
- 200 basis points	$	+1,477

Item 8. Financial Statements and Supplementary Data.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Potomac Bancshares, Inc.
Charles Town, West Virginia

We have audited the accompanying consolidated balance sheets of Potomac Bancshares, Inc. and Subsidiary as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years ended December 31, 2011, 2010 and 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Potomac Bancshares, Inc. and Subsidiary as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years ended December 31, 2011, 2010 and 2009, in conformity with U.S. generally accepted accounting principles.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 29, 2012

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2011 and 2010
($ in thousands, except per share data)

	2011	2010
ASSETS		
Cash and due from banks	$ 1 485	$ 2 185
Interest-bearing deposits in other financial institutions	11 445	7 995
Federal funds sold	794	2 725
Securities available for sale, at fair value	42 331	42 690
Loans held for sale	198	76
Loans, net of allowance for loan losses of $4,484 in 2011 and $5,012 in 2010	202 761	214 238
Premises and equipment, net	7 923	8 270
Other real estate owned, net of valuation allowance of $2,197 in 2011 and $95 in 2010	6 393	6 563
Accrued interest receivable	832	960
Bank owned life insurance	6 932	6 397
Federal Home Loan Bank of Pittsburgh stock	808	765
Other assets	5 491	4 745
Total Assets	$ 287 393	$ 297 609
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Deposits		
Noninterest-bearing	$ 37 050	$ 26 695
Interest-bearing	216 067	230 727
Total Deposits	253 117	257 422
Securities sold under agreements to repurchase	3 415	7 382
Federal Home Loan Bank advances	1 523	2 717
Accrued interest payable	204	361
Other liabilities	3 669	2 951
Total Liabilities	$ 261 928	$ 270 833
STOCKHOLDERS EQUITY		
Common stock, $1 per share par value; 5,000,000 shares authorized; 3,671,691 shares issued	$ 3 672	$ 3 672
Surplus	3 943	3 932
Undivided profits	22 648	23 725
Accumulated other comprehensive (loss), net	(1 932)	(1 687)
	$ 28 331	$ 29 642
Less cost of shares acquired for the treasury, 281,513 shares	2 866	2 866
Total Stockholders Equity	$ 25 465	$ 26 776
Total Liabilities and Stockholders Equity	$ 287 393	$ 297 609

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2011, 2010 and 2009
($ in thousands, except per share data)

	2011	2010	2009
Interest and Dividend Income:			
Interest and fees on loans	$ 11 648	$ 12 923	$ 13 801
Interest on securities available for sale - taxable	660	755	933
Interest on securities available for sale - nontaxable	231	202	148
Interest on federal funds sold	1	3	7
Other interest and dividends	31	21	24
Total Interest and Dividend Income	12 571	13 904	14 913
Interest Expense:			
Interest on deposits	2 804	3 972	4 772
Interest on securities sold under agreements to repurchase and federal funds purchased	59	84	148
Interest on Federal Home Loan Bank and Federal Reserve Bank advances	37	87	201
Total Interest Expense	2 900	4 143	5 121
Net Interest Income	9 671	9 761	9 792
Provision for Loan Losses	3 343	1 599	6 690
Net Interest Income after Provision for Loan Losses	6 328	8 162	3 102
Noninterest Income:			
Trust and financial services	894	842	758
Service charges on deposit accounts	1 831	1 854	2 205
Visa/MC Fees	759	676	563
Cash surrender value of life insurance	234	235	238
Miscellaneous income	287	38	4
Gain on sale of securities	- -	- -	42
Other operating income	363	431	471
Total Noninterest Income	4 368	4 076	4 281
Noninterest Expenses:			
Salaries and employee benefits	4 980	4 731	5 351
Net occupancy expense of premises	629	648	570
Furniture and equipment expenses	912	783	948
Accounting, audit and compliance	189	145	194
Computer services and online banking	331	184	91
Loss (gain) on sale of other real estate	343	(223)	(776)
FDIC assessment	453	563	711
Printing, stationery and supplies	195	182	207
Communications	187	183	184
Foreclosed property expense	551	677	1 272
Write down of other real estate	2 182	17	303
ATM and check card expense	344	291	326
Other operating expenses	1 660	1 583	1 678
Total Noninterest Expenses	12 956	9 764	11 059
(Loss) Income Before Income Tax (Benefit) Expense	(2 260)	2 474	(3 676)
Income Tax (Benefit) Expense	(1 250)	680	(1 436)
Net (Loss) Income	$ (1 010)	$ 1 794	$ (2 240)

(Loss) Earnings Per Share, basic and diluted	$ (.30)	$ .53	$ (.66)

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
Years Ended December 31, 2011, 2010 and 2009
($ in thousands, except per share data)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive (Loss)	Comprehensive Income (Loss)	Total
Balances, December 31, 2008	$ 3 672	$ 3 851	$ 25 070	$ (2 837)	$ (1 952)		$ 27 804
Comprehensive loss							
Net loss 2009	- -	- -	(2 240)	- -	- -	$ (2 240)	(2 240)
Other comprehensive income:							
Unrealized holding losses arising during the period (net of tax, $14)	- -	- -	- -	- -	(27)	(27)	(27)
Reclassification for gains included in net income (net of tax, $14)	- -	- -	- -	- -	(28)	(28)	(28)
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, $486)	- -	- -	- -	- -	944	944	944
Total other comprehensive income						889	
Total comprehensive loss						$ (1 351)	
Purchase of treasury shares:							
3,427 shares	- -	- -	- -	(29)	- -		(29)
Stock-based compensation expense	- -	47	- -	- -	- -		47
Cash dividends 2009 ($.27 per share)	- -	- -	(899)	- -	- -		(899)
Balances, December 31, 2009	$ 3 672	$ 3 898	$ 21 931	$ (2 866)	$ (1 063)		$ 25 572
Comprehensive income							
Net income 2010	- -	- -	1 794	- -	- -	$ 1 794	1 794
Other comprehensive loss:							
Unrealized holding losses arising during the period (net of tax, $143)	- -	- -	- -	- -	(276)	(276)	(276)
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, $178)	- -	- -	- -	- -	(348)	(348)	(348)
Total other comprehensive loss						(624)	
Total comprehensive income						$ 1 170	
Stock-based compensation expense	- -	34	- -	- -	- -		34
Balances, December 31, 2010	$ 3 672	$ 3 932	$ 23 725	$ (2 866)	$ (1 687)		$ 26 776

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (CONTINUED)
Years Ended December 31, 2011, 2010 and 2009
($ in thousands, except per share data)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive (Loss)	Comprehensive Income (Loss)	Total
Balances, December 31, 2010	$ 3 672	$ 3 932	$ 23 725	$ (2 866)	$ (1 687)		$ 26 776
Comprehensive loss							
Net loss 2011	- -	- -	(1 010)	- -	- -	$ (1 010)	(1 010)
Other comprehensive loss:							
Unrealized holding gains arising during the period (net of tax, $157)	- -	- -	- -	- -	304	304	304
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, $283)	- -	- -	- -	- -	(549)	(549)	(549)
Total other comprehensive loss						(245)	
Total comprehensive loss						$ (1 255)	
Stock-based compensation expense	- -	11	- -	- -	- -		11
Cash dividends 2011 ($.02 per share)	- -	- -	(67)	- -	- -		(67)
Balances, December 31, 2011	$ 3 672	$ 3 943	$ 22 648	$ (2 866)	$ (1 932)		$ 25 465

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2011, 2010 and 2009
($ in thousands)

	2011	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	$ (1 010)	$ 1 794	$ (2 240)
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Provision for loan losses	3 343	1 599	6 690
Depreciation	477	550	573
Deferred tax (benefit) expense	(1 197)	494	(609)
Premium amortization on securities, net	268	214	129
Write down of other real estate	2 182	17	303
Gain on sale of securities	- -	- -	(42)
Loss (gain) on sale of other real estate	343	(223)	(776)
Loss on disposal of premises and equipment	- -	5	4
Stock-based compensation expense	11	34	47
Proceeds from sale of loans for sale	968	3 845	8 703
Origination of loans held for sale	(1 090)	(3 824)	(8 471)
Change in cash surrender value of bank owned life insurance	(234)	(235)	(238)
Changes in assets and liabilities:			
Decrease (increase) in accrued interest receivable	128	(8)	156
(Increase) decrease in other assets	535	783	(1 176)
Decrease in accrued interest payable	(157)	(44)	(76)
(Decrease) increase in other liabilities	(115)	118	(1 901)
Net cash provided by operating activities	$ 4 452	$ 5 119	$ 1 076
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from maturity of securities available for sale	$ 5 110	$ 1 000	$ 5 645
Proceeds from call of securities available for sale	30 046	28 545	18 000
Proceeds from sale of securities available for sale	- -	- -	3 042
Purchases of securities available for sale	(34 604)	(38 555)	(32 594)
Net decrease (increase) in loans	2 977	9 565	(2 728)
Purchases of premises and equipment	(130)	(99)	(1 288)
Purchases of bank owned life insurance	(301)	- -	- -
Proceeds from sale of other real estate	2 802	2 849	5 602
Net cash provided by (used in) investing activities	$ 5 900	$ 3 305	$ (4 321)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase (decrease) in noninterest-bearing deposits	$ 10 355	$ (1 258)	$ 2 484
Net (decrease) increase in interest-bearing deposits	(14 660)	(5 787)	7 895
Net (repayment) proceeds of securities sold under agreements to repurchase	(3 967)	42	(1 012)
Net repayment of Federal Home Loan Bank advances	(1 194)	(1 139)	(920)
Purchase of treasury shares	- -	- -	(29)
Cash dividends	(67)	- -	(899)
Net cash (used in) provided by financing activities	$ (9 533)	$ (8 142)	$ 7 519
Increase in cash and cash equivalents	$ 819	$ 282	$ 4 274
CASH AND CASH EQUIVALENTS			
Beginning	12 905	12 623	8 349
Ending	$ 13 724	$ 12 905	$ 12 623
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			

Cash payments for:			
Interest	$ 3 057	$ 4 187	$ 5 197
Income taxes	$ - -	$ 720	$ 41
SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES			
Unrealized gain (loss) on securities available for sale	$ 461	$ (419)	$ (83)
Change in benefit obligations and plan assets for pension and other postretirement benefits	$ (832)	$ (526)	$ 1 430
Loans transferred to other real estate owned	$ 5 157	$ 3 574	$ 8 814
Loans made on sale of other real estate owned	$ 249	$ 695	$ 1 568

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Nature of Banking Activities and Significant Accounting Policies

Potomac Bancshares, Inc., and subsidiary (collectively the company), through Bank of Charles Town, (the bank) a wholly owned subsidiary of Potomac Bancshares, Inc., grants commercial, financial, agricultural, residential and consumer loans to customers, primarily in Jefferson, Berkeley and Morgan Counties of West Virginia; Clarke, Frederick and Loudoun Counties of Virginia and Washington and Frederick Counties of Maryland. The loan portfolio, while having a higher concentration of real estate loans, is diversified among a large number of borrowers and loans generally are collateralized by assets of the customers. The loans are expected to be repaid from cash flows or proceeds from the sale of selected assets of the borrowers.

The company also offers deposit products to the same primary market area as loans. These products include noninterest-bearing and interest bearing checking accounts, savings accounts and certificates of deposit in various terms.

The accounting and reporting policies of the company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The following is a summary of the more significant policies.

Principles of Consolidation

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

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate, deferred tax assets, fair value determination and the pension benefit obligation.

Interest-bearing Deposits in Financial Institutions

Interest-bearing deposits in financial institutions mature within one year and are carried at cost.

Securities

Investments in debt and equity securities with readily determinable fair values are classified as either held to maturity, available for sale, or trading, based on management s intent. Currently all debt securities of the company are classified as available for sale. All equity securities, except investment in FHLB are classified as available for sale. FHLB stock is classified as restricted and carried at cost. Available for sale securities are carried at estimated fair value with the corresponding unrealized gains and losses excluded from earnings and reported in other comprehensive income. Gains or losses are recognized in earnings on the trade date using the amortized cost of the specific security sold. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (1) the company intends to sell the security or (2) it is more-likely-than-not that the company will be required to sell the security before recovery of its amortized cost basis. If, however, the company does not intend to sell the security and it is not more-likely-than-not that it will be required to sell the security before recovery, the company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is credit loss, the loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Securities (Continued)

For equity securities, impairment is considered to be other-than-temporary based on the company s ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income.

Management regularly reviews each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, its intention with regard to holding the security to maturity and the likelihood that the company would be required to sell the security before recovery.

Loans

The company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is comprised of loans secured by real estate. The ability of the company s debtors to honor their contracts is dependent upon customer s recurring income or income derived from collateral securing the loan, real estate and general economic conditions of the company s market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off, generally, are reported at their recorded investment, which is the outstanding unpaid principal balance adjusted for the allowance for loan losses and any deferred fees or costs on the originated loan. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Loans are placed on nonaccrual status when the loan officer or collections officer who is supervising a particular loan determines that it is no longer prudent for a loan to continue to accrue interest, the loan is to be placed on nonaccrual status.

Generally it is the policy of this bank to stop accruing interest when principal or interest is greater than 90 days past due based upon the loan s contractual terms, unless the loan is well secured and in the process of collection. Furthermore, should the bank become aware of events which have occurred or are expected to occur which causes doubt as to the full collectability of principal or interest in the future, even though the loan is currently less than 90 days past due, the loan should be considered for nonaccrual status.

In order to justify the continuation of the accrual of interest on a loan which is greater than 90 days past due, the loan must be well secured and in the process of collection. In order to determine whether the loan is well secured, the loan officer shall obtain an appraisal of the collateral establishing a value at least equal to principal and accrued interest for all loans with an aggregate borrower liability to the bank greater than $100,000. For all loans greater than 90 days past due which fall below this threshold, the bank may complete its own appraisal or valuation of the collateral as long as its methodology is documented and consistently applied. For a loan to be considered in the process of collection, there must be corrective action contemplated by the borrower, such as payment of all past due amounts, or the bank must be ready to liquidate the underlying collateral within a relatively short time frame such as 30 days.

All interest accrued but not collected for all classes of loans that are placed on nonaccrual or charged-off is reversed against interest income. If the ultimate repayment of principal, in whole or in part, is not expected, any payment received on a loan on which the accrual of interest has been suspended is applied to reduce principal to the extent necessary to restore the expectation of ultimate collectability. At such time as full collection of the remaining recorded balance is expected, interest payments are recorded as interest income on a cash basis until such time the loan can be restored to accrual status in accordance with regulatory guidelines. Loans of all classes are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

For all classes of loans, approval of the President or Chief Lending Officer is required for all loans greater than 90 days past due which are not placed on nonaccrual status and for restoration of nonaccrual loans to accrual status.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

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 for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance is based on two basic principles of accounting: (1) losses be accrued when they are probable of occurring and are capable of estimation and (2) 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.

The allowance for loan losses is evaluated on a regular basis, at least monthly by management, and is based upon management s ongoing review of the collectability of the loans in light of historical experience, the economic environment, concentration and growth trends, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. Management monitors the loan portfolio on a continual basis with procedures that allow for problem loans and potentially problem loans to be highlighted and watched. Written reports are prepared on a monthly basis for all loans including commercial loans graded below a certain level for management review and are reported to the Board of Directors on a quarterly basis. In addition, a subcommittee of the board of directors meets monthly to review all classified assets.

Based on experience, these loan policies and the bank s grading and review system, management believes the loan loss allowance is adequate. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

During these evaluations, particular risk characteristics associated with a segment of the loan portfolio are also considered. These characteristics are detailed below:

- Loans secured by farmland, commercial real estate, and commercial loans not secured by real estate carry risks associated with the successful operation of a business or farm and the repayment of these loans may depend on the profitability and cash flows of the business or farm. Additional risk relates to the value of collateral other than real estate where depreciation occurs and the appraisal is less precise.
- Real estate secured construction loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point, be less than the principal amount of the loan. Additional risks may occur if the general contractor, who may not be a loan customer, is unable to finish the project as planned due to financial pressures unrelated to the project.
- Consumer loans carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral, such as automobiles which may depreciate more rapidly than other assets. In addition, these loans may be unsecured. Consumer loans are more likely than real estate loans to be immediately affected in an adverse manner by job loss, divorce, illness or personal bankruptcy.
- Residential real estate loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Allowance for Loan Losses (Continued)

The primary tool used in managing and controlling problem loans is a watch list report. The report is a listing of all commercial loans or commitments that are considered problem loans. The report is controlled by the Credit Administrator and the President. Consumer and residential mortgage loans are included only if related to a borrower with commercial or other real estate loans on the watch list report. It is a primary responsibility of the loan officer to manage the credit risk within their loan portfolio. As such they should be proactive rather than reactive when considering adding a loan to the watch list report. Occurrence of any of the following criteria is a basis for adding a loan (other than consumer and residential mortgage loans) to the watch list report.

- Loans classified as substandard, doubtful or loss by bank examiners, external auditors, loan officer or the bank s credit administration department personnel based upon financial trends of the business.
- Loans on nonaccrual status.
- Loans more than 60 days delinquent.
- Loans renewed or extended more than three times with little or no principal curtailment.
- Loans judgmentally selected by executive management or the Board of Directors due to unexpected changes or events which could have a potentially adverse effect on the borrower s ability to repay.

When a loan is added to the watch list report, both the loan officer and the Credit Administrator will estimate the need for a specific loss to be calculated in the bank s loan loss allowance.

The following guidance has been given as an aid to loan officers in detecting problem loans.

- Financial Statement Analysis As customer financial statements are received, they should be immediately analyzed to see if there are any significant changes in the financial position or operating results.
- Delayed Financial Statements If we are having problems getting financial statements from a customer, a problem may be developing.
- Delinquent Principal or Interest Delinquencies are often the first indication of a problem. We carefully review each loan as soon as it becomes past due.
- Marital Difficulties Marital difficulties often cause business financial stress and are a major cause of problem loans.
- Lack of Cooperation It is in the borrower s best interest to cooperate with the bank. We suspect a problem if the customer becomes uncooperative.
- Other Red Flags The following are additional red flags which could mean a problem loan situation is developing: illness or death of a principal or key employee, overdrafts, unexpected renewals or unanticipated new borrowing, a too high or too low inventory level in comparison to industry standards, irresponsible behavior on the part of a borrower, trade payables begin to increase abnormally and cancellation of insurance.

The allowance consists of specific and general components. The specific component relates to loans that are classified as doubtful or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for environmental factors such as economic, concentration and growth trends. The historical period used in calculating the loss factor has changed. Prior to August 2011 the bank used a thirty six month rolling average to calculate the historical loss factor in the loan portfolio. In August 2011 bank management changed to a twelve month rolling average. The change was made due to management s belief that the twelve month average more accurately compares with the current economic environment. The impact of the change was an increase in the allowance of $476 thousand at December 31, 2011.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Allowance for Loan Losses (Continued)

Characteristics of the bank s risk classification grades are as follows:

- Pass Pass rated loans are to persons or business entities with an acceptable financial condition, appropriate collateral margins, appropriate cash flow to service the existing loan, and an appropriate leverage ratio. Borrower has paid all obligations as agreed and it is expected that this type of payment history will continue. Acceptable personal guarantors support the loan as needed.
- Special Mention Are assets that have potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the institution s credit position at some future date.
- Substandard The bank is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- Doubtful Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.
- Loss Loans classified in this category are considered uncollectable and of such little value that their continuation as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. Any time a credit is placed in this category, it will be in non-accrual status.

A loan is generally considered impaired when, in the judgment of management, based on current information and events, it is probable that the company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent. If an impaired loan is on nonaccrual status, any payments received will generally be applied first to principal. If an impaired loan is not on nonaccrual status, generally any payments received will be applied to principal and interest using usual procedures.

Large groups of smaller balance homogeneous loans (consumer and residential mortgage loans) are collectively evaluated for impairment. Accordingly, the company does not necessarily separately identify individual consumer and residential loans for impairment disclosures unless these loans are related to a borrower with commercial or other real estate loans that are classified.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

In connection with the evaluation of the collectability of all classes of loans which are greater than 90 days past due as to principal or interest for nonaccrual status, any amounts not deemed well secured or otherwise collectible shall be recommended for charge-off at that time. Additionally, charge-off consideration shall be given to loans evaluated in connection with the bank s loan review policy and procedures and loans identified for repossession or foreclosure or meet the criteria for classification as an in-substance foreclosure. In any event, it shall be the policy of the bank to charge-off amounts deemed uncollectible in the periods when identified. All charge-off amounts are approved by the Chief Lending Officer or the President, subject to Board ratification.

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower s financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. All home equity, lot, real estate, and commercial loans that are processed for a renewal, modification or refinance are reviewed to determine if it qualifies as a TDR.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or market value determined in the aggregate. The company does not retain mortgage servicing rights on loans held for sale.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method. Estimated useful lives range from five to forty years for premises and improvements, and three to twenty-five years for furniture and equipment.

Maintenance and repairs of property and equipment are charged to operations and major improvements are capitalized. Upon retirement, sale or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts and gain or loss is included in operations.

Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are recorded at the lower of the loan balance or the fair value net of estimated selling costs at the date of foreclosure, establishing a new cost basis. The value of real estate collateral is determined based on an internal evaluation, appraisal outside of the company or a comparative market analysis. Revenue and expenses from operations and changes in the valuation allowance are included in foreclosed property expense and write down of other real estate, respectively.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Employee Benefit Plans

Summaries of company employee benefit plans are given below:

- The noncontributory, defined benefit pension plan covering employees meeting certain age and service requirements was frozen at October 31, 2009, the end of the plan year. No additional participants may enter the plan, and there will be no further increase in benefits due to increases in salaries and years of service.
- A postretirement life insurance plan covers certain current retirees who met certain requirements. This plan is not available for future retirees.
- A health care plan covers certain retirees who met certain eligibility requirements. This plan is not available for future retirees.
- A contributory health care plan is available to current full time employees.
- A 401(k) retirement savings plan is available to all employees meeting certain age and service requirements. The employer match for this plan was increased with the freezing of the defined benefit plan as described above. Under this plan, the employer may make a discretionary matching contribution each plan year and may also make other discretionary contributions to the plan.

Earnings Per Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the company relate solely to outstanding stock options and are determined using the treasury method.

Income Taxes

Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary difference between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the consolidated statements of operations.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits in financial institutions, securities purchased under agreements to resell and federal funds sold. Generally, securities purchased under agreements to resell and federal funds sold are purchased and sold for one-day periods.

One Financial Center (formerly the Trust Division)

Securities and other property held by One Financial Center in a fiduciary or agency capacity are not assets of the company and are not included in the accompanying consolidated financial statements.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Advertising

The company follows the policy of charging the costs of advertising to expense as incurred. Advertising expense was $63 thousand, $61 thousand and $96 thousand for the years ended December 31, 2011, 2010, and 2009, respectively.

Treasury Stock

Common shares repurchased are recorded as treasury stock at cost.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in pension and postretirement benefit obligations, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 15. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Stock-Based Compensation Plan

The 2003 Stock Incentive Plan was approved by stockholders on May 13, 2003. This is the first stock incentive plan adopted by the company. 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. Options granted to employees are subject to a five year vesting period. Options granted to non-employee directors vest on the grant date.

The stockholders initially authorized up to 183,600 shares of common stock to be used in the granting of incentive and non-qualified options to employees and directors. On April 24, 2007, the shareholders authorized an additional 250,000 shares of common stock to be used in the granting of incentive and non-qualified options to employees and directors.

Stock option compensation expense is the estimated fair value of options granted, and is amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award. There were no options granted in 2011 and 2010. Fair value is estimated using the Black-Scholes option-pricing model. Expected volatility is based on the historic volatility of the company s stock price over the expected life of the options. We have determined that the expected term for options is their contractual life of 10 years. The risk-free interest rate is the U. S. Treasury zero-coupon issue with a remaining term equal to the expected term of the options granted. The dividend yield is estimated as the ratio of the company s historical dividends paid per share of common stock to the stock price on the date of grant.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the company presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Reclassifications

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

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures were effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, Receivables (Topic 310) Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance significantly expands the existing requirements and has lead to greater transparency into an entity s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures, will be required for periods beginning on or after December 15, 2010. The company has included the required disclosures in its consolidated financial statements.

The SEC issued Final Rule No. 33-9002, Interactive Data to Improve Financial Reporting. The rule requires companies to submit financial statements in extensible business reporting language (XBRLformat with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. generally accepted accounting principles (GAAP) were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011. The company has submitted financial statements in extensible business reporting language (XBRL) format with their SEC filings in accordance with the phased-in schedule.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements

In January 2011, the FASB issued ASU 2011-01, Receivables (Topic 310) Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings. The amendments in this ASU temporarily delayed the effective date of the disclosures about troubled debt restructurings in Update 2010-20 for public entities. The delay was intended to allow the Board time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring was effective for interim and annual periods ending after June 15, 2011. The company has adopted ASU 2011-01 and included the required disclosures in its consolidated financial statements.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB s Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the company s consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02, Receivables (Topic 310) A Creditor s Determination of whether a Restructuring Is a Troubled Debt Restructuring. The amendments in this ASU clarify the guidance on a creditor s evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor s evaluation of whether a debtor is experiencing financial difficulty. The amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The company has adopted ASU 2011-02 and included the required disclosures in its consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The company is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders equity. The amendments require that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

In August 2011, the SEC issued Final Rule No. 33-9250, Technical Amendments to Commission Rules and Forms related to the FASB s Accounting Standards Codification. The SEC has adopted technical amendments to various rules and forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. These revisions were necessary to conform those rules and forms to the FASB Accounting Standards Codification. The technical amendments include revision of certain rules in Regulation S-X, certain items in Regulation S-K, and various rules and forms prescribed under the Securities Act, Exchange Act and Investment Company Act. The Release was effective as of August 12, 2011. The adoption of the new guidance did not have a material impact on the company s consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The company is currently assessing the impact that ASU 2011-11 will have on its consolidated financial statements.

Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The amendments are being made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The company is currently assessing the impact that ASU 2011-12 will have on its consolidated financial statements.

Note 2. Securities

There were no securities held to maturity as of December 31, 2011 and 2010.

The amortized cost and fair value of securities available for sale as of December 31, 2011 and 2010 (in thousands) are as follows:

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government sponsored agencies	$ 34 475	$ 357	$ (9)	$ 34 823
State and municipal obligations	6 450	265	- -	6 715
Equity securities	1 099	- -	(306)	793
	$ 42 024	$ 622	$ (315)	$ 42 331

	2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government sponsored agencies	$ 36 207	$ 241	$ (160)	$ 36 288
State and municipal obligations	5 537	71	(84)	5 524
Equity securities	1 100	- -	(222)	878
	$ 42 844	$ 312	$ (466)	$ 42 690

Note 2. Securities (Continued)

The amortized cost and fair value of the securities available for sale as of December 31, 2011 (in thousands), by contractual maturity, are shown below. The equity securities have no stated maturities.

	Amortized Cost	Fair Value
Due in one year or less	$ 3 333	$ 3 361
Due after one year through five years	32 095	32 457
Due after five years	5 497	5 720
Equity securities	1 099	793
	$ 42 024	$ 42 331

There were no sales of securities during 2011 or 2010. The gross realized gain from the sale of one security was $42 thousand as of December 31, 2009.

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 behind the instrument. The primary cause of impairments is the decline in the prices of the bonds as rates have risen. There are four debt securities accounts in the consolidated portfolio that have losses at December 31, 2011. The primary cause of the temporary impairments in the company s investments in debt securities was fluctuations in interest rates. Because the company intends to hold these investments in debt securities to maturity and it is more likely than not that the company will not be required to sell these investments before a recovery of unrealized losses, the company does not consider these investments to be other-than-temporarily impaired at December 31, 2011 and no impairment has been recognized.

There are three equity securities accounts in the company s portfolio with losses at December 31, 2011. The company considers these investments to be temporarily impaired at December 31, 2011 and is recognizing no impairment. These are community bank stock related holdings that the company has the ability and intent to hold until a recovery of fair value.

US Government sponsored agencies include the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation debt securities with a fair value of $25.3 million as of December 31, 2011 and $11.7 million as of December 31, 2010.

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 December 31, 2011 and 2010 (in thousands).

Note 2. Securities (Continued)

	December 31, 2011					
	Less than 12 months		More than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of U.S. Government sponsored agencies	$ 5 023	$ (9)	$ - -	$ - -	$ 5 023	$ (9)
Equity securities	- -	- -	793	(306)	793	(306)
	$ 5 023	$ (9)	$ 793	$ (306)	$ 5 816	$ (315)

	December 31, 2010					
	Less than 12 months		More than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of U.S. Government sponsored agencies	$ 9 899	$ (147)	$ 1 108	$ (13)	$ 11 007	$ (160)
State and municipal obligations	1 912	(84)	- -	- -	1 912	(84)
Equity securities	878	(222)	- -	- -	878	(222)
	$ 12 689	$ (453)	$ 1 108	$ (13)	$ 13 797	$ (466)

The company s investment in Federal Home Loan Bank (FHLB) stock totaled $808 thousand at December 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. Despite the FHLB s limited repurchase of excess capital stock in 2011, the company does not consider this investment to be other-than-temporarily impaired at December 31, 2011 and no impairment has been recognized. FHLB stock is shown as a separate line item on the consolidated balance sheet and is not a part of the available for sale securities portfolio.

Securities with a carrying value of $12.8 million and $24 million at December 31, 2011 and 2010, respectively were pledged to secure public funds, securities sold under agreement to repurchase, other borrowings, and for other purposes as required or permitted by law.

Note 3. Loans and Related Party Transactions

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

	December 31 2011 (in thousands)	2010
Commercial non real estate		
Commercial and industrial	$ 8 361	$ 7 920
Commercial real estate		
Owner occupied	61 086	67 517
Non-owner occupied	15 796	12 098
Construction		
Residential	2 492	5 922
Commercial	16 687	18 252
Real Estate		
Farmland	598	792
Residential		
Revolving open end	5 015	5 975
1 to 4 family first liens	80 311	82 691
1 to 4 family junior liens	7 530	8 871
5 or more family	3 088	1 976
Consumer loans		
Titled vehicles	2 650	3 713
Deposit accounts	617	737
All other consumer loans	2 898	2 350
All other loans	116	436
Total loans	$ 207 245	$ 219 250
Less: allowance for loan losses	4 484	5 012
	$ 202 761	$ 214 238

At December 31, 2011 and 2010, overdraft demand deposits reclassified to loans totaled $116 thousand and $186 thousand, respectively.

Loans to directors and executive officers of the company or to their associates at December 31, 2011 and 2010 totaled $2.9 and $3.1 million, respectively. Such loans were made on substantially the same terms as those prevailing for comparable transactions with similar risks. During 2011, total principal additions were $0.4 million and total principal payments were $0.6 million.

The FHLB of Pittsburgh has a blanket lien on all the company s loans except those loans specifically pledged to the Federal Reserve and removed from the FHLB lien. Currently, the FHLB lien is securing an advance to the company in the amount of $1.5 million and letters of credit issued on behalf of a customer of the company in the amount of $11 million.

Note 4. Allowance for Loan Losses

The following is a summary of transactions in the allowance for loan losses for 2011, 2010 and 2009 (in thousands):

	2011	2010	2009
Balance at beginning of year	$ 5 012	$ 5 718	$ 4 079
Provision charged to operating expense	3 343	1 599	6 690
Recoveries added to the allowance	183	321	232
Loan losses charged to the allowance	(4 054)	(2 626)	(5 283)
Balance at end of year	$ 4 484	$ 5 012	$ 5 718

Note 4. Allowance for Loan Losses (Continued)

Allowance for Loan Losses By Segment
December 31, 2011
(in thousands)

	Farmland	Commercial	Commercial Real Estate	Construction	Consumer	Residential	All Other	Unallocated	Total
Beginning balance	$ 166	$ 239	$ 859	$ 2 022	$ 20	$ 1 691	$ 1	$ 14	$ 5 012
Charge-offs	- -	(20)	(653)	(1 673)	(172)	(1 536)	- -	- -	(4 054)
Recoveries	- -	30	6	5	131	11	- -	- -	183
Provision	(149)	(93)	670	152	105	2 673	(1)	(14)	3 343
Ending balance	$ 17	$ 156	$ 882	$ 506	$ 84	$ 2 839	$ 0	$ 0	$ 4 484
Individually evaluated for impairment	$ 0	$ 161	$ 122	$ 102	$ 39	$ 349	$ - -	$ - -	$ 773
Collectively evaluated for impairment	17	(5)	760	404	45	2 490	- -	- -	3 711
	$ 17	$ 156	$ 882	$ 506	$ 84	$ 2 839	$ 0	$ 0	$ 4 484
Financing receivables:									
Ending balance	$ 598	$ 8 361	$ 76 882	$ 19 179	$ 6 165	$ 95 944	$ 116	$ - -	$ 207 245
Ending balance:									
Individually evaluated for impairment	$ - -	$ 161	$ 6 995	$ 5 250	$ 109	$ 5 662	$ - -	$ - -	$ 18 177
Collectively evaluated for impairment	598	8 200	69 887	13 929	6 056	90 282	116	- -	189 068
Total	$ 598	$ 8 361	$ 76 882	$ 19 179	$ 6 165	$ 95 944	$ 116	$ - -	$ 207 245

Allowance for Loan Losses By Segment
December 31, 2010
(in thousands)

	Farmland	Commercial	Commercial Real Estate	Construction	Consumer	Residential	All Other	Unallocated	Total
Ending balance	$ 166	$ 239	$ 859	$ 2 022	$ 20	$ 1 691	$ 1	$ 14	$ 5 012
Individually evaluated for impairment	$ 161	$ 217	$ 528	$ 1 812	$ - -	$ 429	$ - -	$ - -	$ 3 147
Collectively evaluated for impairment	5	22	331	210	20	1 262	1	14	1 865
	$ 166	$ 239	$ 859	$ 2 022	$ 20	$ 1 691	$ 1	$ 14	$ 5 012
Financing receivables:									
Ending balance	$ 792	$ 7 920	$ 79 615	$ 24 174	$ 6 800	$ 99 513	$ 436	$ - -	$ 219 250
Ending balance:									
Individually evaluated for impairment	$ 539	$ 367	$ 9 398	$ 11 484	$ - -	$ 2 874	$ - -	$ - -	$ 24 662
Collectively evaluated for impairment	253	7 553	70 217	12 690	6 800	96 639	436	- -	194 588
Total	$ 792	$ 7 920	$ 79 615	$ 24 174	$ 6 800	$ 99 513	$ 436	$ - -	$ 219 250

Note 4. Allowance for Loan Losses (Continued)

Credit Quality Information By Class
December 31, 2011
(in thousands)

Internal Risk Rating Grades	Pass	Special Mention	Sub-Standard	Doubtful	Loss
Commercial non real estate					
Commercial and industrial	$ 8 094	$ 105	$ 162	$ - -	$ - -
Commercial real estate					
Owner occupied	39 405	12 768	8 817	96	- -
Non-owner occupied	14 824	333	583	56	- -
Construction					
Residential	1 986	- -	506	- -	- -
Commercial	10 077	2 123	4 397	90	- -
Real estate					
Farmland	598	- -	- -	- -	- -
Consumer					
Titled vehicles	N/A	N/A	N/A	N/A	N/A
Deposit accounts	N/A	N/A	N/A	N/A	N/A
All other	N/A	25	N/A	N/A	N/A
Residential					
Revolving open end	N/A	1 276	224	N/A	N/A
1-4 family first liens	N/A	2 894	2 351	N/A	N/A
1-4 family junior liens	N/A	172	94	N/A	N/A
5 or more family	N/A	N/A	N/A	N/A	N/A
Totals	$ 74 984	$ 19 696	$ 17 134	$ 242	$ - -

As a matter of practice, we do not risk rate consumer or residential mortgage loans. Any of these loans listed in the risk rating table above are associated with commercial loans that have been risk rated as per our policy. When a loan is designated as a loss, the loss portion is charged off, and if applicable the remaining balance classified as substandard.

Credit Quality Information By Class
December 31, 2011
(in thousands)

Non Risk Rated Loans	Performing	Nonperforming
Consumer non real estate		
Titled vehicles	$ 2 645	$ 5
Deposit accounts	617	- -
All other	2 870	3
Residential		
Revolving open end	3 498	17
1-4 family first liens	74 227	839
1-4 Family junior liens	7 264	- -
5 or more family	3 088	- -
All other	116	- -
Totals	$ 94 325	$ 864

Note 4. Allowance for Loan Losses (Continued)

Credit Quality Information By Class
December 31, 2010
(in thousands)

Internal Risk Rating Grades	Pass	Special Mention	Sub-Standard	Doubtful	Loss
Commercial non real estate					
Commercial and industrial	$ 7 373	$ 180	$ 95	$ 106	$ 166
Commercial real estate					
Owner occupied	53 078	5 041	3 829	5 375	194
Non-owner occupied	11 470	628	- -	- -	- -
Construction					
Residential	282	489	4 005	1 095	51
Commercial	10 348	2 789	3 575	1 363	- -
Real estate					
Farmland	253	- -	- -	539	- -
Consumer					
Titled vehicles	N/A	N/A	N/A	N/A	N/A
Deposit accounts	N/A	N/A	N/A	N/A	N/A
All other	N/A	N/A	N/A	N/A	N/A
Residential					
Revolving open end	N/A	N/A	N/A	N/A	N/A
1-4 family first liens	N/A	3 234	956	1 434	242
1-4 family junior liens	N/A	187	42	175	25
5 or more family	N/A	308	- -	- -	- -
Totals	$ 82 804	$ 12 856	$ 12 502	$ 10 087	$ 678

Credit Quality Information By Class
December 31, 2010
(in thousands)

Non Risk Rated Loans	Performing	Nonperforming
Consumer non real estate		
Titled vehicles	$ 3 705	$ 8
Deposit accounts	737	- -
All other	2 345	5
Residential		
Revolving open end	5 962	13
1-4 family first liens	75 901	1 101
1-4 Family junior liens	8 442	- -
5 or more family	1 668	- -
All other	436	- -
Totals	$ 99 196	$ 1 127

Note 4. Allowance for Loan Losses (Continued)

Impaired Loans By Class
December 31, 2011
(in thousands)

With no related allowance:

	Unpaid Principal	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial non real estate					
Commercial and industrial	$ - -	$ - -	$ N/A	$ 67	$ - -
Commercial real estate					
Owner occupied	4 622	4 440	N/A	3 752	217
Non-owner occupied	587	583	N/A	132	11
Construction					
Residential	512	506	N/A	799	14
Commercial	4 106	3 976	N/A	3 353	168
Real estate					
Farmland	- -	- -	N/A	- -	- -
Residential					
Revolving open end	225	224	N/A	160	15
1 to 4 family first liens	948	870	N/A	1 257	26
1 to 4 family junior liens	- -	- -	N/A	177	- -
5 or more family	- -	- -	N/A	- -	- -
Consumer					
Titled vehicles	- -	- -	N/A	- -	- -
Deposit accounts	- -	- -	N/A	- -	- -
All other consumer	- -	- -	N/A	4	- -
All other	- -	- -	N/A	- -	- -
	$ 11 000	$ 10 599	$ N/A	$ 9 701	$ 451

With an allowance recorded:

	Unpaid Principal	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial non real estate					
Commercial and industrial	$ 163	$ 161	$ 161	$ 187	$ 8
Commercial real estate					
Owner occupied	1 989	1 972	122	4 800	93
Non-owner occupied	- -	- -	- -	163	- -
Construction					
Residential	- -	- -	- -	979	- -
Commercial	771	768	102	2 443	30
Real estate					
Farmland	- -	- -	- -	108	- -
Residential					
Revolving open end	1 277	1 274	31	331	65
1 to 4 family first liens	2 550	2 540	299	2 342	102
1 to 4 family junior liens	758	754	19	311	28
5 or more family	- -	- -	- -	- -	- -
Consumer					
Titled vehicles	- -	- -	- -	- -	- -
Deposit accounts	- -	- -	- -	- -	- -
All other consumer	109	109	39	37	3
All other	- -	- -	- -	- -	- -
	$ 7 617	$ 7 578	$ 773	$ 11 701	$ 329
Totals:					
Commercial non real estate	$ 163	$ 161	$ 161	$ 254	$ 8
Commercial real estate	7 198	6 995	122	8 847	321
Construction	5 389	5 250	102	7 574	212
Real estate farmland	- -	- -	- -	108	- -
Residential	5 758	5 662	349	4 578	236

Consumer	109	109	39	41	3
All other	- -	- -	- -	- -	- -
	$ 18 617	$ 18 177	$ 773	$ 21 402	$ 780

Note 4. Allowance for Loan Losses (Continued)

Impaired Loans By Class
December 31, 2010
(in thousands)

With no related allowance:

	Unpaid Principal	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial non real estate					
Commercial and industrial	$ 117	$ 95	$ N/A	$ 53	$ - -
Commercial real estate					
Owner occupied	4 206	4 256	N/A	3 591	158
Non-owner occupied	75	- -	N/A	15	- -
Construction					
Residential	1 188	1 183	N/A	1 769	52
Commercial	2 641	2 631	N/A	3 655	112
Real estate					
Farmland	- -	- -	N/A	- -	- -
Residential					
Revolving open end	- -	- -	N/A	- -	- -
1 to 4 family first liens	1 259	1 242	N/A	1 351	15
1 to 4 family junior liens	175	175	N/A	142	3
5 or more family	- -	- -	N/A	- -	- -
Consumer					
Titled vehicles	- -	- -	N/A	- -	- -
Deposit accounts	- -	- -	N/A	- -	- -
All other consumer	- -	- -	N/A	- -	- -
All other	- -	- -	N/A	- -	- -
	$ 9 661	$ 9 582	$ N/A	$ 10 576	$ 340

With an allowance recorded:

	Unpaid Principal	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial non real estate					
Commercial and industrial	$ 274	$ 272	$ 217	$ 355	$ 6
Commercial real estate					
Owner occupied	5 201	5 142	528	4 972	272
Non-owner occupied	- -	- -	- -	- -	- -
Construction					
Residential	2 786	2 767	600	3 910	175
Commercial	4 924	4 903	1 212	3 242	216
Real estate					
Farmland	549	539	161	547	- -
Residential					
Revolving open end	- -	- -	- -	- -	- -
1 to 4 family first liens	1 412	1 390	362	1 186	56
1 to 4 family junior liens	71	67	67	220	- -
5 or more family	- -	- -	- -	- -	- -
Consumer					
Titled vehicles	- -	- -	- -	- -	- -
Deposit accounts	- -	- -	- -	- -	- -
All other consumer	- -	- -	- -	4	- -
All other	- -	- -	- -	- -	- -
	$ 15 217	$ 15 080	$ 3 147	$ 14 436	$ 725
Totals:					
Commercial non real estate	$ 391	$ 367	$ 217	$ 408	$ 6
Commercial real estate	9 482	9 398	528	8 578	430
Construction	11 539	11 484	1 812	12 576	555
Real estate farmland	549	539	161	547	- -

Residential	2 917	2 874	429	2 899	74
Consumer	- -	- -	- -	4	- -
All other	- -	- -	- -	- -	- -
	$ 24 878	$ 24 662	$ 3 147	$ 25 012	$ 1 065

Note 4. Allowance for Loan Losses (Continued)

The following is a summary of information pertaining to impaired loans as of December 31, 2009 (in thousands):

	2009	
Impaired loans without a valuation allowance	$	12 397
Impaired loans with a valuation allowance		14 985
Total impaired loans	$	27 382
Valuation allowance related to impaired loans	$	3 799
Total nonaccrual loans	$	3 819
Total loans past due ninety days or more and still accruing	$	- -

	2009	
Average investment in impaired loans	$	16 262
Interest income recognized on impaired loans	$	1 233
Interest income recognized on a cash basis on impaired loans	$	68

No additional funds are committed to be advanced in connection with impaired loans. Nonaccrual loans excluded from impaired loans at December 31, 2011 and 2010 totaled $1.1 million and $1.1 million, respectively. If interest had been accrued on these nonaccrual loans, such income would have approximated $56 thousand in 2011 and $44 thousand in 2010.

Note 4. Allowance for Loan Losses (Continued)

Modifications
(in thousands except number of contracts)

For the Year Ended
December 31, 2011

Troubled Debt Restructurings	Number Of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial non real estate			
Commercial and industrial	- -	$ - -	$ - -
Commercial real estate			
Owner Occupied	6	725	725
Non owner occupied	1	583	583
Construction			
Residential	1	121	121
Commercial	9	684	684
Real Estate			
Farmland	- -	- -	- -
Residential			
Revolving open end 1 to 4 family	- -	- -	- -
1 to 4 family first liens	19	2 371	2 484
1 to 4 family junior liens	23	808	808
5 or more family	- -	- -	- -
Consumer			
Titled Vehicles	- -	- -	- -
Deposit Accounts	- -	- -	- -
All other consumer	3	77	77
All Other	- -	- -	- -
Totals	62	$ 5 369	$ 5 482

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts	Recorded Investment
Commercial non real estate		
Commercial and industrial	- -	$ - -
Commercial real estate		
Owner Occupied	1	220
Non owner occupied	- -	- -
Construction		
Residential	1	121
Commercial	- -	- -
Real Estate		
Farmland	- -	- -
Residential		
Revolving open end 1 to 4 family	- -	- -
1 to 4 family first liens	6	1 132
1 to 4 family junior liens	6	247
5 or more family	- -	- -
Consumer		
Titled Vehicles	- -	- -
Deposit Accounts	- -	- -
All other consumer	- -	- -

All Other		- -		- -
Totals		14	$	1 720

Note 4. Allowance for Loan Losses (Continued)

As of December 31, 2011 there are five TDRs in non-performing assets with balances totaling $2.9 million. In addition, two TDRs with balances totaling $107k are 30 or more days past due.

Granting a concession and assessing financial difficulty (ASU 2011-02) are effective for the first interim or annual period beginning on or after June 15, 2011. ASU 2011-2 is to be applied retrospectively to the beginning of the annual period of adoption. As of December 31, 2010 there were $7.3 million of TDRs outstanding.

Nonaccrual and Past Due Loans By Class
December 31, 2011
(in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due Still Accruing	Non-Accrual
Commercial non real estate								
Commercial and industrial	$ - -	$ 6	$ - -	$ 6	$ 8 355	$ 8 361	$ - -	$ 93
Commercial real estate								
Owner occupied	2 376	996	344	3 716	57 370	61 086	- -	1 339
Non owner occupied	- -	- -	179	179	15 617	15 796	- -	179
Construction								
Residential	- -	- -	385	385	2 107	2 492	- -	506
Commercial	19	44	1 602	1 665	15 022	16 687	143	3 693
Real estate								
Farmland	- -	- -	- -	- -	598	598	- -	- -
Residential								
Revolving open end	- -	- -	- -	- -	5 015	5 015	- -	17
1 to 4 family first liens	1 386	139	360	1 885	78 426	80 311	61	1 408
1 to 4 family junior liens	176	- -	- -	176	7 354	7 530	- -	- -
5 or more family	- -	- -	- -	- -	3 088	3 088	- -	- -
Consumer								
Titled vehicles	1	15	- -	16	2 634	2 650	- -	5
Deposit accounts	- -	- -	- -	- -	617	617	- -	- -
All other consumer	8	4	3	15	2 883	2 898	- -	3
All other	- -	- -	- -	- -	116	116	- -	- -
Totals	$ 3 966	$ 1 204	$ 2 873	$ 8 043	$ 199 202	$ 207 245	$ 204	$ 7 243
Percentage to Total Loans	1.91%	0.58%	1.39%	3.88%	96.12%		0.10%	3.49%

Included in the 30 or more days past due loans are certain non-accrual loans in the amount of $3.7 million. The remaining non-accrual loans of $3.5 million are in current status.

Note 4. Allowance for Loan Losses (Continued)

Nonaccrual and Past Due Loans By Class
December 31, 2010
(in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due Still Accruing	Non-Accrual
Commercial non real estate								
Commercial and industrial	$ 80	$ 92	$ 2	$ 174	$ 7 746	$ 7 920	$ - -	$ 97
Commercial real estate								
Owner occupied	612	- -	- -	612	66 905	67 517	- -	- -
Non owner occupied	194	- -	- -	194	11 904	12 098	- -	- -
Construction								
Residential	238	- -	- -	238	5 684	5 922	- -	- -
Commercial	115	- -	285	400	17 852	18 252	- -	405
Real estate								
Farmland	- -	- -	539	539	253	792	- -	539
Residential								
Revolving open end	- -	- -	- -	- -	5 975	5 975	- -	38
1 to 4 family first liens	2 269	416	881	3 566	79 125	82 691	- -	1 099
1 to 4 family junior liens	135	19	- -	154	8 717	8 871	- -	42
5 or more family	- -	- -	- -	- -	1 976	1 976	- -	- -
Consumer								
Titled vehicles	37	2	- -	39	3 674	3 713	- -	8
Deposit accounts	11	- -	- -	11	726	737	- -	- -
All other consumer	3	- -	5	8	2 342	2 350	- -	5
All other	- -	- -	- -	- -	436	436	- -	- -
Totals	$ 3 694	$ 529	$ 1 712	$ 5 935	$ 213 315	$ 219 250	$ - -	$ 2 233
Percentage to Total Loans	1.69%	0.24%	0.78%	2.71%	97.29%		- -%	1.02%

Included in the 30 or more days past due loans are certain non-accrual loans in the amount of $1.8 million. The remaining non-accrual loans of $429 thousand are in current status.

The past due policy of the bank is to report all classes of loans past due in the following categories:

- 30 to 59 days past due (principal or interest)
- 60 to 89 days past due (principal or interest)
- 90 days or more past due (principal or interest)
- Nonaccrual status.

Note 5. Premises and Equipment, Net

Premises and equipment consists of the following:

	December 31 2011	2010
	(in thousands)	
Premises and improvements	$ 9 438	$ 9 438
Furniture and equipment	4 407	4 377
	$ 13 845	$ 13 815
Less accumulated depreciation	5 922	5 545
	$ 7 923	$ 8 270

Depreciation included in operating expense for 2011, 2010 and 2009 was $477 thousand, $550 thousand and $573 thousand, respectively.

Note 6. Deposits

The aggregate amount of time deposits with a balance of $100,000 or more was $33.6 million and $45.0 million at December 31, 2011 and 2010, respectively.

At December 31, 2011, the scheduled maturities of all time deposits (in thousands) are as follows:

2012	$	34 004
2013		14 804
2014		9 738
2015		9 562
2016		9 085
	$	77 193

Brokered deposits totaled $13.0 million and $14.9 million at December 31, 2011 and 2010, respectively. Certificates of deposits included in these totals are $8.3 million and $14.7 million at December 31, 2011 and 2010, respectively.

Deposits of the company s directors, executive officers and associates totaled $2.1 million at December 31, 2011 and 2010.

No deposits of public funds entities exceeded 5% of the bank s total deposits.

Note 7. Borrowings

Short-term borrowings consist of securities sold under agreements to repurchase, which totaled $3.4 million and $7.4 million as of December 31, 2011 and 2010, respectively.

During 2010, the bank incurred fixed rate long term debt consisting of a Federal Home Loan Bank, three year loan, with an original balance of $3.6 million and monthly payments of interest and principal with an interest rate of 1.72%. The December 31, 2011 balance of this advance is $1.5 million. This loan modified the five year, $5 million, 4.61% fixed rate advance originated in 2008. Included with the refinancing was payment of a $162 thousand penalty that is being amortized over the life of the modified advance.

Principal payments (in thousands) on the note are due as follows:

2012		1 215
2013		308
	$	1 523

Noncore funding capabilities, including borrowing, provide additional liquidity. The subsidiary bank maintains a federal funds line with one financial institution and is a member of the Federal Home Loan Bank of Pittsburgh. In July 2009 the subsidiary bank secured a credit line with the Federal Reserve discount window. At December 31, 2011, the subsidiary bank has total credit available through these institutions of approximately $87.2 million.

Note 8. Employee Benefit Plans

The company s defined benefit pension plan, covering full-time employees over 21 years of age upon completion of one year of service, was frozen as of October 31, 2009, the end of the plan year. Benefits will be based on average compensation for the five consecutive full calendar years of service which produces the highest average as of October 31, 2009. No additional participants may enter the plan, and there will be no further increases in benefits due to increases in salaries and years of service.

The company sponsors an unfunded postretirement life insurance plan covering certain retirees with 25 years of service who are over the age of 60 and an unfunded health care plan for certain retirees that met certain eligibility requirements. This plan is not available to future retirees.

Note 8. Employee Benefit Plans (Continued)

The company sponsors a 401(k) retirement savings plan available to all employees meeting certain age and service requirements. Employees become eligible to participate in the plan upon reaching age 21 and completing one year of service. Entry dates are January 1, April 1, July 1 and October 1. Employees can make a salary deferral election authorizing the company to withhold up to the amount allowed by law each calendar year. The company may make a discretionary matching contribution each plan year. The company may also make other discretionary contributions to the plan. The company s match for this plan has been increased with the freezing of the defined benefit plan as described above. The company made 401(k) matching contributions of $215 thousand, $214 thousand and $111 thousand in 2011, 2010 and 2009, respectively.

The company has entered into contracts with three retirees where the company has agreed to pay the beneficiaries of two participants $50,000 each and the beneficiary of one participant $25,000 at the death of the participants. This postretirement benefit has been accrued as of December 31, 2011. While these liabilities are unfunded, life insurance has been obtained by the company to help offset these payments.

Obligations and funded status:

	Pension Benefits		Other Postretirement Benefits	
	2011 (in thousands)	2010	2011 (in thousands)	2010
Change in benefit obligation:				
Benefit obligation, beginning	$ 7 656	$ 6 962	$ 625	$ 568
Service cost	- -	- -	12	12
Interest cost	402	413	37	34
Change in assumptions	- -	- -	29	27
Actuarial loss (gain)	710	592	- -	- -
Amendment	- -	- -	(341)	4
Benefits paid	(346)	(311)	(19)	(20)
Curtailment	- -	- -	- -	- -
Benefit obligation, ending	$ 8 422	$ 7 656	$ 343	$ 625
Change in plan assets:				
Fair value of plan assets, beginning	$ 6 098	$ 5 621	$ - -	$ - -
Actual return on plan assets	155	443	- -	- -
Employer contributions	9	345	19	20
Benefits paid	(346)	(311)	(19)	(20)
Fair value of plan assets, ending	$ 5 916	$ 6 098	$ - -	$ - -
Funded status at end of year	$ (2 506)	$ (1 558)	$ (343)	$ (625)
Unrecognized net (gain)	- -	- -	- -	(21)
Unrecognized transition asset	- -	- -	- -	70
Accounts recognized on consolidated balance sheet as:				
Accrued benefit liabilities	$ (2 506)	$ (1 558)	$ (343)	$ (576)
Amounts recognized in accumulated other comprehensive loss consist of:				
Net actuarial loss (gain)	$ 3 235	$ 2 354	$ - -	$ (21)
Transition liability	- -	- -	- -	70
Deferred tax asset	(1 100)	(800)	- -	(17)
	$ 2 135	$ 1 554	$ - -	$ 32

The accumulated benefit obligation for the defined benefit pension plan was $8.4 million and $7.7 million at December 31, 2011 and 2010, respectively.

Note 8. Employee Benefit Plans (Continued)

Components of net periodic benefit cost and other amounts recognized in accumulated other comprehensive loss:

	Pension Benefits			Other Postretirement Benefits		
	2011 (in thousands)	2010	2009	2011 (in thousands)	2010	2009
Components of net periodic benefit cost:						
Service cost	$ - -	$ - -	$ 266	$ 12	$ 12	$ 12
Interest cost	402	413	447	37	34	32
Expected return on plan assets	(475)	(460)	(373)	- -	- -	- -
Amortization of net obligation at transition	- -	- -	- -	70	17	17
Recognized actuarial loss	- -	96	159	- -	- -	- -
Amortization of prior service cost	- -	- -	- -	(341)	- -	- -
Amortization of Loss	150	- -	- -	8	- -	- -
Net periodic benefit cost	$ 77	$ 49	$ 499	$ (214)	$ 63	$ 61
Other changes in plan assets and benefit obligations recognized in other comprehensive loss:						
Net actuarial loss (gain)	$ 1 030	$ 609	$ (201)	$ 21	$ 31	$ 1
Transition liability	- -	- -	- -	(70)	(18)	(17)
Deferred tax	(299)	(174)	481	17	(4)	5
Amortization of net (gain)	(150)	(96)	(159)	- -	- -	- -
Adjustment to (gain) for curtailment	- -	- -	(1 054)	- -	- -	- -
Total recognized in accumulated other comprehensive loss	$ 581	$ 339	$ (933)	$ (32)	$ 9	$ (11)
Total recognized in net periodic benefit cost and accumulated other comprehensive loss	$ 658	$ 388	$ (434)	$ (246)	$ 72	$ 50

The estimated net loss and prior service cost for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year approximates $212 thousand. The estimated unrecognized transition liability for the other defined benefit postretirement plan is zero due to the termination of benefits for current employees.

Assumptions

	Pension Benefits			Other Postretirement Benefits		
	2011	2010	2009	2011	2010	2009
Weighted-average assumptions used to determine net periodic benefit cost:						
Discount rate	4.99%	6.08%	6.30%	5.70%	6.00%	6.00%
Expected return on plan assets	6.31%	8.00%	8.00%	- -	- -	- -
Rate of compensation increase	N/A	N/A	3.00%	3.00%	3.00%	3.00%
Weighted-average assumptions used to determine benefit obligations:						
Discount rate	4.99%	5.37%	6.08%	4.70%	5.70%	6.00%
Rate of compensation increase	N/A	N/A	N/A	N/A	3.00%	3.00%

Note 8. Employee Benefit Plans (Continued)

Long-Term Rate of Return

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

		Fair Value Measurement at December 31, 2011		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash & cash equivalents	$ 190	$ 190	$ - -	$ - -
Equity securities				
U.S. companies	1 830	1 830	- -	- -
International companies	465	465	- -	- -
U. S. Treasury securities	989	989	- -	- -
U. S. Corporate bonds	2 229	2 229	- -	- -
International Corporate bonds	213	213	- -	- -
Total	$ 5 916	$ 5 916	$ - -	$ - -

		Fair Value Measurement at December 31, 2010		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$ 615	$ 615	$ - -	$ - -
Equity securities				
U.S. companies	2 502	2 502	- -	- -
International companies	646	646	- -	- -
U. S. Treasury securities	718	718	- -	- -
U. S. Corporate bonds	1 531	1 531	- -	- -
International Corporate bonds	86	86	- -	- -
Total	$ 6 098	$ 6 098	$ - -	$ - -

Note 8. Employee Benefit Plans (Continued)

Asset Allocation

The pension plan s weighted-average asset allocations at December 31, 2011 and 2010 by asset category are as follows:

	Plan Assets at December 31 2011	2010
Asset Category		
Equities	39%	52%
Fixed income/cash	61%	48%
Total	100%	100%

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 50% equities and 50% fixed income/cash and acceptable ranges within these categories of 40% to 60%. The trust fund allocation is reviewed on a monthly basis and rebalanced to within the acceptable ranges as needed. The investment manager selects investment fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the plan s investment strategy. The investment manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the trustee to administer the investments of the trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the trust.

After review of the December 2011 allocations shown above, the funds were rebalanced and were within policy at February 29, 2012.

There is no company common stock included in the equity securities of the pension plan at December 31, 2011 and 2010.

Cash Flow

The company expects to contribute $2 million to its pension plan in 2012 and $18 thousand to its postretirement plan in 2012.

The following benefit payments (in thousands) are expected to be paid:

	Pension Benefits	Other Postretirement Benefits
2012	$ 417	$ 18
2013	435	19
2014	456	21
2015	472	24
2016	491	24
Thereafter	2 641	130

For measurement purposes, a 6.05%, 6.40% and 6.85% annual rate of increase in per capita health care costs of covered benefits was assumed for the retiree health care plan for 2011, 2010 and 2009, with such annual rate of increase gradually declining to 5% in 2013.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

1% Decrease

	1% Increase	
	(in thousands)	
Effect on the health care component of the accumulated postretirement benefit obligation	$ 49	$ (42)
Effect on total of service and interest cost components of net periodic other postretirement health care benefit cost	9	(4)

Note 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 stockholders.

	2011		2010		2009	
	Average Shares (in thousands)	Per Share Amount	Average Shares (in thousands)	Per Share Amount	Average Shares (in thousands)	Per Share Amount
Basic (loss) earnings per share	3 390	$ (.30)	3 390	$ .53	3 391	$ (.66)
Effect of dilutive securities:						
Stock options	- -		- -		- -	
Diluted (loss) earnings per share	3 390	$ (.30)	3 390	$ .53	3 391	$ (.66)

Stock options for 119,908, 124,911 and 129,067 average shares of common stock were not considered in computing diluted earnings per common share for 2011, 2010 and 2009, respectively, because they were anti-dilutive.

Note 10. Stock-Based Compensation

During 2003, the company adopted an incentive stock plan which allows key employees and directors to increase their personal financial interest in the company. This plan permits the issuance of incentive stock options and non-qualified stock options. The plan authorizes the issuance of up to 183,600 shares of common stock. In 2007, the shareholders authorized an additional 250,000 shares of common stock to be used in the granting of incentive and non-qualified stock options to employees and directors.

A summary of option activity under the plan as of December 31, 2011, and changes during the year then ended is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value (in thousands)
Outstanding at beginning of year	120 974	$ 14.76		
Granted	- -	- -		
Exercised	- -	- -		
Forfeited	(1 066)	15.60		
Outstanding at end of year	119 908	$ 14.76	4	$ - -
Exercisable at end of year	116 896	$ 14.73	4	$ - -

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2011. The aggregate intrinsic values change based on changes in the market value of the company s stock.

The exercise price of stock options granted under this plan, both incentive and non-qualified, cannot be less than the fair market value of the common stock on the date that the option is granted. The maximum term for an option granted under this plan is ten years and options granted may be subject to a vesting schedule. The non-qualified options granted are exercisable immediately. The incentive options granted are subject to a five year vesting period whereby the grantees are entitled to exercise one fifth of the options on the anniversary of the grant date over the next five years. The following table summarizes options outstanding at December 31, 2011:

Note 10. Stock-Based Compensation (Continued)

	Options Outstanding			Options Exercisable	
Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 11.28	24 468	2.0	$ 11.28	24 468	$ 11.28
14.00	32 735	3.0	14.00	32 735	14.00
17.25	34 477	4.0	17.25	34 477	17.25
15.60	28 228	5.0	15.60	25 216	15.60
	119 908			116 896	

As of December 31, 2011, there was $248 of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period. The unrecognized compensation expense has a weighted average life of less than one year.

Note 11. Income Taxes

The company files income tax returns in the U. S. Federal jurisdiction and the state of West Virginia. With few exceptions, the company is no longer subject to U. S. Federal, state and local income tax examinations by tax authorities for years prior to 2008.

Net deferred tax assets (in thousands) consist of the following components as of December 31, 2011 and 2010:

	2011	2010
Deferred tax assets:		
Reserve for loan losses	$ 949	$ 1 245
Accrued pension expense	823	530
Accrued postretirement benefits	178	255
Nonaccrual interest	83	36
Stock option expense	35	35
Home equity closing costs	11	23
Net loan origination fees	102	69
Securities available for sale	- -	52
Net operating loss carryforward	553	- -
OREO expense	240	138
OREO valuation allowance	835	32
OREO built in gain	280	250
	$ 4 089	$ 2 665
Deferred tax liabilities:		
Depreciation	$ 84	$ 89
Securities available for sale	105	- -
	$ 189	$ 89
Net deferred tax assets	$ 3 900	$ 2 576

The (benefit) provision for income taxes charged to operations for the years ended December 31, 2011, 2010 and 2009 consists of the following (in thousands):

	2011	2010	2009
Current tax (benefit) expense	$ (53)	$ 186	$ (827)

Deferred tax (benefit) expense	(1 197)	494	(609)
	$ (1 250)	$ 680	$ (1 436)

Note 11. Income Taxes (Continued)

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2011, 2010 and 2009 due to the following (in thousands):

	2011	2010	2009
Computed expected tax (benefit) expense	$ (768)	$ 841	$ (1 250)
Increase (decrease) in income taxes resulting from:			
Tax exempt income	(168)	(165)	(146)
State income tax (benefit) expense	(250)	- -	(163)
Other	(64)	4	123
	$ (1 250)	$ 680	$ (1 436)

The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is more likely than not that all or a portion of the deferred tax asset will not be realized. More likely than not is defined as greater than a 50% chance. Management considers all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed. Management s assessment is primarily dependent on historical taxable income and projections of future taxable income, which are directly related to the company s core earnings capacity and its prospects to generate core earnings in the future. Projections of core earnings and taxable income are inherently subject to uncertainty and estimates that may change given the uncertain economic outlook, banking industry conditions and other factors. Based upon an analysis of available evidence, management has determined that it is more likely than not that the company s deferred income tax assets as of December 31, 2011 will be fully realized and therefore no valuation allowance to the company s deferred income tax assets was recorded. However, the company can give no assurance that in the future its deferred income tax assets will not be impaired because such determination is based on projections of future earnings and the possible effect of certain transactions, which are subject to uncertainty and based on estimates that may change due to changing economic conditions and other factors. Due to the uncertainty of estimates and projections, it is possible that the company will be required to record adjustments to the valuation allowance in future reporting periods.

Under the provisions of the Internal Revenue Code, the Company has approximately $697,168 of net operating loss carryforwards which can be offset against future taxable income. The carryforwards expire through December 31, 2031. In addition, the Company has approximately $3,958,316 of net operating loss carryforwards which can be offset against future West Virginia taxable income. These carryforwards also expire through December 31, 2031. The full realization of the tax benefits associated with the carryforwards depends predominately upon the recognition of ordinary income during the carryforward period.

Note 12. Commitments and Contingent Liabilities

In the normal course of business, there are outstanding various commitments and contingent liabilities which are not reflected in the accompanying financial statements. The company does not anticipate losses as a result of these transactions. See Note 14 with respect to financial instruments with off-balance-sheet risk.

The company must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final bi-weekly reporting periods which included December 31, 2011 and 2010, this requirement was met by the amount of vault cash.

The table below presents the contractual obligations of the company as of December 31, 2011 not disclosed in other notes:

	Lease Obligations for Real Estate	Lease Obligations for Equipment
2012	$ 40	$ 29
2013	31	29
2014	- -	29
2015	- -	10
2016	- -	- -
Thereafter	- -	- -
	$ 71	$ 97

Note 13. Retained Earnings

Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by the bank to the company. The approval of the State Banking Commissioner is required if the total of all dividends declared in any calendar year exceeds the bank s net profits for that year combined with its retained net profits for the preceding two calendar years and loans or advances are limited to 10 percent of the bank s capital stock and surplus on a secured basis.

At December 31, 2011, none of the bank s retained earnings were available for the payment of dividends. Accordingly, $24.5 million of the company s equity in the net assets of the bank was restricted at December 31, 2011. Funds available for loans or advances by the bank to the company amounted to $600 thousand.

In addition, dividends paid by the bank to the company would be prohibited if the effect thereof would cause the bank s capital to be reduced below applicable minimum capital requirements.

Note 14. 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 company s exposure to credit loss in the event of nonperformance by the borrowers 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, 2011 and 2010 (in thousands) is as follows:

	2011	2010
Financial instruments whose amounts represent credit risk:		
Commitments to extend credit	$ 27 466	$ 28 050
Standby letters of credit	2 382	2 225

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 borrower. Collateral held varies but typically is cash or real estate.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. The majority of these lines of credit are collateralized and usually contain a specified maturity date.

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 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, 2011, the company had no rate lock commitments to originate mortgage loans and had mortgage loans held for sale in the amount of $198 thousand. The company enters into corresponding mandatory commitments, on a best-efforts basis, to sell the 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.

Note 15. Fair Value Measurements

Determination of Fair Value

The company uses fair value measurements to record fair value adjustments for certain assets and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3 Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following methods and assumptions were used by the company in estimating fair value disclosures for financial instruments:

Cash and Short-Term Investments

The carrying amounts of cash and short-term instruments approximate fair values based on the short-term nature of the assets.

Note 15. Fair Value Measurements (Continued)

Securities

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). Certain of the equity securities with inactive markets utilize level 3 which may include judgment or estimation.

Loans

For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans were estimated using discounted cash flow analyses, using interest rates currently being offered.

Loans held for Sale

The fair value of loans held for sale is based on outstanding commitments from investors.

FHLB Stock

The carrying amounts of FHLB stock approximate fair value based on redemption provisions of the FHLB.

Bank Owned Life Insurance (BOLI)

The carrying amounts of BOLI approximate fair value.

Deposit Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Short-Term Borrowings

The carrying amounts of borrowings under repurchase agreements and federal funds purchased approximate fair value.

FHLB Advances

The fair values of the company s FHLB advances are estimated using discounted cash flow analysis based on the company s incremental borrowing rates for similar types of borrowing arrangements.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Off-Balance Sheet Financial Instruments

At December 31, 2011 and 2010, the fair value of loan commitments and standby-letters of credit was immaterial. Therefore, they have not been included in the following table.

Note 15. Fair Value Measurements (Continued)

The carrying amounts and estimated fair values of the company s financial instruments are as follows:

	2011 Carrying Amount (in thousands)	Fair Value	2010 Carrying Amount (in thousands)	Fair Value
Financial assets:				
Cash and interest bearing deposits	$ 12 930	$ 12 930	$ 10 180	$ 10 180
Federal funds sold	794	794	2 725	2 725
Securities available for sale	42 331	42 331	42 690	42 690
Loans, net	202 761	202 737	214 238	212 200
Loans held for sale	198	198	76	76
FHLB stock	808	808	765	765
BOLI	6 932	6 932	6 397	6 397
Accrued interest receivable	832	832	960	960
Financial liabilities:				
Deposits	253 117	253 885	257 422	258 240
Securities sold under agreements to repurchase	3 415	3 415	7 382	7 382
FHLB advances	1 523	1 534	2 717	2 734
Accrued interest payable	204	204	361	361

Assets Measured at Fair Value on a Recurring Basis

The following table presents the balances (in thousands) of financial assets measured at fair value on a recurring basis as of December 31, 2011 and 2010:

		Fair Value Measurements at December 31, 2011 Using		
Description	Balance as of December 31 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale debt securities				
U.S. Government sponsored agency securities	$ 34 823	$ - -	$ 34 823	$ - -
State and municipal securities	6 715	- -	6 715	- -
Total available for sale debt securities	41 538	- -	41 538	- -
Available for sale equity securities				
Financial services industry	793	- -	149	644
Total available for sale securities	$ 42 331	$ - -	$ 41 687	$ 644

Note 15. Fair Value Measurements (Continued)

Description	Balance as of December 31 2010	Fair Value Measurements at December 31, 2010 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government sponsored agency securities	$ 36 288	$ - -	$ 36 288	$ - -
State and municipal securities	5 524	- -	5 524	- -
Total available for sale debt securities	41 812	- -	41 812	- -
Available for sale equity securities				
Financial services industry	878	- -	878	- -
Total available for sale securities	$ 42 690	$ - -	$ 42 690	$ - -

Assets Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3)

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) ($ in thousands)	Available for Sale Equity Securities
Beginning Balance January 1, 2011	$ - -
Transfers into Level 3	834
Transfers out of Level 3	- -
Total losses (unrealized) included in other comprehensive income	(190)
Ending Balance December 31, 2011	$ 644

Assets Measured at Fair Value on a Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the years ended December 31, 2011 and 2010. Gains and losses on the sale of loans are recorded within other operating income on the consolidated statements of operations.

Note 15. Fair Value Measurements (Continued)

Impaired Loans: Loans are generally designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business s financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of operations.

Other Real Estate Owned: Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. The value of real estate collateral is determined by internal evaluation or an appraisal outside of the company or a comparative market analysis (level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, or the property is in the process of being appraised then the fair value is considered level 3.

The following table summarizes the company s assets that were measured at fair value (in thousands) on a nonrecurring basis as of December 31, 2011 and 2010.

		Carrying Value at December 31, 2011		
Description	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Input (Level 3)
Assets				
Loans held for sale	$ 198	$ - -	$ 198	$ - -
Impaired Loans with a valuation allowance	6 805	- -	308	6 497
OREO	6 393	- -	4 365	2 028

		Carrying Value at December 31, 2010		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Input (Level 3)
Assets				
Loans held for sale	$ 76	$ - -	$ 76	$ - -
Impaired Loans with a valuation allowance	11 933	- -	10 593	1 340
OREO	6 563	- -	6 563	- -

Note 16. Regulatory Matters

The company (on a consolidated basis) and the bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the company s and the bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the company and bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the company and the bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2011 and 2010, that the company and the bank meet all capital adequacy requirements to which they are subject. The most recent notification from the FDIC categorized the bank as well capitalized under the regulatory framework for prompt, corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table.

The company s and the bank s actual capital amounts and ratios are presented in the table.

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized	
	Amount (in thousands)	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2011:						
Total capital (to risk-weighted assets):						
Consolidated	$27 487	13.10%	$16 782	8.0%	N/A	N/A
Bank of Charles Town	$26 331	12.64%	$16 662	8.0%	$20 828	10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	$24 842	11.84%	$8 391	4.0%	N/A	N/A
Bank of Charles Town	$23 704	11.38%	$8 331	4.0%	$12 497	6.0%
Tier 1 capital (to average assets):						
Consolidated	$24 842	8.56%	$11 602	4.0%	N/A	N/A
Bank of Charles Town	$23 704	8.21%	$11 544	4.0%	$14 430	5.0%
As of December 31, 2010:						
Total capital (to risk-weighted assets):						
Consolidated	$30 798	14.24%	$17 306	8.0%	N/A	N/A
Bank of Charles Town	$29 584	13.74%	$17 223	8.0%	$21 529	10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	$28 065	12.97%	$8 653	4.0%	N/A	N/A
Bank of Charles Town	$26 864	12.48%	$8 612	4.0%	$12 917	6.0%
Tier 1 capital (to average assets):						
Consolidated	$28 065	9.36%	$11 992	4.0%	N/A	N/A
Bank of Charles Town	$26 864	8.99%	$11 947	4.0%	$14 934	5.0%

Note 17. Parent Company Only Financial Statements

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Balance Sheets
December 31, 2011 and 2010
(in thousands)

	2011		2010	
ASSETS				
Cash	$	2	$	70
Investment in subsidiary		24 492		25 685
Equity securities available for sale, at fair value		793		858
Other assets		178		163
Total Assets	$	25 465	$	26 776
LIABILITIES AND STOCKHOLDERS EQUITY				
LIABILITIES				
Other liabilities	$	- -	$	- -
Total Liabilities	$	- -	$	- -
STOCKHOLDERS EQUITY				
Common stock	$	3 672	$	3 672
Surplus		3 943		3 932
Undivided profits		22 648		23 725
Accumulated other comprehensive (loss), net		(1 932)		(1 687)
	$	28 331	$	29 642
Less cost of shares acquired for the treasury		2 866		2 866
Total Stockholders Equity	$	25 465	$	26 776
Total Liabilities and Stockholders Equity	$	25 465	$	26 776

Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Statements of Operations
Years Ended December 31, 2011, 2010 and 2009
(in thousands)

	2011		2010		2009	
Income						
Dividends from subsidiary	$	68	$	80	$	977
Interest income		- -		- -		1
Total Income	$	68	$	80	$	978
Expenses						
Stock-based compensation expense	$	11	$	34	$	47
Public relations & new business development		5		3		4
Transfer agent expense		16		15		15
Computer services		4		4		3
Director and committee fees		10		9		8
Legal fees		11		17		11
Other professional fees		21		16		63
Postage		5		4		4
Proxy solicitation		9		9		8
Printing, stationery and supplies		13		15		16
Other taxes		1		1		1
Other operating expenses		- -		- -		117
Total Expenses	$	106	$	127	$	297
(Loss) Income before Income Tax (Benefit) and Equity in Undistributed (Loss) Income of Subsidiary	$	(38)	$	(47)	$	681
Income Tax (Benefit)		(31)		(31)		(84)
(Loss) Income before Equity in Undistributed (Loss) Income of Subsidiary	$	(7)	$	(16)	$	765
Equity in Undistributed (Loss) Income of Subsidiary		(1 003)		1 810		(3 005)
Net (Loss) Income	$	(1 010)	$	1 794	$	(2 240)

Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2011, 2010 and 2009
(in thousands)

	2011	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	$ (1 010)	$ 1 794	$ (2 240)
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:			
Equity in undistributed loss (income) of subsidiary	1 003	(1 810)	3 005
Stock-based compensation expense	11	34	47
(Increase) decrease in other assets	(5)	52	68
(Decrease) increase in other liabilities	- -	(1)	1
Net cash (used in) provided by operating activities	$ (1)	$ 69	$ 881
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash dividends	$ (67)	$ - -	$ (899)
Purchase of treasury shares	- -	- -	(29)
Net cash (used in) financing activities	$ (67)	$ - -	$ (928)
(Decrease) increase in cash and cash equivalents	$ (68)	$ 69	(47)
CASH AND CASH EQUIVALENTS			
Beginning	70	1	48
Ending	$ 2	$ 70	$ 1

Note 18. Subsequent Events

In accordance with ASC 855-10, the company evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

Based on the evaluation, the company did not identify any recognized or nonrecognized subsequent events that would have required adjustment to or disclosure in the financial statements.

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.

Not Applicable.

Item 9A. 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.

As a smaller reporting company, management s report will not be subject to attestation by the company s registered public accounting firm pursuant to permanent rules of the Securities and Exchange Commission that permit the company to provide only management s report in this annual report.

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.

Management s Report on Internal Control Over Financial Reporting

To the Stockholders:

Management is responsible for the preparation and fair presentation of the financial statements included in this annual report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management s judgments and estimates concerning effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. The company s internal control over financial reporting includes those policies and procedures that pertain to the company s ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the company s internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2011. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management has concluded that the internal control over financial reporting was effective as of December 31, 2011.

The Board of Directors, acting through its Audit Committee, is responsible for the oversight of the company s accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent registered public accounting firm and approves decisions regarding the appointment or removal of the company s internal auditor. It meets periodically with management, the independent registered public accounting firm and the internal auditor to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the company in addition to reviewing the company s financial reports. The independent registered public accounting firm and the internal auditor have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee.

Item 9B. Other Information.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information contained on pages 7-10 of the Proxy Statement dated March 30, 2012, for the May 15, 2012 Annual Meeting under the captions Management Nominees to the Board of Potomac and Directors Continuing to Serve Unexpired Terms, and page 16-17 under the caption Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

The Executive Officers are as follows:

Name	Position Since	Age	Principal Occupation
Robert F. Baronner, Jr.	President & CEO 2001	53	Employed by bank as of 1/1/01 as President and CEO.
Dean Cognetti	Sr. Vice President & Chief Financial Officer 2011	52	Employed with the bank as of 7/11/11 as Sr. Vice President and Chief Financial Officer.
Arch A. Moore, III	Executive Vice President & Chief Lending Officer 2011	60	Employed with the bank as of 1/1/11 as Executive Vice President and Chief Lending Officer.

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. Additionally, there is a Code of Ethics for Senior Financial Officers which applies to Potomac s and the bank s chief executive officer and chief financial officer. These Codes of Ethics are attached to this document as Exhibits 14.1 and 14.2. 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 11. Executive Compensation.

The information contained on pages 12-15 of the Proxy Statement dated March 30, 2012, for the May 15, 2012 Annual Meeting under the captions Executive Compensation, Employee Benefit Plans, Employment Agreement, and Compensation of Directors is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information contained on pages 11-12 of the Proxy Statement dated March 30, 2012, for the May 15, 2012 Annual Meeting under the caption Ownership of Securities by Nominees, Directors and Officers is incorporated herein by reference.

Securities authorized for issuance under Potomac s 2003 Stock Incentive Plan are listed below:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
2003 Stock Incentive Plan amended by shareholders April 24, 2007	119,908	$ 14.76	311,652

Item 13. Certain Relationships and Related Transactions.

The information contained on page 16 of the Proxy Statement dated March 30, 2012, for the May 15, 2012 Annual Meeting under the caption Certain Transactions with Directors, Officers and Their Associates is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services.

The information contained on pages 6-7 of the Proxy Statement dated March 30, 2012, for the May 15, 2012 Annual Meeting under the caption Audit Committee Report is incorporated herein by reference.

Item 15. Exhibits and Financial Statement Schedules.

(a) (1) Financial Statements. Reference is made to Part II, Item 8 of this Annual Report on Form 10-K.

(2) Financial Statement Schedules. These schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

(3) Exhibits. See below.

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 the Registration Statement on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092, 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, both incorporated by reference from the Form 10-K for the year ended December 31, 2009, and filed with the Securities and Exchange Commission, File No. 0-24958.

3.2 Amended and Restated Bylaws of Potomac Bancshares, Inc. and subsequent amendments thereto, incorporated by reference from the Form 10-K for the year ended December 31, 2009, 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, amended by the company s shareholders on April 24, 2007 and incorporated by reference from Potomac s Form 10-K for the year ended December 31, 2006 and filed with the Securities and Exchange Commission, File No. 0-24958.

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.

14.1 Code of Ethics (for all employees)*

14.2 Code of Ethics for Senior Financial Officers*

21 Subsidiaries of the Registrant*

23.1 Consent of Independent Registered Public Accounting Firm *

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

31.2 Rule 13a-15(e)/15d-15(e) 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 2012 Annual Meeting for Potomac, portions are incorporated by reference in Form 10-K Annual Report*

101.INS XBRL Instance Document. **

101.SCH XBRL Taxonomy Extension Schema. **

101.CAL XBRL Taxonomy Extension Calculation Linkbase. **

101.LAB XBRL Taxonomy Extension Label Linkbase. **

101.PRE XBRL Taxonomy Extension Presentation Linkbase. **

101.DEF XBRL Taxonomy Definition Linkbase. **

* Filed herewith.

** Furnished, not filed, herewith

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. Robert F. Baronner, Jr. President & Chief Executive Officer	March 29, 2012
By	/s/ Dean Cognetti Dean Cognetti Sr. Vice President & Chief Financial Officer	March 29, 2012

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/ Dr. Keith Berkeley Dr. Keith Berkeley, Director	March 29, 2012
By	/s/ J. Scott Boyd J. Scott Boyd, Director	March 29, 2012
By	/s/ John P. Burns, Jr. John P. Burns, Jr., Director	March 29, 2012
By	/s/ Guy Gareth Chicchirichi Guy Gareth Chicchirichi, Director	March 29, 2012
By	/s/ Margaret Cogswell Margaret Cogswell, Director	March 29, 2012
By	/s/ Mary Clare Eros Mary Clare Eros, Director	March 29, 2012
By	/s/ William R. Harner William R. Harner, Director	March 29, 2012
By	/s/ Stanley L. Merson Stanley L. Merson, Director	March 29, 2012

By	/s/ Barbara H. Pichot Barbara H. Pichot, Director	March 29, 2012
By	/s/ John C. Skinner, Jr. John C. Skinner, Jr., Director	March 29, 2012
By	/s/ C. Larry Togans C. Larry Togans, Director	March 29, 2012