POTOMAC BANCSHARES INC
Form 10-Q
May 15, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2007

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

Commission File Number 0-24958

POTOMAC BANCSHARES, INC.

(Exact Name of Registrant as Specified in Its Charter)

West Virginia **(State or Other Jurisdiction of** **Incorporation or Organization)**	**55-0732247** **(I.R.S. Employer** **Identification No.)**
111 East Washington Street **PO Box 906, Charles Town WV**	**25414-0906**

(Address of Principal Executive Offices) **(Zip Code)**

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

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 x No ¨

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer x

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

APPLICABLE ONLY TO CORPORATE REGISTRANTS

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

3,433,583 as of May 8, 2007

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

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FORWARD-LOOKING STATEMENTS

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

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

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	(Unaudited) March 31 2007	December 31 2006
Assets:		
Cash and due from banks	$ 6,442	$ 6,214
Interest-bearing deposits in financial institutions	256	367
Securities purchased under agreements to resell and federal funds sold	10,925	345
Securities available for sale, at fair value	45,309	42,706
Loans held for sale		405
Loans, net of allowance for loan losses of $2,437 and $2,423 respectively	228,473	227,646
Premises and equipment, net	6,362	6,421
Accrued interest receivable	1,457	1,431
Other assets	7,353	7,214
Total Assets	$ 306,577	$ 292,749
Liabilities and Stockholders Equity:		
Liabilities:		
Deposits		
Noninterest-bearing	$ 29,918	$ 29,873
Interest-bearing	234,735	221,905
Total Deposits	264,653	251,778
Accrued interest payable	856	672
Securities sold under agreements to repurchase and federal funds purchased	10,111	10,526
Federal Home Loan Bank advances	520	620
Other liabilities	2,986	2,436
Total Liabilities	$ 279,126	$ 266,032
Stockholders Equity:		
Common stock, $1 per share par value; 5,000,000 shares authorized; 3,671,691 shares issued	$ 3,672	$ 3,672
Surplus	3,746	3,661
Undivided profits	23,278	22,677
Accumulated other comprehensive (loss)	(966)	(1,014)
	$ 29,730	$ 28,996
Less cost of shares acquired for the treasury, 238,108 shares	2,279	2,279
Total Stockholders Equity	$ 27,451	$ 26,717

Total Liabilities and Stockholders Equity	$ 306,577	$ 292,749

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share data)

(Unaudited)

	For the Three Months Ended March 31 2007	2006
Interest and Dividend Income:		
Interest and fees on loans	$ 4,284	$ 3,848
Interest on securities available for sale taxable	487	484
Interest on securities available for sale nontaxable	16	13
Interest on securities purchased under agreements to resell and federal funds sold	126	7
Other interest and dividends	43	35
Total Interest and Dividend Income	$ 4,956	$ 4,387
Interest Expense:		
Interest on deposits	$ 2,023	$ 1,217
Interest on securities sold under agreements to repurchase and federal funds purchased	101	158
Federal Home Loan Bank advances	8	43
Total Interest Expense	$ 2,132	$ 1,418
Net Interest Income	$ 2,824	$ 2,969
Provision for Loan Losses		
Net Interest Income after Provision for Loan Losses	$ 2,824	$ 2,969
Noninterest Income:		
Trust and financial services	$ 259	$ 238
Service charges on deposit accounts	445	394
Visa/MC fees	97	79
Other operating income	148	135
Total Noninterest Income	$ 949	$ 846
Noninterest Expenses:		
Salaries and employee benefits	$ 1,275	$ 1,330
Net occupancy expense of premises	141	144
Furniture and equipment expenses	230	210
Advertising and marketing	66	72
ATM and check card expenses	86	70
Other operating expenses	506	517
Total Noninterest Expenses	$ 2,304	$ 2,343

Income before Income Tax Expense	$ 1,469	$ 1,472
Income Tax Expense	524	534
Net Income	$ 945	$ 938
Earnings Per Share, basic	$ .28	$ .27
Earnings Per Share, diluted	$ .27	$ .27

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006

(in thousands, except per share data)

(Unaudited)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive (Loss)	Comprehensive Income	Total
Balances, December 31, 2005	$ 3,600	$ 2,400	$ 21,158	$ (1,850)	$ (276)		$ 25,032
Comprehensive income							
Net income			938			$ 938	938
Other comprehensive (loss): unrealized holding (losses) arising during the period (net of tax, $35)					(67)	(67)	(67)
Total comprehensive income						$ 871	
2% stock dividend	72	1,152	(1,224)				
Stock compensation expense		72					72
Cash dividends ($.09 per share)			(306)				(306)
Balances, March 31, 2006	$ 3,672	$ 3,624	$ 20,566	$ (1,850)	$ (343)		$ 25,669
Balances, December 31, 2006	$ 3,672	$ 3,661	$ 22,677	$ (2,279)	$ (1,014)		$ 26,717
Comprehensive income							
Net income			945			$ 945	945
Other comprehensive gain: unrealized holding gains arising during the period (net of tax, $25)					48	48	48
Total comprehensive income						$ 993	
Stock compensation expense		85					85
Cash dividends ($.10 per share)			(344)				(344)
Balances, March 31, 2007	$ 3,672	$ 3,746	$ 23,278	$ (2,279)	$ (966)		$ 27,451

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Three Months Ended March 2007	March 2006
CASH FLOWS FROM OPERATING ACTIVITIES	$ 945	$ 938
Net income		
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses		
Depreciation	140	136
Discount accretion and premium amortization on securities, net	(32)	(15)
Stock compensation expense	85	72
Proceeds from sale of loans	1,609	1,298
Origination of loans for sale	(1,204)	(1,711)
Changes in assets and liabilities:		
(Increase) in accrued interest receivable	(26)	(172)
(Increase) in other assets	(164)	(358)
Increase in accrued interest payable	184	31
Increase in other liabilities	550	4
Net cash provided by operating activities	$ 2,087	$ 223
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from maturity of securities available for sale	$ 2,500	$
Purchase of securities available for sale	(4,999)	(4,183)
Net (increase) in loans	(826)	(3,396)
Purchases of premises and equipment	(81)	(161)
Net cash (used in) investing activities	$ (3,406)	$ (7,740)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in noninterest-bearing deposits	$ 45	$ (1,787)
Net increase in interest-bearing deposits	12,830	7,452
Net (repayment) of securities sold under agreements to repurchase and federal funds purchased	(415)	(3,713)
Net (repayment) proceeds of Federal Home Loan Bank advances	(100)	3,906
Cash dividends	(344)	(306)
Net cash provided by financing activities	$ 12,016	$ 5,552
Increase (decrease) in cash and cash equivalents	$ 10,697	$ (1,965)
CASH AND CASH EQUIVALENTS		
Beginning	6,926	8,472
Ending	$ 17,623	$ 6,507

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION				
Cash payments for:				
Interest	$	1,948	$	1,387
Income taxes	$	181	$	636
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES				
Unrealized gain (loss) on securities available for sale	$	73	$	(102)

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2007 (UNAUDITED) AND DECEMBER 31, 2006

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

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

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

2. The 2003 Stock Incentive Plan was approved by stockholders on May 13, 2003 which authorized up to 183,600 shares of common stock to be used in the granting of incentive options to employees and directors. This is the first stock incentive plan adopted by the company. Under the plan, the option price cannot be less than the fair market value of the stock on the date granted. An option s maximum term is ten years from the date of grant. The company granted 36,723 options in the first quarter of 2007 and 45,889 options in the first quarter of 2006. Options granted under the plan may be subject to a graded vesting schedule.

In December 2004, The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R). SFAS 123R requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, such as stock options and restricted stock, based on the fair value of those awards at the date of grant and eliminates the choice to account for employee stock options under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). The company adopted SFAS 123R effective January 1, 2006 using the modified prospective method and as such, results for prior periods have not been restated. Prior to January 1, 2006, no compensation expense was recognized for stock option grants as all such grants had an exercise price not less than fair market value on the date of grant.

Incremental stock-based compensation expense recognized for the three month period ending March 31, 2007 was $85 thousand. Although the stock-based compensation expense reduced net income for the first quarter of 2007, it had no impact on basic and diluted earnings per share.

Stock option compensation expense is the estimated fair value of options granted amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award. The weighted average estimated fair value of stock options granted in the three months ended March 31, 2007 and 2006 was $3.76 and $3.88, respectively. Fair value is estimated using the Black-Scholes option-pricing model with the following assumptions for grants during 2007 and 2006: option term until exercise 10 years, expected volatility of 19.56% and 17.86%, risk-free interest rates of 4.66% and 4.43%, and expected dividend yields of 2.74% and 2.66%, respectively.

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Stock option plan activity for the three months ended March 31, 2007 is summarized below:

	Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
	(dollars in thousands, except per share amounts)			
Options outstanding, January 1	116	$ 14		
Granted	37	16		
Exercised				
Canceled or expired				
Options outstanding, March 31	153	15	8	$ 968
Options exercisable, March 31	84	14	8	$ 643

As of March 31, 2007 there was $228 thousand of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period.

3. On March 14, 2006 the Board of Directors of Potomac Bancshares, Inc. declared a 2% stock dividend payable on June 1, 2006. Shares issued increased from 3,600,000 to 3,671,691. All per share information for all periods presented has been restated to reflect this dividend.

4. The amortized cost and fair value of securities available for sale as of March 31, 2007 and December 31, 2006 (in thousands) are as follows:

	March 31, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U. S. Government agencies	$ 43,745	$ 31	$ (185)	$ 43,591
State and municipal obligations	1,723	3	(8)	1,718
	$ 45,468	$ 34	$ (193)	$ 45,309

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

The primary purpose of the investment portfolio is to generate income and meet liquidity needs of the company through readily saleable financial instruments. The portfolio is made up of fixed rate bonds, whose prices move inversely with rates. At the end of any accounting period, the investment portfolio has unrealized gains and losses. The company monitors the portfolio which is subject to liquidity needs, market rate changes and credit risk changes to see if adjustments are needed. The primary concern in a loss situation is the credit quality of the business behind the instrument. The primary cause of impairments is the decline in the prices of the bonds as rates have risen. There are approximately 23 accounts in the consolidated portfolio that have losses at March 31, 2007. These securities have not suffered credit deterioration and the company has the ability and intent to hold these issues to maturity; therefore, the gross unrealized losses are considered temporary as of March 31, 2007.

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

	March 31, 2007					
	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 agencies	$ 3,994	$ (6)	$ 25,080	$ (179)	$ 29,074	$ (185)
State and municipal obligations			731	(8)	734	(8)
Total	$ 3,994	$ (6)	$ 25,811	$ (187)	$ 29,805	$ (193)

	December 31, 2006					
	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 agencies	$ 6,753	$ (11)	$ 20,733	$ (231)	$ 27,486	$ (242)
State and municipal obligations			731	(9)	731	(9)
Total	$ 6,753	$ (11)	$ 21,464	$ (240)	$ 28,217	$ (251)

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

	March 31 2007	December 31 2006
	(in thousands)	
Mortgage loans on real estate:		
Construction, land development and other land loans	$ 53,312	$ 53,801
Secured by farmland	4,616	1,557
Secured by 1-4 family residential	104,052	103,983
Secured by multifamily residential	3,717	3,733
Secured by nonfarm nonresidential	45,061	46,367
Commercial and industrial loans (except those secured by real estate)	4,268	4,247
Consumer loans	15,645	16,089
All other loans	239	292
Total loans	$ 230,910	$ 230,069
Less: allowance for loan losses	2,437	2,423
	$ 228,473	$ 227,646

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

	March 31 2007	March 31 2006
Balance at beginning of period	$ 2,423	$ 2,161
Provision charged to operating expense		

Recoveries added to the allowance	57	38
Loan losses charged to the allowance	(43)	(37)
Balance at end of period	$ 2,437	$ 2,162

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7. There were no impaired loans at March 31, 2007 and at December 31, 2006. Nonaccrual loans totaled $15 thousand and $144 thousand at March 31, 2007 and December 31, 2006, respectively.

8. Components of net periodic benefit cost for the pension and postretirement benefit plans are shown below:

	Pension Benefits Three Months Ended		Postretirement Benefits Three Months Ended	
	March 31 2007	March 31 2006	March 31 2007	March 31 2006
	(in thousands)		(in thousands)	
Components of Net Periodic Benefit Cost				
Service cost	$ 68	$ 57	$ 3	$ 2
Interest cost	81	79	8	8
Expected return on plan assets	(83)	(79)		
Amortization of net obligation (asset) at transition		(4)	4	4
Recognized net actuarial (gain) loss	9	7		(1)
Net periodic benefit cost	$ 75	$ 60	$ 15	$ 13

Employer Contribution

The company anticipates the 2007 contribution for the pension plan will approximate $350,000. No contribution has been made to date. The company has made payments of $6,661 for the postretirement benefits plan for the first three months of 2007 and anticipates remaining payments for 2007 to total $16,279.

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 a $.01 effect on March 31, 2007 earnings per share and no effect on earnings per share available to shareholders on March 31, 2006.

	Three Months Ended March 31, 2007		Three Months Ended March 31, 2006	
	Average Shares	Per Share Amount	Average Shares	Per Share Amount
Basic earnings per share	3,433,583	$ .28	3,460,692	$ .27
Effect of dilutive securities:				
Stock options	8,103		18,725	
Diluted earnings per share	3,441,686	$ .27	3,479,417	$ .27

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

As discussed in Note 3, average shares outstanding for all periods presented have been restated to reflect the 2% stock dividend declared March 14, 2006.

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10. Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The company does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS 157, Fair Value Measurements . The company is in the process of evaluating the impact this statement may have on its consolidated financial statements but does not intend to adopt early.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

CRITICAL ACCOUNTING POLICIES

General

The company s financial statements are prepared in accordance with 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: (i) SFAS 5, Accounting for Contingencies, which requires that estimated losses be accrued when they are probable of occurring and estimatable and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. 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 qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management s estimate of probable losses. The unallocated component of the allowance reflects that margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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FINANCIAL OVERVIEW

Total assets have increased $13.8 million or 4.7% from the December 2006 total of $292.7 million to $306.6 million at March 31, 2007. Federal funds sold increased approximately $10 million as a result of deposit growth increasing at a higher rate than loan growth. Management decided to keep funds in federal funds temporarily while federal fund rates are competitive with other investments such as bonds. Other contributing factors were increases in securities available for sale and loans of $2.6 million and $800 thousand, respectively.

Total deposits have increased $12.9 million or 5.1% at March 31, 2007 compared to December 31, 2006. Noninterest-bearing deposits have increased .2% and interest-bearing deposits have increased 5.8% during the first quarter of 2007. During the last six quarters the bank has initiated the use of brokered certificates of deposit. These transactions involve both direct purchase of brokered CDs and participation in the CDARS program. These options and an increase in interest rates paid on core deposits have contributed to the increase in interest-bearing deposits and total deposits.

The March 31, 2007 annualized return on average assets is 1.25% compared to 1.39% at December 31, 2006. At March 31, 2007 the annualized return on average equity is 13.86% compared to 15.15% at December 31, 2006. The leverage capital (equity to assets) ratio is 9.41% at March 31, 2007 compared to 9.34% at December 31, 2006.

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

	March 31, 2007	March 31, 2006
Balance at beginning of period	$ 2,423	$ 2,161
Charge-offs:		
Commercial, financial and agricultural		
Real estate construction		
Real estate mortgage	15	
Consumer	28	37
Total charge-offs	43	37
Recoveries:		
Commercial, financial and agricultural	30	
Real estate construction		
Real estate mortgage		
Consumer	27	38
Total recoveries	57	38
Net charge-offs (recoveries)	(14)	(1)
Additions charged to operations		
Balance at end of period	$ 2,437	$ 2,162
Ratio of net charge-offs (recoveries) during the period to average loans outstanding during the period	(.006)%	

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

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	March 31, 2007	March 31, 2006
Nonaccrual loans	$ 15	$ 131
Restructured loans		
Foreclosed properties		
Total nonperforming assets	$ 15	$ 131
Loans past due 90 days accruing interest	$	$
Allowance for loan losses to period end loans	1.06%	1.01%
Nonperforming assets to period end loans and foreclosed properties	.006%	.06%

At March 31, 2007, other potential problem loans (excluding impaired loans) total $1.7 million. Loans are viewed as potential problem loans according to the ability of such borrowers to comply with current repayment terms. These loans are subject to constant management attention, and their status is reviewed on a regular basis.

The details of the income statements for the three months ended March 31, 2007 and 2006 are highlighted below.

Ø Net income in 2007 is .7% greater than 2006 net income.

Ø At March 31, 2007 total interest and dividend income is up 13.0% compared to March 31, 2006 due to loan growth and some increase in interest rates.

Ø The income on the federal funds sold increased greatly because of the increase in volume and in interest rates. Management decided to temporarily invest higher than normal amounts in federal funds because of the competitive rate compared to alternative types of investments. Federal funds provide additional liquidity versus those alternative investments.

Ø Interest expense continues to increase. At the end of March 31, 2007 interest expense was 50.4% above 2006 expense for the same time period. The increase in expense is a combination of growth in deposits and higher interest rates being paid to retain deposits and attract additional deposit growth.

Ø Net interest income through March 31, 2007 has decreased 4.9% compared to March 31, 2006. Rising interest rates and deposit growth outpacing loan growth are the major contributing factors to the decrease.

Ø Net interest margin at March 31, 2007 is 4.0%, down from the December 31, 2006 figure of 4.5%. During the first three months of 2007, the overall average rate on loans matched the 7.6% overall average rate on loans at December 31, 2006. During this same period the overall average rate being paid on deposits increased to 3.5% from 2.9% at December 31, 2006.

Noninterest income increased 12.2% for the three months ended March 31, 2007 compared to March 31, 2006. Some significant income items are listed here.

Ø Trust and financial services income increased 8.8% at March 31, 2007 compared to March 31, 2006 due to some increase in interest rates and to increased contributions from BCT Investments.

- Ø Service charges on deposit accounts have increased 12.9% in 2007 over 2006. Increased volume of overdraft and returned check charges are responsible for this increase. Volume of ATM and dormant account fees have decreased during the same period.

- Ø Credit and debit card fees have increased 22.8% at March 31, 2007 compared to the same time in 2006 due to the growth in the deposit account base and continued concentration on sale of cards by bank personnel.

- Ø Net gain on sale of loans has increased 30.4% at March 31, 2007 compared to the same time in 2006. Secondary market loan business picked up in the fourth quarter of 2006. The increase is due to the sale of those loans.

- Ø Cash surrender value of life insurance has increased 20.0% in 2007 over the same period in 2006 due to increased interest rates on some policies.

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Noninterest expense decreased 1.7% for the three months ended March 31, 2007 compared to the same period in 2006. Some details are listed below.

- Ø Salaries and employee benefits for the first three months of 2007 have decreased 4.1% compared to the first three months of 2006. The largest contributors to this reduction are FASB 91 salary deferrals and a decrease in group insurance costs.

- Ø Occupancy and furniture and equipment expense has increased 4.8% in 2007 compared to 2006. As the bank continues to grow so does the space and equipment needed to respond to the growth. Facilities have been remodeled, several additional office spaces have been leased and, as has been the case for a number of years, the bank s continual attention to staying on the cutting edge of technology comes at considerable cost.

- Ø Advertising and marketing expenses have decreased 8.3% in 2007 compared to 2006. As the new marketing program has evolved the bank has been able to reduce costs through collaboration with our outside marketing agency.

- Ø Auditing and accounting expenses have decreased 27.0% in 2007 compared to 2006 due to the internal audit department not outsourcing any work in the first quarter of 2007.

- Ø ATM and check card expenses have increased 22.9% in the first three months of 2007 compared to the same time period in 2006 due to growth in the deposit account base and concentrated sales efforts of the bank staff to market this product.

- Ø Other noninterest expenses have decreased at March 31, 2007 compared to March 31, 2006. Significant details in this category include the following.

    - Printing, stationery and supplies expense is 53.4% greater in 2007 than in 2006. The increase is due in part to increased costs related to deposit account supplies such as statements and printed checks since deposit accounts have increased in 2007 compared to 2006. There have also been some procedure changes that have required reprinting of forms and timing differences in payments for supplies.

    - Home equity closing costs are down 61.9% in 2007 compared to 2006 due to a slowdown in the housing market and home values dropping.

    - Other professional fees have decreased 27.8% in 2007 compared to 2006. In 2006 a fee was paid to an employment consulting company in relation to hiring their client.

LIQUIDITY

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

Operating Activities. The company s net income provides cash from the bank s operating activities. The net income figure is adjusted for certain noncash transactions, such as depreciation expense, that reduce net income but do not require a cash outlay. Through March 31, 2007 net income as adjusted has provided cash of $2.1 million. Interest income earned on loans and investments is the company s major income source.

Investing Activities. Customer deposits and company borrowings provide the funds used to invest in loans and securities investments. In addition, the principal portion of loan payments and payoffs and funds from maturing investments provide cash flow. Purchases of bank premises and equipment are an investing activity. The net amount of cash used in investing activities through March 31, 2007 is $3.4 million.

Financing Activities. Customer deposits and company borrowings provide the financing for the investing activities as stated above. If the company has an excess of funds on any given day, the bank will sell these funds to make additional interest income to fund activities. Likewise, if the company has a shortage of funds on any given day it will purchase funds and pay interest for the use of these funds. Financing activities also include payment of dividends, purchase of shares of the company s common stock for the treasury and repayment of any borrowed or purchased funds. The net amount of cash provided by financing activities in 2007 through March 31 is $12.0 million.

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The company has additional funding sources in the Federal Home Loan Bank, The Bankers Bank and Mercantile-Safe Deposit and Trust Company. Liquidity of the company is adequate to meet present and future financial obligations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

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

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

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

Item 1A. Risk Factors.

There have been no significant changes during the first quarter of 2007 to the risk factors as discussed in the annual report on Form 10-K as of December 31, 2006.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Programs	(d) Maximum Number of Shares that May Yet be Purchased Under the Program
January 1 through January 31	NONE			107,960
February 1 through February 28	NONE			107,960
March 1 through March 31	NONE			107,960

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

Item 5. Other Information

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

Item 6. Exhibits

31.1 Certification Under Exchange Act Rule 13a-14, Chief Executive Officer (and Section 302 of Sarbanes-Oxley Act of 2002)

31.2 Certification Under Exchange Act Rule 13a-14, Chief Financial Officer (and Section 302 of Sarbanes-Oxley Act of 2002)

32 Certification Pursuant to 18 U.S.C. Section 1350, Chief Executive Officer and Chief Financial Officer (pursuant to Section 906 of Sarbanes-Oxley Act of 2002)

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SIGNATURES

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

	POTOMAC BANCSHARES, INC.
Date: May 15, 2007	/s/ Robert F. Baronner, Jr. Robert F. Baronner, Jr. President & CEO
Date: May 15, 2007	/s/ Gayle Marshall Johnson Gayle Marshall Johnson Sr. Vice President and Chief Financial Officer