POTOMAC BANCSHARES INC
Form 10-K
March 29, 2007

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, 2006
____	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	**55-0732247**
(State or Other Jurisdiction of Incorporation or Organization)	(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**

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 if disclosure of delinquent filers in response to Item 405 of Regulation S-K 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. ____

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 _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.
$52,106,876 as of June 30, 2006

APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Indicate by check mark whether the registrant has filed all documents and reports required by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes____ No____ Not Applicable XX

(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 March 1, 2007

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 2007 Annual Meeting of Shareholders	Part III, Items 10, 11, 12, 13 and 14

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Potomac Bancshares, Inc.
Annual Report on Form 10-K
For the Year Ended December 31, 2006

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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 Annual Report on Form 10-K, including the Presidents letter and the Managements 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 companys actual results and experiences to differ materially from the anticipated results or other expectations expressed in the companys forward-looking statements.

The risks and uncertainties that may affect the operations, performance, development and results of the companys 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 this 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.

PART I

Item 1. Business.

History and Operations

The Board of Directors of Bank of Charles Town (the "bank") caused Potomac Bancshares, Inc. ("Potomac") to be formed on March 2, 1994, as a single-bank holding company. To date, Potomac's only activities have involved the acquisition of the bank. Potomac acquired all of the shares of the banks 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 banks deposits. The bank engages in general banking business primarily in Jefferson County and Berkeley County, West Virginia. The bank also provides services to Washington County and Frederick County, Maryland and Loudoun County, Frederick County and Clarke County, Virginia. In 2005 the bank opened a loan production office in Winchester, Virginia. The main office is in Charles Town, West Virginia at 111 East Washington Street, with branch offices in

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

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

- Commercial credit lines, equipment loans, 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.

Automated teller machines located at each of the five offices and Touchline 24, an interactive voice response system available at 1-304-728-2424, provide certain services to customers on a twenty-four hour basis. The bank initiated the formation of an ATM network with two banks in the community to provide customers of all three banks 17 ATM locations in the eastern panhandle of West Virginia. Bill paying and certain other banking services are available through the Internet. The trust and financial services department provides financial management, investment and trust services. BCT Investments provides financial management, investment and brokerage services.

Lending Activities. The bank offers a variety of loans for consumer and commercial purposes. The majority of these loans are secured.

Underwriting standards for all lending include

- Sound credit analysis,
- Proper documentation according to the bank's loan policy standards,
- Avoidance of loan concentrations to a single industry or with a single class of collateral,
- Diligent maintenance of past due and nonaccrual loans and
- 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 of a balance between maximum yield and minimum risk. It is the bank's policy to avoid concentrations of loans such as loans to one industry, loans to one borrower or guarantor or loans secured by similar collateral.

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

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

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

Approximately 91% of the bank's loans are secured by real estate. These loans had an average delinquency rate of .28% and a loss rate of 0% during 2006. The average delinquency rate and loss rate are based on comparisons to 2006 average total loans.

As of December 31, 2006, aggregate dollar amounts (in thousands) in loan categories secured by real estate are as follows:

Construction and land development	$	53 801

l	Secured by farmland	1 557
l	Secured by 1-4 family residential	103 983
l	Secured by multifamily residential	3 733
l	Secured by nonfarm nonresidential	46 367
		$ 209 441

Commercial loans not secured by real estate with an aggregate balance of $4.2 million at December 31, 2006 make up approximately 1.8% of the total loan portfolio. The bank□s loan policy for commercial loans including those commercial loans secured by real estate is to

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

Average delinquency for commercial loans not secured by real estate was less than 1% and the loss rate was 0% during 2006.

Retail loans to individuals for personal expenditures are approximately 7.0% of the bank's total loans at December 31, 2006. The aggregate balance of these loans was $16.1 million at December 31, 2006. The majority of these loans are installment loans with the remainder made as term loans.

There is some risk in every retail loan transaction. The bank accepts moderate levels of risk while minimizing retail loan losses through careful investigation into the character of each borrower, determining the source of repayment before closing each loan, collateralizing most loans, exercising care in documentation procedures, administering an aggressive retail loan collection program, and following the retail loan policies. Loans to individuals for personal expenditures had an average delinquency rate of .05% and a loss rate of .02% in 2006 (based on comparisons to 2006 average total loans).

All other loans total $292 thousand (less than 1% of total loans) at December 31, 2006. These loans had a 0% average delinquency rate and a 0% average loss rate in 2006 compared to 2006 average total loans.

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

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

According to the policy, funds in excess of those invested in federal funds sold and securities purchased under agreements to resell are to be invested in (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 AAA 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 statement savings accounts. The bank offers automatically renewable certificates of deposit in various terms from 91 days to five years. Individual retirement accounts in the form of certificates of deposit are also available.

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

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

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

Competition

As of March 1, 2007, there were 65 bank holding companies (including multi-bank and one bank holding companies) operating in the State of West Virginia. These holding companies are headquartered in various West Virginia cities and control banks throughout the State of West Virginia, including banks that compete with the bank in its market area.

The bank's market area is generally defined as Jefferson County and Berkeley County, West Virginia. As of June 30, 2006, there were seven banks in Jefferson County with 17 banking offices. The total deposits of these commercial banks as of June 30, 2006 were $708.1 million, and the bank ranked number one in total deposits with $212.9 million or 30.1% of the total deposits in the market at that time. The bank has two branch offices in Berkeley County at this time. Opening in July 2001 and June 2003, these branches have 3.4% of the market share of deposits in Berkeley County where there are nine banks with 29 banking offices.

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

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

Employees

Potomac currently has no employees.

As of March 1, 2007, the bank had 88 full-time employees and 17 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.

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

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

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. As of January 1, 2007, the FDIC set the Financing Corporation (FICO) Bank Insurance Fund (BIF) premium for the bank at the annual rate of 1.220 basis points or .0001220 times the total deposits of the bank. This premium is not tied to the bank's risk classification. The rate of the premium based on the bank's risk classification is at 0.00%. It is possible that BIF insurance assessments will be changed, and it is also possible that there may be a special additional assessment. A large special assessment could have an adverse impact on Potomacs results of operations.

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

As of December 31, 2006, Potomac had capital in excess of all applicable requirements as shown below:

	Actual	Required (in thousands)	Excess
Tier 1 capital:			
Common stock	$ 3,672		
Surplus	3,661		
Retained earnings	22,677		

		30,010				
Less cost of shares acquired for the treasury		2,279				
Total tier 1 capital	$	27,731	$	8,728	$	19,003
Tier 2 capital:						
Allowance for loan losses (1)		2,423				
Total risk-based capital	$	30,154	$	17,455	$	12,699
Risk-weighted assets	$	218,193				
Tier 1 capital	$	27,731	$	11,882	$	15,849
Average total assets	$	297,041				
Capital ratios:						
Tier 1 risk-based capital ratio		12.71%		4.00%		8.71%
Total risk-based capital ratio		13.82%		8.00%		5.82%
Tier 1 capital to average total assets (leverage)		9.34%		4.00%		5.34%

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

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

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

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

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

A notice of proposed non-banking activities must be furnished to the Federal Reserve and the Banking Board before Potomac engages in such activities, and an application must be made to the Federal Reserve and Banking

Board concerning acquisitions by Potomac of corporations engaging in those activities. In addition, the Federal Reserve may, by order issued on a case-by-case basis, approve additional non-banking activities.

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

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

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, Potomacs chief executive officer and chief financial officer are each required to certify that Potomacs 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 Potomacs internal controls; they have made certain disclosures to Potomacs auditors and the audit committee of the Board of Directors about Potomacs internal controls; and they have included information in Potomacs Quarterly and Annual Reports about their evaluation and whether there have been significant changes in Potomacs internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. Effective in 2007, Section 404 of Sarbanes-Oxley will become applicable to Potomac.

Available Information. The company files annual, quarterly and current reports, proxy statements and other information with the SEC. The companys SEC filings are filed electronically and are available to the public through the Internet at the SECs website at http://www.sec.gov. In addition, any document filed by the company with the SEC can be read and copied at the SECs 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 Gayle Marshall Johnson, Sr. Vice President and Chief Financial Officer, Potomac Bancshares, Inc., PO Box 906, Charles Town, WV 25414.

Item 1A. Risk Factors.

Due to Increased Competition, the Company May Not Be Able to Attract and Retain Banking Customers At Current Levels.

If, due to competition from competitors in the companys market area of Jefferson and Berkeley Counties, West Virginia, the company is unable to attract new and retain current customers, loan and deposit growth could decrease causing the companys results of operations and financial condition to be negatively impacted. The company faces competition from the following:

- local, regional and national banks;
- savings and loans;
- internet banks;
- credit unions;
- insurance companies;
- finance companies; and
- brokerage firms serving the companys market areas.

Because of the banks geographic location, the existence of larger financial institutions in Maryland, Virginia and Washington, DC influences the competition in the banks market area.

The Companys Lending Limit May Prevent It from Making Large Loans.

In the future, the company may not be able to attract larger volume customers because the size of loans that the company can offer to potential customers is less than the size of the loans that many of the companys larger competitors can offer. Accordingly, the company may lose customers seeking large loans to regional and national banks. We anticipate that our lending limit will continue to increase proportionately with the companys growth in earnings; however, the company may not be able to successfully attract or maintain larger customers.

It should also be noted that the company may choose with its larger volume customers to participate or syndicate that portion of a loan that exceeds its legal lending limit. This may be done from time to time to retain that customers primary relationship within the bank**.**

Certain Loans That the Bank Makes Are Riskier than Loans for Real Estate Lending.

The bank makes loans that involve a greater degree of risk than loans involving residential real estate lending. Commercial business loans may involve greater risks than other types of lending although the banks commercial loans are generally real estate secured. Only a small portion of the banks commercial loans are secured by collateral other than real estate. Consumer loans may involve greater risk because adverse changes in borrowers incomes and employment after funding of the loans may impact their abilities to repay the loans.

The Company Is Subject to Interest Rate Risk.

Aside from credit risk, the most significant risk resulting from the companys normal course of business, extending loans and accepting deposits, is interest rate risk. If market interest rate fluctuations cause the companys cost of funds to increase faster than the yield of its interest-earning assets, then its net interest income will be reduced. The companys results of operations depend to a large extent on the level of net interest income, which is the difference between income from interest-earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Interest rates are highly sensitive to many factors that are beyond the companys control, including general economic conditions and the policies of various governmental and regulatory authorities.

The Company May Not Be Able to Retain Key Members of Management.

The departure of one or more of the companys officers or other key personnel could adversely affect the companys operations and financial position. The companys management makes most decisions that involve the companys operations. The key personnel have all been with the company since 2001. They include Robert F. Baronner, Jr., David W. Irvin and Gayle Marshall Johnson.

An Economic Slowdown in the Company's Market Area Could Hurt Our Business.

Because we focus our business in Jefferson and Berkeley Counties, West Virginia, an economic slowdown in these areas could hurt our business. An economic slowdown could have the following consequences:

- Loan delinquencies may increase;
- Problem assets and foreclosures may increase;
- Demand for the products and services of the company may decline; and
- Collateral (including real estate) for loans made by the company may decline in value, in turn reducing customers' borrowing power and making existing loans less secure.

The Company and the Bank are Extensively Regulated.

The operations of the company are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on them. Policies adopted or required by these governmental authorities can affect the company's business operations and the availability, growth and distribution of the company's investments, borrowings and deposits. Proposals to change the laws governing financial institutions are frequently raised in Congress and before bank regulatory authorities. Changes in applicable laws or policies could materially affect the company's business, and the likelihood of any major changes in the future and their effects are impossible to determine.

The Company's Allowance for Loan Losses May Not Be Sufficient.

In the future, the company could experience negative credit quality trends that could head to a deterioration of asset quality. Such deterioration could require the company to incur loan charge-offs in the future and incur additional loan loss provision, both of which would have the effect of decreasing earnings. The company maintains an allowance for possible loan losses, which is a reserve established through a provision for possible loan losses charged to expense that represents management's best estimate of probable losses that may be incurred within the existing portfolio of loans. Any increases in the allowance for possible loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on the company's financial condition and results of operation.

A Shareholder May Have Difficulty Selling Shares.

Because a very limited public market exists for the holding company's common stock, a shareholder may have difficulty selling his or her shares in the secondary market. We cannot predict when, if ever, we could meet the listing qualifications of the NASDAQ Stock Market's National Market Tier or any exchange. We cannot assure you that there will be a more active public market for the shares in the near future.

Shares of the Company's Common Stock Are Not FDIC Insured.

Neither the Federal Deposit Insurance Corporation nor any other governmental agency insures the shares of the company's common stock. Therefore, the value of your shares in the company will be based on their market value and may decline.

Customers May Default on the Repayment of Loans.

The bank's customers may default on the repayment of loans, which may negatively impact the company's earnings due to loss of principal and interest income. Increased operating expenses may result from the allocation of management time and resources to the collection and work-out of these loans. Collection efforts may or may not be successful causing the company to write off these loans or repossess the collateral securing these loans which may or may not exceed the balance of these loans.

The Company's Controls and Procedures May Fail or Be Circumvented.

Management regularly reviews and updates the company's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, no matter how well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the company's business, results of operations and financial conditions.

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Item 2. Properties.

Potomac currently has no property.

The bank owns the land and buildings of the main office and the branch office facilities in Harpers Ferry, Kearneysville, and Hedgesville. The bank owns the branch office facility in Martinsburg and the land is leased through February 2008 when the bank will purchase the land at a predetermined price. The bank also owns a lot at the corner of Route 340 and Washington Street in Bolivar that may be used for future expansion.

The main office property is located at 111 East Washington Street, Charles Town, West Virginia. This property consists of two separate two story buildings located side by side with adjoining corridors. During 2000, the construction of the newer of these two buildings was completed. The first floor of the new building houses the Trust and Financial Services Division. The second floor of the new building houses certain administrative and loan offices. Both of these floors open into the older bank premises. The older premises, constructed in 1967, was renovated at the same time the new building was constructed. The renovation includes all new lighting, new ceilings, new floor and wall coverings as well as some minor structural changes for more efficient operations. In July of 2006, the bank completed the purchase of a property adjacent to the main office for future expansion.

In October 2005 to provide additional office and storage areas, the bank leased space in Burr Industrial Park in Kearneysville, West Virginia. The leased space houses the Finance Department and provides record storage facilities 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 (which opened for business in July 2001) is now located in a building owned by the bank. The construction of the one story brick facility was started in 2004 and completed in January 2005. The amended lease for this property expires in February 2008 when the bank will purchase the land at a predetermined price.

The bank is leasing offices in Winchester, Virginia, to house a loan production office that opened in late 2005.

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

Item 3. Legal Proceedings.

Currently Potomac is involved in no legal proceedings.

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

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

Not Applicable.

PART II

Item 5. Market for 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. This information has been restated, where applicable, to reflect a 2% stock dividend declared on March 14, 2006 and a 100% stock dividend declared on February 8, 2005. As of March 1, 2007, 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., Koonce Securities Inc. and Ferris, Baker Watts, 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 2005 and 2006 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	
2005	First Quarter	$ 21.00	$ 13.38	$ .0784
	Second Quarter	18.85	15.35	.0809
	Third Quarter	18.00	16.10	.0833
	Fourth Quarter	17.75	16.60	.0858
2006	First Quarter	$ 17.25	$ 16.50	$ .0900
	Second Quarter	17.25	15.05	.0925
	Third Quarter	16.85	15.35	.0950
	Fourth Quarter	16.00	15.40	.0975

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

Performance Graph

The following graph compares the yearly percentage change in Potomacs cumulative total shareholder return on common stock for the five-year period ending December 31, 2006, with the cumulative total return of the Bank Holding Companies Index (SIC Code 6712) and the Hemscott Index. Shareholders may obtain a copy of the index by calling Hemscott, Inc. at telephone number (301) 760-2609. There is no assurance that Potomacs 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.

COMPARE 5-YEAR CUMULATIVE TOTAL RETURN AMONG POTOMAC BANCSHARES, INC., BANK HOLDING COMPANIES INDEX AND HEMSCOTT INDEX

ASSUMES $100 WAS INVESTED ON JANUARY 1, 2002 AND ASSUMES DIVIDENDS WERE REINVESTED THROUGH FISCAL YEAR ENDING DECEMBER 31,2006.

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	--	--	123 627
November 1 through November 30	NONE	--	--	123 627
December 1 through December 31	15,667	15.65	238 108	107 960

On February 12, 2002, the companys Board of Directors originally authorized the repurchase program. The program authorized the repurchase of up to 10% of the companys 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 6. Selected Financial Data.

	2006	2005	2004	2003
	(Dollars in Thousands Except Per Share Data)			
Summary of Operations				

Interest income	$ 19 099	$ 15 424	$ 12 008	$ 10 786	$
Interest expense	6 932	4 135	2 409	2 235	
Net interest income	12 167	11 289	9 599	8 551	
Provision for loan losses	331	330	289	147	
Net interest income after provision for loan losses	11 836	10 959	9 310	8 404	
Noninterest income	3 766	3 185	3 158	2 844	
Noninterest expense	9 261	8 460	7 668	7 142	
Income before income taxes	6 341	5 684	4 800	4 106	
Income tax expense	2 306	2 020	1 710	1 432	
Net income	$ 4 035	$ 3 664	$ 3 090	$ 2 674	$
Per Share Data **					
Net income, basic	$ 1.17	$ 1.06	$ .89	$ .75	$
Net income, diluted	1.16	1.05	.89	.75	
Cash dividends declared	.38	.33	.29	.26	
Book value at period end	7.78	7.23	6.58	6.15	
Weighted-average shares outstanding, basic	3 454 961	3 460 984	3 463 373	3 570 143	3 [illegible]
Weighted-average shares outstanding, diluted	3 467 918	3 477 538	3 465 895	3 570 143	3 [illegible]
Average Balance Sheet Summary					
Assets	$ 289 303	$ 264 314	$ 226 052	$ 197 052	$
Loans	220 895	196 478	155 546	125 407	
Securities	48 891	47 183	46 701	47 087	
Deposits	243 833	217 307	190 153	163 328	
Stockholders’ equity	26 632	23 822	22 045	21 274	
Performance Ratios					
Return on average assets	1.39%	1.39%	1.37%	1.36%	
Return on average equity	15.15%	15.38%	14.02%	12.57%	
Dividend payout ratio	32.48%	31.13%	32.58%	34.67%	
Capital Ratios					
Leverage ratio	9.34%	9.18%	9.45%	10.20%	
Risk-based capital ratios					
Tier 1 capital	12.71%	12.68%	13.29%	14.67%	
Total capital	13.82%	13.76%	14.44%	15.89%	

** All figures have been restated to reflect a 2% stock dividend declared on March 14, 2006, a 100% stock dividend declared on February 8, 2005 and a 200% stock dividend declared on February 3, 2003.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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.

	2006			2005			2004	
	Average Balances	Income/ Expense	Average Yield/Rate	Average Balances	Income/ Expense	Average Yield/Rate	Average Balances	Income/ Expense
	(in thousands)			(in thousands)			(in thousands)	
ASSETS								
Loans								
Taxable	$ 219 795	$ 16 641	7.57%	$ 195 357	$ 13 635	6.98%	$ 154 486	$ 10 283
Tax exempt	1 100	107	9.73%	1 121	106	9.46%	1 060	114
Total loans	220 895	16 748	7.58%	196 478	13 741	6.99%	155 546	10 397
Taxable securities	47 333	2 095	4.42%	45 721	1 516	3.32%	46 473	1 575
Nontaxable securities	1 558	87	5.58%	1 462	79	5.40%	228	11
Securities purchased under agreements to resell and federal funds sold	1 331	65	4.88%	1 164	43	3.69%	3 457	39
Other earning assets	3 609	170	4.71%	3 278	108	3.29%	1 069	29
Total earning assets	**274 726**	**$ 19 165**	**6.98%**	**248 103**	**$ 15 487**	**6.24%**	**206 773**	**$ 12 051**
Allowance for loan losses	(2 218)			(2 077)			(1 842)	
Cash and due from banks	5 356			7 704			10 888	
Premises and equipment, net	6 353			5 975			5 163	
Other assets	5 086			4 609			5 070	
Total assets	$ 289 303			$ 264 314			$ 226 052	
LIABILITIES AND STOCKHOLDERS’ EQUITY								
Deposits								
Savings and interest-bearing demand deposits	$ 127 869	$ 2 752	2.15%	$ 119 998	$ 1 333	1.11%	$ 104 182	$ 442
Time deposits	84 082	3 431	4.08%	63 661	2 107	3.31%	55 961	1 649
Total interest-bearing deposits	211 951	6 183	2.92%	183 659	3 440	1.87%	160 143	2 091
Securities sold under agreements to repurchase and federal funds purchased	13 846	564	4.07%	16 557	516	3.12%	10 777	232
Advances from FHLB	3 463	185	5.34%	4 937	179	3.63%	1 584	86
Total interest bearing liabilities	**229 260**	**$ 6 932**	**3.02%**	**205 153**	**$ 4 135**	**2.02%**	**172 504**	**$ 2 409**
Noninterest-bearing demand deposits	31 881			33 648			30 010	
Other liabilities	1 530			1 691			1 493	
Stockholders’ equity	26 632			23 822			22 045	
Total liabilities and stockholders’ equity	$ 289 303			$ 264 314			$ 226 052	

Net interest income	**$ 12 233**	**$ 11 352**	**$ 9 642**
Net interest spread	**3.96%**	**4.22%**	
Interest expense as a percent of average earning assets	**2.52%**	**1.67%**	
Net interest margin	**4.45%**	**4.58%**	

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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 (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.

GENERAL

Once again the review of the company results of operations and financial position over the past five years as shown in the Selected Consolidated Financial Data schedule shows success and accomplishment of long term goals set by management. Management wishes to grow the company by increasing loans and deposits and increasing earnings on a regular basis so that we are providing the best service possible to our customers as well

as increasing the value of our shareholders investments. Regular earnings increases allow us to build our capital and pay increased dividends to our shareholders. Increasing capital in turn provides the basis for continued expansion of the company including the ability to keep pace with the technology of our ever changing world. Maintaining the technology advantage is one of the most costly yet most necessary goals of doing business after costs of real estate and human resources.

The continuing increase of regulation in the banking industry and the associated costs continue to be a major concern of management. The cost of initial compliance with Sarbanes-Oxley Act of 2002 has been spread out over several years now, with the delay of the banks initial complete implementation date to December 31, 2008. Compliance costs add additional pressure for management to find ways to increase income.

The major source of income for the company is interest income earned on loans and investments and, is, of course, dependent on market conditions, so in addition to increasing income in these areas, management has concentrated on finding additional types of noninterest income. The bank continues to derive a generous amount of income from the overdraft protection plan introduced about five years ago. There has been some concern that future regulation may diminish earnings on this product, which would have an adverse affect on the earnings of the company.

The company continues to benefit from tax exempt loan income, tax exempt income of bank owned life insurance policies and tax exempt municipal securities in the investment portfolio. These items reduce the income tax expense for the company as well as produce income.

The company continues to seek ways to reduce expenses in addition to ways to increase income while benefiting from processes introduced in the past five years for that purpose including (1) utilization of personnel to full potential by growing the company as much as possible without increasing personnel, (2) continuing the reclassification of deposits to allow a lower balance requirement at the Federal Reserve allowing funds to be used for other purposes such as making loans, (3) increasing service charges as appropriate and (4) the outsourcing of official checks which has been a generous income producer as the bank earns interest on the outstanding balances of the official checks.

The bank has been monitoring its efficiency through the calculation of the efficiency ratio each month and that ratio declined over the course of 2006, which is good. This ratio is the comparison of the banks noninterest expenses (overhead) with net income. A decrease in noninterest expenses or an increase in net income will cause the ratio to decrease.

Management is unaware of any trends, events or uncertainties that would have a material effect on liquidity, capital resources or operations. There are no current recommendations by regulatory authorities that, if they were to be implemented, would have a material effect on the company.

The following table sets forth selected quarterly results (with dollars in thousands) of the company for 2006 and 2005.

	2006				2005			
	Three Months Ended				Three Months Ended			
	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31
Interest income	$ 4 995	$ 4 961	$ 4 756	$ 4 387	$ 4 247	$ 4 053	$ 3 716	$ 3 408
Interest expense	1 977	1 926	1 611	1 418	1 301	1 140	915	779
Net interest income	3 018	3 035	3 145	2 969	2 946	2 913	2 801	2 629
Provision for loan losses	152	104	75	- -	19	134	113	64
Net interest income after provision for loan losses	2 866	2 931	3 070	2 969	2 927	2 779	2 688	2 565
Noninterest income	913	936	1 071	846	913	955	913	773
(Loss) sale of securities, net	- -	- -	- -	- -	(369)	- -	- -	- -

Noninterest expense	2 227	2 356	2 335	2 343	2 261	2 188	2 041	1 970
Income before income taxes	1 552	1 511	1 806	1 472	1 210	1 546	1 560	1 368
Income tax expense	610	542	620	534	411	572	558	479
Net income	$ 942	$ 969	$ 1 186	$ 938	$ 799	$ 974	$ 1 002	$ 889
Earnings per share, basic	$ .28	$ .28	$ .34	$ .27	$ .23	$ .29	$ .30	$ .26
Earnings per share, diluted	$ .27	$ .28	$ .34	$ .27	$ .23	$ .29	$ .29	$ .26

NET INTEREST INCOME

Increasing interest rates affected loan growth and net interest income in 2006. Loan growth slowed to 9% and net interest income increased 8% in 2006 compared to 2005. Income on securities and other interest and dividends continued to show slight increases during 2006.

The loan portfolio grew 18% during 2005 and consistent increases in loan rates played an important part in the 18% increase in net interest income in 2005. Other factors affecting 2005 net interest income compared to 2004 were a slight increase in securities interest income and increased other interest and dividends due to interest earned on balances held at Travelers Express for funding of the bank's official checks.

Interest expense increased 68% in 2006 compared to 2005 due in large part to increased interest rates. Increased borrowings have also contributed to increased interest expense in 2006 compared to 2005.

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During the last quarter of 2006, management has seen some leveling off of loan growth and expects that this will continue through much of 2007. Economic indicators suggest that the economy is strengthening and the Federal Reserve is expected to leave rates alone for the foreseeable future. Management is optimistic that these factors will help sustain the bank's loan growth.

By reviewing the volume and rate analysis schedule below, the affects of changes in volumes and rates of the various other assets and liabilities on net interest income can be seen.

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 and rates on tax exempt loans and securities are computed on a tax equivalent basis using a federal tax rate of 34%. Non-accruing loans are included in average loans outstanding.

	2006 Compared to 2005 (in thousands)			2005 Compared to 2004 (in thousands)		
	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect
INTEREST INCOME						
Taxable loans	$ 3 006	$ 1 794	$ 1 212	$ 3 352	$ 2 837	$ 515
Tax exempt loans	1	(2)	3	(8)	8	(16)
Taxable securities	579	56	523	(59)	(25)	(34)
Nontaxable securities	8	5	3	68	67	1
Securities purchased under						

agreements to resell and federal funds sold	22	7	15	4	(2)	6
Other earning assets	62	12	50	79	72	7
TOTAL	$ 3 678	$ 1 872	$ 1 806	$ 3 436	$ 2 957	$ 479
INTEREST EXPENSE						
Savings and interest-bearing demand deposits	$ 1 419	$ 92	$ 1 327	$ 891	$ 75	$ 816
Time deposits	1 324	768	556	458	246	212
Securities sold under agreements to repurchase and federal funds purchased	48	(57)	105	284	154	130
Advances from FHLB	6	(11)	17	93	111	(18)
TOTAL	$ 2 797	$ 792	$ 2 005	$ 1 726	$ 586	$ 1 140
NET INTEREST INCOME	$ 881	$ 1 080	$ (199)	$ 1 710	$ 2 371	$ (661)

NONINTEREST INCOME AND EXPENSE

As in 2005 and 2004, fees generated through the bank's overdraft protection plan available for customers continues to be a major contributor to the bank's noninterest income. These fees are included in the service charges on deposit accounts category which totaled $1.7 million in 2006, $1.6 million in 2005 and $1.5 million in 2004. Trust and financial services is the next largest contributor to the 2006 noninterest income figure with an 8.6 % increase in income compared to 2005. Trust income was boosted in the last three years by the accrual of fees for settlement of several large estates. One of these fees was totally accrued in March of 2006. There are other estate fees being accrued but these two were significantly larger than most fees the bank has earned. Estate settlement fees are one area of income that is not particularly consistent from year to year. In comparing 2004 trust income with 2005 and 2006, the estate fees were a major difference. The financial services area is also continuing to benefit from the growth of BCT Investments that offers brokerage and other financial services.

The growth of the bank customer base continues to have a positive affect on various components of noninterest income in addition to the overdraft protection plan mentioned above. It provides for increases in other service charges such as stop payments, sales of cashiers checks and money orders, wire transfer fees, debit, ATM and charge card transaction fees.

Fees on sales of loans in the secondary market are a source of noninterest income that varies with the market conditions. Our income from this source was $117 thousand in 2006, $187 thousand in 2005 and $157 thousand in 2004.

During the fourth quarter of 2005, the company's net income was negatively affected by the one time sale of approximately $14 million in Federal agency securities that had an average coupon yield of 2.6%. The gross loss on this sale was $369 thousand with an after tax net income affect of $243 thousand. The proceeds of this sale were reinvested in Federal agency securities with an average coupon yield of 4.9% which going forward, will favorably impact income.

Salaries and employee benefits of $5.1 million are about 55% of the total noninterest expense for 2006. This percentage was about the same in 2005. Even though the bank has grown during the past few years, full utilization of personnel has allowed the bank to hold down salaries and benefit costs by holding down the increase in personnel. During 2007 salaries and employee benefits are expected to increase due to annual salary and wage increases including merit increases rather than any extensive increase in personnel and due to

increased group health insurance expenses.

Expenses related to premises have increased 8% in 2006 compared to 2005. These costs include new branch facilities, refurbished branch facilities, additional leased facilities, increased utility costs due to increased facilities and increased property taxes due to new facilities. Furniture and equipment expenses have remained relatively stable.

The other noninterest expense category is the total of approximately 60 separate expense accounts. The percentage of increase for this category has decreased in each of the past three years which is evidence of the more efficient manner in which the bank is being run. Other noninterest expense increased 5% or $81 thousand in 2006 compared to 2005, 15% or $182 thousand in 2005 compared to 2004 and 20% or $207 thousand in 2004 compared to 2003. There is no significant change in any one account for any of these time period comparisons. Most of the increases are due to the growth in the bank's customer base and growth in facilities.

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INTEREST RATE SENSITIVITY

The table below shows the opportunities the company will have to reprice interest earning assets and interest-bearing liabilities as of December 31, 2006 (in thousands).

	Mature or Reprice				
	Within Three Months	After Three Months But Within Twelve Months	After One Year But Within Five Years	After Five Years	Nonsensitive
Interest Earning Assets:					
Loans	$ 71 467	$ 18 599	$ 75 746	$ 64 257	$ - -
Securities	2 495	11 844	27 285	1 082	- -
Securities purchased under agreements to resell and federal funds sold	345	- -	- -	- -	- -
Other earning assets	367	- -	- -	- -	- -
Total	$ 74 674	$ 30 443	$ 103 031	$ 65 339	$ - -
Interest-Bearing Liabilities:					
Time deposits $100,000 and over	$ 6 381	$ 7 955	$ 8 282	$ - -	$ - -
Other time deposits	21 393	27 395	30 344	- -	- -
Gold and Platinum accounts (NOW accounts)	48 018	- -	- -	- -	36 844
Savings accounts	- -	- -	- -	- -	35 293
Securities sold under agreements to repurchase and federal funds purchased	10 526	- -	- -	- -	- -
Federal Home Loan Bank advances	- -	- -	620	- -	- -

Total	$ 86 318	$ 35 350	$ 39 246	$ - -	$ 72 137
Rate Sensitivity Gap	$ (11 644)	$ (4 907)	$ 63 785	$ 65 339	
Cumulative Gap	$ (11 644)	$ (16 551)	$ 47 234	$ 112 573	

The matching of the maturities or repricing opportunities of interest earning assets and interest-bearing liabilities may be analyzed by examining the extent to which these assets and liabilities are interest rate sensitive and by monitoring an institution's interest rate sensitivity gap. An asset or liability is interest rate sensitive within a specific time period if it will mature or reprice within that period. The interest rate sensitivity gap is the difference between the amount of interest earning assets that will mature or reprice within a specific time period and the amount of interest-bearing liabilities that will mature or reprice within the same time period.

A gap is considered negative when the amount of liabilities maturing or repricing in a specific period exceeds the amount of assets maturing or repricing in the same period. An even match between assets and liabilities in each time frame is the safest position especially in times of rapidly rising or declining rates. During other times, the even match is not as critical. The advantages or disadvantages of positive and negative gaps depend totally on the direction in which interest rates are moving. An asset sensitive institution's net interest margin and net interest income generally will be impacted favorably by rising interest rates, while that of a liability sensitive institution generally will be impacted favorably by declining interest rates.

During the first twelve months shown in the schedule above, the company is liability sensitive, and after that time period the company is asset sensitive. During January, February and March of 2007, $11.6 million more liabilities may reprice or will mature than assets. During April through December of 2007, $5 million more liabilities may reprice or will mature than assets. The total effect for 2007 is that $16.5 million more liabilities may reprice or mature than assets. Over the year this is minimal sensitivity in comparison to the total of all assets and liabilities repricing and maturing. During the 2007 time period the company should be only slightly impacted by either rising or falling interest rates.

LOAN PORTFOLIO

Loans at December 31 (in thousands) for each of the five years in the period ended 2006.

	2006	2005	2004	2003	2002
Commercial, financial and agricultural	$ 4 247	$ 6 046	$ 5 949	$ 6 217	$ 3 696
Mortgage loans on real estate:					
Construction and land development	53 801	41 174	28 929	14 071	2 211
Secured by farm land	1 557	2 381	3 986	3 711	1 821
Secured by 1-4 family residential	103 983	98 408	79 800	62 693	63 239
Secured by multifamily residential	3 733	3 486	3 088	1 635	2 623
Secured by nonfarm nonresidential	46 367	43 019	39 671	33 317	23 528
Consumer loans	16 089	15 549	17 346	17 697	19 198
All other loans	292	372	236	717	730
	$ 230 069	$ 210 435	$ 179 005	$ 140 058	$ 117 046

Loan production continues from the bank's seasoned staff, although there has been some slowdown in the housing market that has provided a large portion of the bank's loans in past years. The overall loan growth in 2006 was 9% compared to loan growth in 2005 of 18%. The bank's loan staff anticipates growth in 2007 similar to 2006 and hopes 2008 may show more spark. Economic indicators suggest that the economy is strengthening and the Federal Reserve is expected to leave rates alone in the foreseeable future.

There were no categories of loans that exceeded 10% of outstanding loans at December 31, 2006 that were not disclosed in the table above.

REMAINING MATURITIES (in thousands) OF SELECTED LOANS

At December 31, 2006	Commercial, Financial and Agricultural	Real Estate-Construction
Loans maturing within one year	$ 1 580	$ 43 015
Variable rate loans due after one year	183	3 828
Fixed rate loans due after one year through five years	2 393	6 910
Fixed rate loans due after five years	91	48
Total maturities	$ 4 247	$ 53 801

ALLOWANCE FOR LOAN LOSSES

The table shown below is an analysis of the company's allowance for loan losses. Historically, 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. Based on experience, the loan policies and the current monitoring program, management believes the allowance for loan losses is adequate.

	2006	2005	2004	2003	2002
			(in thousands)		
lance at beginning of period	$ 2 161	$ 1 966	$ 1 724	$ 1 642	$ 1 402
arge-offs:					
Commercial, financial and agricultural	- -	30	- -	- -	- -
Real estate – construction	- -	- -	- -	- -	- -
Real estate – mortgage	- -	- -	- -	- -	- -
Consumer	207	218	202	191	287
Total charge-offs	207	248	202	191	287
coveries:					
Commercial, financial and agricultural	- -	- -	- -	- -	- -
Real estate – construction	- -	- -	- -	- -	- -
Real estate – mortgage	- -	- -	- -	8	1
Consumer	138	113	155	118	103
Total recoveries	138	113	155	126	104
et charge-offs	69	135	47	65	183
dditions charged to operations	331	330	289	147	423
lance at end of period	$ 2 423	$ 2 161	$ 1 966	$ 1 724	$ 1 642
tio of net charge-offs during the period to average loans outstanding during the period	0.03%	0.07%	0.03%	0.05%	0.17%

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.

	2006		2005		2004		2003		2002	
	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)	% Ca T L
Commercial, financial and agricultural	$ 71	1.85%	$ 94	2.87%	$ 81	3.32%	$ 62	4.44%	$ 37	
Mortgage loans on real estate:										
Construction and land development	820	23.38%	538	19.57%	166	16.16%	141	10.05%	22	
Secured by farm land	12	0.68%	17	1.13%	29	2.23%	37	2.65%	2	
Secured by 1-4 family residential	753	45.20%	696	46.76%	458	44.58%	272	44.76%	293	5
Secured by multi-family residential	27	1.62%	25	1.66%	24	1.73%	20	1.17%	22	
Secured by nonfarm nonresidential	478	20.15%	477	20.44%	341	22.16%	330	23.79%	298	2
Consumer loans	248	6.99%	261	7.39%	591	9.69%	536	12.63%	424	1
All other loans	1	0.13%	2	.18%	3	.13%	6	.51%	5	
Unallocated	13	- -	51	- -	273	- -	320	- -	539	
	$ 2 423	100.00%	$ 2 161	100.00%	$ 1 966	100.00%	$ 1 724	100.00%	$ 1 642	10

RISK ELEMENTS IN THE LOAN PORTFOLIO

	2006	2005	2004	2003	2002
			(in thousands)		
Nonaccrual loans	$ 144	$ 122	$ - -	$ 251	$ - -
Restructured loans	- -	- -	- -	- -	- -
Foreclosed properties	- -	- -	- -	- -	- -
	$ 144	$ 122	$ - -	$ 251	$ - -

Total nonperforming assets					
Loans past due 90 days accruing interest	$ - -	$ 65	$ - -	$153	$ 41
Allowance for loan losses to period end loans	1.05%	1.03%	1.10%	1.23%	1.40%
Nonperforming assets to period end loans and foreclosed properties	.06%	.06%	- -	.18%	- -

Loans are placed on nonaccrual status when a loan is specifically determined to be impaired or 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.

There were no impaired loans at December 31, 2006 and 2005.

At December 31, 2006, other potential problem loans totaled $2.1 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.

SECURITIES PORTFOLIO

In accordance with Financial Accounting Standards Board Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the company records securities being held to maturity at amortized cost and securities available for sale at fair value. The effect of unrealized gains and losses, net of tax effects, is recognized in stockholders equity.

The schedule below summarizes the book value of the portfolio by maturity classifications and shows the weighted average yield in each group.

	2006 Carrying Value (in thousands)	Weighted Average Yield	2005 Carrying Value (in thousands)	Weighted Average Yield	2004 Carrying Value (in thousands)	Weighted Average Yield
Securities available for sale						
Obligations of U.S. Government agencies:						
Maturing within one year	$ 14 169	4.05%	$ 15 435	3.82%	$ 9 042	4.12%
Maturing after one year but within five years	26 819	4.86%	30 243	4.10%	36 982	3.32%
Municipal obligations:						
Maturing within one year	170	2.53%	- -	- -	- -	- -
Maturing after on year but						

within five years	466	3.59%	147	3.75%	529	3.57%
Maturing after five years	1 082	3.97%	1 126	3.87%	786	3.70%
Total securities available for sale	$ 42 706		$ 46 951		$ 47 339	

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DEPOSITS

Deposit growth of 10% in 2006 and our business sweep accounts outpaced loan growth by a very small margin (less than 1%) during the year. Periodically we have continued to depend on alternative methods of funding. We have seen additional deposit growth through our Berkeley County branch offices and anticipate continued growth in those areas. We are a relatively new face in the Berkeley County neighborhood and Berkeley County residents are still learning about us and continue to respond in a positive manner. As of June 2005, the bank had almost 3% of the market share of deposits in Berkeley County and as of June 2006, we had approximately 3.4% of that market. Jefferson County deposit market share has grown to just over 30%. We have increased market share in both counties and had a total market share of approximately 14.5% at June 30, 2006.

Schedule of Average Deposits and Average Rates Paid

	Year Ended December 31					
	2006		2005		2004	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing demand deposits	$ 31 881		$ 33 648		$ 30 010	
Interest-bearing demand deposits	95 146	2.30%	93 563	1.27%	82 426	.46%
Savings deposits	32 723	1.73%	26 435	.56%	21 756	.29%
Time deposits	84 082	4.08%	63 661	3.31%	55 961	2.96%
Total interest-bearing deposits	211 951	2.92%	183 659	1.87%	160 143	1.31%
Total deposits	$ 243 832		$ 217 307		$ 190 153	

At December 31, 2006 time deposits of $100 thousand or more were 8.98 % of total deposits compared with 7.03% at December 31, 2005. Maturities of time deposits of $100 thousand or more (in thousands) at December 31, 2006 are as follows:

Within three months	$ 6 381
Over three through six months	4 212
Over six months through twelve months	3 743
Over twelve months	8 282
Total	$ 22 618

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. The company had a ratio of total capital to risk-weighted assets of 13.82% and a ratio of Tier 1 capital to risk-weighted assets of 12.71% at December 31, 2006. These two ratios have increased due to the growth in capital and purchase of additional shares for the treasury during 2006. Both ratios exceed the capital requirements adopted by the federal regulatory agencies.

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	(In thousands)		
	2006	2005	2004
Tier 1 capital:			
Common stock	$ 3 672	$ 3 600	$ 1 800
Surplus	3 661	2 400	4 200
Retained earnings	22 677	21 158	18 631
	30 010	27 158	24 631
Less cost of shares acquired for the treasury	2 279	1 850	1 850
Total tier 1 capital	$ 27 731	$ 25 308	$ 22 781
Tier 2 capital:			
Allowance for loan losses (1)	2 423	2 161	1 966
Total risk-based capital	$ 30 154	$ 27 469	$ 24 747
Risk-weighted assets	$ 218 193	$ 199 602	$ 171 432
Capital ratios:			
Tier 1 risk-based capital ratio	12.71%	12.68%	13.29%
Total risk-based capital ratio	13.82%	13.76%	14.44%
Leverage ratio	9.34%	9.18%	9.45%

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

LIQUIDITY

Liquidity represents an institution's ability to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. This could also be termed the management of the cash flows of an organization. Liquid assets include cash and due from banks, interest-bearing deposits in financial institutions, securities purchased under agreements to resell, federal funds sold, securities available for sale, and loans and investments maturing within one year. The company's

liquidity during 2006 is detailed in the statement of cash flows included in the financial statements.

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 reduces net income but does not require a cash outlay. During 2006 net income as adjusted has provided cash of $3.8 million. Interest income earned on loans and investment securities is the company's major income source.

Investing Activities. Customer deposits and company borrowings 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. As mentioned in the deposit discussion above, we have taken advantage of our borrowing capabilities for additional funding since deposit growth is not always sufficient to cover our needs. The net amount of cash used in investing activities in 2006 is $16.1 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 to shareholders, 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 2006 is $10.8 million.

At December 31, 2006, cash and due from banks, interest-bearing deposits in financial institutions, securities purchased under agreements to resell, federal funds sold and loans and securities maturing within one year were $51.7 million.

Borrowing capabilities provide additional liquidity. The subsidiary bank maintains a federal funds line of $7 million with one financial institution and a federal funds line of $4 million with a second financial institution. The subsidiary bank is also a member of the Federal Home Loan Bank of Pittsburgh and has short and/or long-term borrowing capabilities of approximately $159 million. In June 2001, the subsidiary bank borrowed $2.5 million amortized over seven years from the Federal Home Loan Bank. The subsidiary bank has a Repo Plus account with the FHLB with a current credit line of $20 million that can be renewed on an annual basis.

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

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

A summary of the contract or notional amount of the company's exposure to off-balance-sheet risk as of December 31, 2006 and 2005 is as follows:

	2006	2005
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 60 683	$ 63 747
Standby letters of credit	4 750	5 265

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 customers 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 managements credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. The majority of these lines of credit is collateralized and usually contains a specified maturity date and may not be drawn upon to the extent to which the company is committed.

Standby letters of credit are conditional commitments issued by the company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar 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, 2006, the company had zero rate lock commitments to originate mortgage loans.

Short-Term Borrowings. At December 31, 2006, short-term borrowings consist of securities sold under agreements to repurchase that are secured transactions with customers and federal funds purchased through The Bankers Bank. These borrowings generally mature the day following the day sold. The total of short-term borrowings were $10.5 million on December 31, 2006 and $19.6 million on December 31, 2005. The short-term borrowings at December 31, 2005 were securities sold under agreements to repurchase that were secured transactions with customers.

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

	December 31	
	2006	2005
Balance outstanding at year end	$ 10 526	$ 19 557
Maximum balance at any month-end during the year	$ 24 979	$ 27 467
Average balance for the year	$ 16 497	$ 20 307
Weighted average rate for the year	4.26%	3.10%
Weighted average rate at year end	4.13%	3.63%
Estimated fair value	$ 10 526	$ 19 557

Contractual Obligations. The table below presents the contractual obligations of the company as of December 31, 2006:

	Payments (in thousands) Due By Period			
	Total	Less than 1 Year	Over 1 Year through 3 Years	Over 3 Years through 5 Years
Long-Term Debt Obligations	$ 620	$ 408	$ 212	$ - -

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 table represents the interest rate sensitivity on net income (fully tax equivalent basis) for the company using different rate scenarios as of December 31, 2006:

Change in Yield Curve	% Change in Net Income
+200 basis points	+ 5.1%
+100 basis points	+ 2.6%
Most likely	0
- 100 basis points	- 2.8%
- 200 basis points	- 5.9%

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, 2006:

Change in Yield Curve	Change in Economic Value of Equity (dollars in thousands)
+ 200 basis points	$ - 4,599
+ 100 basis points	- 2,182
Most likely	0
- 100 basis points	+ 1,652
- 200 basis points	+ 2,628

Item 8. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

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

We have audited the consolidated balance sheets of Potomac Bancshares, Inc. and Subsidiary as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders equity and cash flows for the years ended December 31, 2006, 2005 and 2004. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 provided 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, 2006 and 2005, and the results of their operations and their cash flows for the years ended December 31, 2006, 2005 and 2004, in conformity with U.S. generally accepted accounting principles.

As described in Note 8 to the consolidated financial statements, on December 31, 2006, Potomac Bancshares, Inc. changed its method of accounting for its pension plan to adopt FASB Statement No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.*

Winchester, Virginia
March 15, 2007

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2006 and 2005
(in thousands, except per share data)

		2006		2005
ASSETS				
Cash and due from banks	$	6 214	$	7 607
Interest-bearing deposits in other financial institutions		367		508
Securities purchased under agreements to resell and federal funds sold		345		357
Securities available for sale, at fair value		42 706		46 951
Loans held for sale		405		- -
Loans, net of allowance for loan losses of $2,423 in 2006 and $2,161 in 2005		227 646		208 274
Premises and equipment, net		6 421		6 045
Accrued interest receivable		1 431		1 152
Other assets		7 214		6 433
Total Assets	$	292 749	$	277 327
LIABILITIES AND STOCKHOLDERS EQUITY				
LIABILITIES				
Deposits				
Noninterest-bearing	$	29 873	$	32 614
Interest-bearing		221 905		197 266
Total Deposits	$	251 778	$	229 880
Accrued interest payable		672		331
Securities sold under agreements to repurchase and federal funds purchased		10 526		19 557
Federal Home Loan Bank advances		620		1 005
Other liabilities		2 436		1 522
Commitments and contingent liabilities		- -		- -
Total Liabilities	$	266 032	$	252 295
STOCKHOLDERS EQUITY				
Common stock, $1 per share par value; 5,000,000 shares authorized; issued, 2006, 3,671,691 shares; 2005, 3,600,000 shares	$	3 672	$	3 600
Surplus		3 661		2 400
Undivided profits		22 677		21 158
Accumulated other comprehensive (loss)		(1 014)		(276)
	$	28 996	$	26 882
Less cost of shares acquired for the treasury, 2006,				

238,108 shares; 2005, 206,878 shares		2 279		1 850
Total Stockholders Equity	$	26 717	$	25 032
Total Liabilities and Stockholders Equity	$	292 749	$	277 327

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2006, 2005 and 2004
(in thousands, except per share data)

		2006		2005		2004
Interest and Dividend Income:						
Interest and fees on loans	$	16 712	$	13 705	$	10 358
Interest on securities held to maturity - taxable		- -		- -		35
Interest on securities available for sale - taxable		2 095		1 516		1 540
Interest on securities available for sale - nontaxable		57		52		7
Interest on securities purchased under agreements to resell and federal funds sold		65		43		39
Other interest and dividends		170		108		29
Total Interest and Dividend Income	$	19 099	$	15 424	$	12 008
Interest Expense:						
Interest on deposits	$	6 183	$	3 440	$	2 091
Interest on securities sold under agreements to repurchase and federal funds purchased		564		516		232
Federal Home Loan Bank advances		185		179		86
Total Interest Expense	$	6 932	$	4 135	$	2 409
Net Interest Income	$	12 167	$	11 289	$	9 599
Provision for Loan Losses		331		330		289
Net Interest Income after Provision for Loan Losses	$	11 836	$	10 959	$	9 310
Noninterest Income:						
Trust and financial services	$	1 071	$	986	$	826
Service charges on deposit accounts		1 724		1 582		1 512
Visa/MC Fees		364		274		180
Net gain on sale of loans		117		187		157
(Loss) on sale of securities available for sale		- -		(369)		(26)
Other operating income		490		525		509
Total Noninterest Income	$	3 766	$	3 185	$	3 158

Noninterest Expenses:			
Salaries and employee benefits	$ 5 104	$ 4 518	$ 4 076
Net occupancy expense of premises	546	507	399
Furniture and equipment expenses	890	875	881
Advertising and marketing	297	281	222
Stationery and supplies	162	171	156
Postage	159	149	157
Other professional fees	140	144	203
ATM and check card expense	319	252	196
Other operating expenses	1 644	1 563	1 378
Total Noninterest Expenses	$ 9 261	$ 8 460	$ 7 668
Income Before Income Tax Expense	$ 6 341	$ 5 684	$ 4 800
Income Tax Expense	2 306	2 020	1 710
Net Income	$ 4 035	$ 3 664	$ 3 090
Earnings Per Share, basic	$ 1.17	$ 1.06	$ .89
Earnings Per Share, diluted	$ 1.16	$ 1.05	$ .89

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
Years Ended December 31, 2006, 2005 and 2004
(in thousands, except per share data)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balances, December 31, 2003	$ 1 800	$ 4 200	$ 16 543	$ (1 709)	$ 498		$ 21 332
Comprehensive income							
Net income 2004	- -	- -	3 090	- -	- -	$ 3 090	3 090
Other comprehensive (loss):							
Unrealized holding (losses) arising during the period (net of tax, $277)	- -	- -	- -	- -	(540)	(540)	(540)
Reclassification for losses included in net income (net of tax, $9)	- -	- -	- -	- -	17	17	17
Total comprehensive income						$ 2 567	
Cash dividends 2004 ($.29 per share)	- -	- -	(1 002)	- -	- -		(1 002)
Purchase of treasury shares: 6,110 shares	- -	- -	- -	(141)	- -		(141)
Balances, December 31, 2004	$ 1 800	$ 4 200	$ 18 631	$ (1 850)	$ (25)		$ 22 756

Comprehensive income							
Net income — 2005	- -	- -	3 664	- -	- -	$ 3 664	3 664
Other comprehensive (loss):							
Unrealized holding (losses) arising during the period (net of tax, $255)	- -	- -	- -	- -	(495)	(495)	(495)
Reclassification for losses included in net income (net of tax, $125)	- -	- -	- -	- -	244	244	244
Total comprehensive income						$ 3 413	
Stock split in the form of a 100% stock dividend	1 800	(1 800)	- -	- -	- -		- -
Cash dividends — 2005 ($.33 per share)	- -	- -	(1 137)	- -	- -		(1 137)
Balances, December 31, 2005	$ 3 600	$ 2 400	$ 21 158	$ (1 850)	$ (276)		$ 25 032
Comprehensive income							
Net income — 2006	- -	- -	4 035	- -	- -	$ 4 035	4 035
Other comprehensive income:							
Unrealized holding gains arising during the period (net of tax, $63)	- -	- -	- -	- -	123	123	123
Total comprehensive income						$ 4 158	
Adjustment to initially apply FASB Statement No. 158, in regard to pension and other postretirement benefits (net of tax, $444)	- -	- -	- -	- -	(861)		(861)
2% stock dividend	72	1 149	(1 221)	- -	- -		- -
Purchase of treasury shares: 27,093 shares	- -	- -	- -	(429)	- -		(429)
Stock compensation expense	- -	112	- -	- -	- -		112
Cash dividends — 2006 ($.38 per share)	- -	- -	(1 295)	- -	- -		(1 295)
Balances, December 31, 2006	$ 3 672	$ 3 661	$ 22 677	$ (2 279)	$ (1 014)		$ 26 717

See Notes to Consolidated Financial Statements.

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POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2006, 2005 and 2004
(in thousands)

	2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 4 035	$ 3 664	$ 3 090
Adjustments to reconcile net income to net cash provided by operating activities:			

Provision for loan losses	331	330	289
Depreciation	582	578	605
Deferred tax (benefit)	(190)	(41)	(32)
Discount accretion and premium amortization on securities, net	(131)	69	101
Loss on sale of securities available for sale	- -	369	26
Stock compensation expense	112	- -	- -
Proceeds from sale of loans	7 285	10 260	8 749
Origination of loans for sale	(7 690)	(10 112)	(8 333)
Changes in assets and liabilities:			
(Increase) in accrued interest receivable	(279)	(239)	(4)
(Increase) in other assets	(211)	(1 123)	(444)
Increase in accrued interest payable	341	151	52
(Decrease) increase in other liabilities	(391)	420	89
Net cash provided by operating activities	$ 3 794	$ 4 326	$ 4 188
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from maturity of securities held to maturity	$ - -	$ - -	$ 6 000
Proceeds from maturity of securities available for sale	15 500	9 000	2 000
Proceeds from sale of securities available for sale	- -	13 900	8 974
Proceeds from call of securities available for sale	2 500	- -	5 000
Purchases of securities available for sale	(13 437)	(23 331)	(25 805)
Net (increase) in loans	(19 703)	(31 565)	(38 994)
Purchases of premises and equipment	(958)	(836)	(1 401)
Net cash (used in) investing activities	$ (16 098)	$ (32 832)	$ (44 226)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase (decrease) in noninterest-bearing deposits	$ (2 741)	$ (1 622)	$ 8 840
Net increase in interest-bearing deposits	24 639	30 951	18 455
Net proceeds (repayment) of securities sold under agreements to repurchase and federal funds purchased	(9 031)	1 980	8 378
Net proceeds (repayment) of Federal Home Loan Bank advances	(385)	(5 365)	4 655
Purchase of treasury shares	(429)	- -	(141)
Cash dividends	(1 295)	(1 137)	(1 002)
Net cash provided by financing activities	$ 10 758	$ 24 807	$ 39 185
(Decrease) in cash and cash equivalents	$ (1 546)	$ (3 699)	$ (853)
CASH AND CASH EQUIVALENTS			
Beginning	8 472	12 171	13 024
Ending	$ 6 926	$ 8 472	$ 12 171
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash payments for:			
Interest	$ 6 591	$ 3 984	$ 2 357
Income taxes	$ 2 936	$ 1 519	$ 1 677
SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES			
Unrealized gain (loss) on securities available for sale	$ 186	$ (381)	$ (791)

Adjustment to initially apply FASB Statement No. 158			
in regard to pension and other postretirement benefits	$ (1 305)	$ - -	$ - -

See Notes to Consolidated Financial Statements.

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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 (the company) grant commercial, financial, agricultural, residential and consumer loans to customers, primarily in Berkeley County and Jefferson County, West Virginia. The companys market area also includes Washington County and Frederick County, Maryland and Frederick County, Loudoun County and Clarke County, Virginia. The loan portfolio is well diversified 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 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 (the bank), include the accounts of both companies. All material intercompany balances and transactions have been eliminated in consolidation.

Interest-bearing Deposits in Financial Institutions

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

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (l) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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 companys debtors to honor their contracts is dependent upon the real estate and general economic conditions of the companys market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses.

Interest income is accrued on the unpaid principal balance.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

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 for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, 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. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either 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.

A loan is considered impaired when, 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.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the company does not separately identify individual consumer and residential loans for impairment disclosures.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or market 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 primarily on the straight-line and declining-balance methods. Estimated useful lives range from five to forty years for premises and improvements and five 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.

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

Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Employee Benefit Plans

The company sponsors the following employee benefit plans:

- a noncontributory, defined benefit pension plan covering employees meeting certain age and service requirements,
- a postretirement life insurance plan covering current and future retirees with 25 years of service over the age of 60,
- a health care plan for current retirees who met certain eligibility requirements that is not available for future retirees and
- a 401(k) retirement savings plan available to fulltime employees meeting certain age and service requirements. Under this plan the employer may make a discretionary matching contribution each plan year and may also make other discretionary contributions to the plan.

Stock Dividends

On March 14, 2006 the Board of Directors declared a 2% stock dividend. Shares increased from 3,600,000 to 3,671,691. On February 8, 2005 the Board of Directors declared a stock split in the form of a 100% stock dividend. Shares increased from 1,800,000 to 3,600,000.

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. All amounts have been retroactively restated for the stock .

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.

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.

Trust Division

Securities and other property held by the Trust Division in a fiduciary or agency capacity are not assets of the company and are not included in the accompanying financial statements.

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

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 reported 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 and deferred tax assets.

Advertising

The company follows the policy of charging the costs of advertising to expense as incurred.

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, 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.

Stock-Based Compensation Plan

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. These shares have been restated to reflect the 2% stock dividend declared March 14, 2006 and the 100% stock dividend declared February 8, 2005. 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 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 non vested shares, 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.

As a result of adopting SFAS 123R on January 1, 2006, incremental stock-based compensation expense recognized for the twelve month period ending December 31, 2006 was $112 thousand, which impacted basic and diluted earnings per share by $.03 for the twelve months ended December 31, 2006.

As of December 31, 2006 there was $171 thousand of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period.

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

Stock-Based Compensation Plan (Continued)

The following illustrates the effect on net income and earnings per share if the company had applied the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, prior to January 1, 2006:

	For the Years Ended December 31	
	2005	2004
	(dollars in thousands except per share amounts)	
Net income, as reported	$ 3 664	$ 3 090
Less pro forma stock option compensation expense, net of tax	(55)	(32)
Pro forma net income	$ 3 609	$ 3 058
Earnings per share:		
Basic as reported	$ 1.06	$ .89
Basic pro forma	$ 1.04	$ .88
Diluted as reported	$ 1.05	$ .89
Diluted pro forma	$ 1.04	$ .88

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 twelve months ended December 31, 2006 and 2005 was $3.88 and $2.91, respectively. Fair value is estimated using the Black-Scholes option-pricing model with the following assumptions for grants during 2006 and 2005: option term until exercise 10 years, expected volatility of 17.86% and 19.46%, risk-free interest rates of 4.43% and 4.26%, and expected dividend yields of 2.66% and 3.15%, respectively. Expected volatility is based on the historic volatility of the companys stock price over the expected life of the options. The expected term is estimated as the average of the contractual life and vesting schedule for the respective options. 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 companys historical dividends paid per share of common stock to the stock price on the date of grant.

Reclassifications

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

Recent Accounting Pronouncements

In September 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 expresses the SEC staffs views regarding the process of quantifying financial statement misstatements. AB 108 expresses the SEC staffs view that a registrants materiality evaluation of an identified unadjusted error should quantify the effects of the error on each financial statement and related financial statement disclosures and that prior year misstatements should be considered in quantifying misstatements in current year financial statements. SAB 108 also states that correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the

offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The SEC staff encourages early application of the guidance in SAB 108 for interim periods of the first fiscal year ending after November 15, 2006**.** The company expects application of the pronouncement will have no material impact on its consolidated financial statements.

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

Recent Accounting Pronouncements (Continued)

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155). SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entitys first fiscal year that begins after September 15, 2006. The company does not expect the implementation of SFAS 155 to have a material impact on its consolidated financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into certain servicing contracts. The statement also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 permits an entity to choose between the amortization and fair value methods for subsequent measurements. At initial adoption, the statement permits a one-time reclassification of available for sale securities to trading securities by entities with recognized servicing rights. SFAS 156 also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. This statement is effective as of the beginning of an entitys first fiscal year that begins after September 15, 2006. The company expects application of the statement to have no material impact on its consolidated financial statements.

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 September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan will be measured as the difference between plan assets at fair value and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The statement also requires additional disclosure in the notes to financial statements about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The company is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employers fiscal year-end statement of financial position is effective for fiscal

years ending after December 15, 2008. The impact of recognizing the underfunded status for the company's defined benefit pension plan and other postretirement plans in the 2006 financial statements is a reduction to accumulated other comprehensive income of $861 thousand.

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

Recent Accounting Pronouncements (Continued)

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109"(FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS 109. The interpretation prescribes a recognition threshold and measurement principles for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return that are not certain to be realized. FIN 48 is effective for fiscal years beginning after December 15, 2006. The company expects that FIN 48 will have no material impact on its consolidated financial statements.

In September 2006, the Emerging Issues Task Force issued EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." This consensus concludes that for a split-dollar life insurance arrangement within the scope of this issue, an employer should recognize a liability for future benefits in accordance with FASB Statement No. 106 (if, in substance, a postretirement benefit plan exits) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007. The company is currently evaluating the effect that EITF No. 06-4 will have on its consolidated financial statements when implemented.

In September 2006, The Emerging Issues Task Force issued EITF 06-5, "Accounting for Purchases of Life Insurance- Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4." This consensus concludes that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. A consensus also was reached that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The consensuses are effective for fiscal years beginning after December 15, 2006. The company is currently evaluating the effect that EITF No. 06-5 will have on its consolidated financial statements when implemented.

Note 2. Securities

There were no securities held to maturity as of December 31, 2006 and 2005.

The amortized cost and fair value of securities available for sale as of December 31, 2006 and 2005 (in thousands) are as follows:

	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

	2005			
	Amortized	Gross Unrealized	Gross Unrealized	Fair

	Cost	Gains	(Losses)	Value
Obligations of U.S. Government agencies	$45 897	$ 6	$ (396)	$45 507
State and municipal obligations	1 473	- -	(29)	1 444
	$47 370	$ 6	$ (425)	$46 951

Note 2. Securities (Continued)

The amortized cost and fair value of the securities available for sale as of December 31, 2006 (in thousands), by contractual maturity, are shown below:

	Amortized Cost	Fair Value
Due in one year or less	$14 434	$14 339
Due after one year through five years	27 419	27 285
Due after five years	1 085	1 082
	$42 938	$42 706

There were no sales of securities available for sale during 2006. Proceeds from sales of securities available for sale were $13.9 million during 2005 and $9.0 million during 2004. Gross losses of $369 thousand were realized on sales in 2005. Gross losses of $30 thousand and gross gains of $4 thousand were realized on sales in 2004.

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 22 accounts in the consolidated portfolio that have losses at December 31, 2006. 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 December 31, 2006.

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, 2006 and 2005 (in thousands).

	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)
	$ 6 753	$ (11)	$21 464	$(240)	$28 217	$ (251)

December 31, 2005

	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	$20 278	$ (105)	$13 717	$(291)	$33 995	$ (396)
State and municipal obligations	1 444	(29)	- -	- -	1 444	(29)
	$21 722	$ (134)	$13 717	$(291)	$35 439	$ (425)

Securities with a carrying value of $25.2 million and $41.8 million at December 31, 2006 and 2005 were pledged to secure public funds and other balances as required by law.

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Note 3. Loans and Related Party Transactions

The loan portfolio is composed of the following:

	December 31	
	2006	2005
	(in thousands)	
Mortgage loans on real estate:		
Construction and land development	$ 53 801	$ 41 174
Secured by farm land	1 557	2 381
Secured by 1-4 family residential	103 983	98 408
Secured by multifamily residential	3 733	3 486
Secured by nonfarm nonresidential	46 367	43 019
Commercial loans (except those secured by real estate)	4 247	6 046
Consumer loans	16 089	15 549
All other loans	292	372
Total loans	$ 230 069	$ 210 435
Less: allowance for loan losses	2 423	2 161
	$ 227 646	$ 208 274

At December 31, 2006 and 2005, overdraft demand deposits reclassified to loans totaled $144 thousand and $129 thousand, respectively.

Loans to directors and executive officers of the company or to their associates at December 31, 2006 and 2005 totaled $3.3 million and $1.7 million, respectively. Such loans were made on substantially the same terms as those prevailing for comparable transactions with similar risks. During 2006, total principal additions were $4.3 million and total principal payments were $2.7 million.

Note 4. Allowance for Loan Losses

The following is a summary of transactions in the allowance for loan losses for 2006, 2005 and 2004 (in thousands):

2006	2005	2004

Balances at beginning of year	$ 2 161	$ 1 966	$ 1 724
Provision charged to operating expense	331	330	289
Recoveries added to the allowance	138	113	155
Loan losses charged to the allowance	(207)	(248)	(202)
Balances at end of year	$ 2 423	$ 2 161	$ 1 966

There were no impaired loans at December 31, 2006 and 2005.

Nonaccrual loans excluded from impaired loan disclosure under SFAS No. 114 at December 31, 2006 and 2005 totaled $144 thousand and $122 thousand, respectively. If interest had been accrued, such income would have approximated $14 thousand in 2006 and $3 thousand in 2005.

Note 5. Premises and Equipment, Net

Premises and equipment consists of the following:

	December 31	
	2006	2005
	(in thousands)	
Premises and improvements	$ 6 537	$ 5 978
Furniture and equipment	5 360	5 304
	$ 11 897	$ 11 282
Less accumulated depreciation	5 476	5 237
	$ 6 421	$ 6 045

Depreciation included in operating expense for 2006, 2005 and 2004 was $582 thousand, $578 thousand and $605 thousand, respectively.

Note 6. Deposits

The aggregate amount of time deposits with a balance of $100,000 or more was $22.6 million and $16.2 million at December 31, 2006 and 2005, respectively.

At December 31, 2006, the scheduled maturities of all time deposits (in thousands) are as follows:

2007	$ 63 112
2008	16 196
2009	14 823
2010	5 490
2011	2 124
	$ 101 745

Brokered deposits (all in the form of certificates of deposit) totaled $12.9 million and $3.4 million at December 31, 2006 and 2005, respectively.

Note 7. Borrowings

Short-term borrowings may consist of securities sold under agreements to repurchase and federal funds purchased. At December 31, 2006 short-term borrowings totaled $10.5 million which included $10.3 in securities sold under agreements to repurchase through secured transactions with customers and $.2 million in federal

funds purchased through The Bankers Bank.

At December 31, 2005, short-term borrowings totaled $19.6 million in securities sold under agreements to repurchase with customers.

In June 2001, the bank incurred fixed rate long term debt consisting of a Federal Home Loan Bank seven year loan with an original balance of $2.5 million and monthly payments of interest and principal with an interest rate of 5.51%. The loan is secured by capital stock, deposits, mortgage collateral and securities collateral of the bank.

Principal payments on the note are due as follows:

2007	$ 408
2008	212
	$ 620

The balance of this loan at December 31, 2005 was $1,005.

The company has unused lines of credit with the Federal Home Loan Bank and other financial institutions totaling approximately $170 million at December 31, 2006.

Note 8. Employee Benefit Plans

The company sponsors a 401(k) retirement savings plan available to full-time 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 employer to withhold up to the amount allowed by law each calendar year. The employer may make a discretionary matching contribution each plan year. The employer may also make other discretionary contributions to the plan. The company made 401(k) matching contributions of $56 thousand, $50 thousand and $49 thousand in 2006, 2005 and 2004, respectively.

The company sponsors a funded noncontributory, defined benefit pension plan covering full-time employees over 21 years of age upon completion of one year of service. Benefits are based on average compensation for the five consecutive full calendar years of service which produces the highest average.

The company sponsors an unfunded postretirement life insurance plan covering current and future retirees with 25 years of service over the age of 60 and an unfunded health care plan for current retirees that met certain eligibility requirements.

The company adopted the recognition provisions of FAS 158 in its December 31, 2006 consolidated financial statements.

Note 8. Employee Benefit Plans (Continued)

Incremental Effect of Applying FASB Statement No. 158
on Individual Line Items in the Statement of Financial Position
December 31, 2006
(in thousands)

	Before Application of	Adjustments	After Application of

	Statement 158		Statement 158
Other liabilities (includes liability for employee benefit plans)	$ 1 131	$ 1 305	$ 2 436
Other assets (includes deferred income taxes)	6 770	444	7 214
Accumulated other comprehensive (loss)	(153)	(861)	(1 014)
Total stockholders equity	27 578	(861)	26 717

Obligations and funded status:

	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Change in benefit obligation:				
Benefit obligation, beginning	$ 5 490	$ 4 923	$ 517	$ 467
Service cost	274	226	10	7
Interest cost	323	314	30	30
Actuarial (gain) loss	271	222	(20)	39
Benefits paid	(210)	(195)	(22)	(26)
Benefit obligation, ending	$ 6 148	$ 5 490	$ 515	$ 517
Change in plan assets:				
Fair value of plan assets, beginning	$ 4 097	$ 3 708	$ - -	$ - -
Actual return on plan assets	436	237	- -	- -
Employer contributions	299	347	22	26
Benefits paid	(210)	(195)	(22)	(26)
Fair value of plan assets, ending	$ 4 622	$ 4 097	$ - -	$ - -
Funded status at end of year	$ (1 526)	$ (1 393)	$ (515)	$ (517)
Accounts recognized on consolidated balance sheet as:				
Accrued benefit liabilities	$ (1 526)	N/A	$ (515)	N/A
Unrecognized net (gain) loss	N/A	1 075	N/A	(27)
Unrecognized net obligation (asset) at transition	N/A	- -	N/A	157
Accrued benefit cost included in other liabilities	(1 526)	$ (318)	(515)	$ (387)

	Pension Benefits 2006	Pension Benefits 2005	Postretirement Benefits 2006	Postretirement Benefits 2005
Amounts recognized in accumulated other comprehensive (loss) consist of:				
Net loss (gain)	$ 1 206	N/A	$ (40)	N/A
Unrecognized transition liability	- -	N/A	139	N/A
	$ 1 206		$ 99	

The accumulated benefit obligation for the defined benefit pension plan was $5.0 million and $4.3 million at December 31, 2006 and 2005, respectively.

Note 8. Employee Benefit Plans (Continued)

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

	Pension Benefits			Postretirement Benefits		
	2006	2005	2004	2006	2005	2004
		(in thousands)			(in thousands)	
Components of net periodic benefit cost:						
Service cost	$ 274	$ 226	$ 238	$ 10	$ 7	$ 6
Interest cost	323	314	259	30	30	29
Expected return on plan assets	(331)	(314)	(316)	- -	- -	- -
Amortization of net (gain)	- -	- -	- -	- -	- -	- -
Amortization of prior service cost	- -	- -	- -	- -	- -	- -
Amortization of net obligation (asset) at transition		(15)	(20)	18	17	18
Recognized actuarial (gain) loss	35	27	- -	- -	(2)	(3)
Net periodic benefit cost	301	$ 238	$ 161	58	$ 52	$ 50
Other changes in plan assets and benefit obligations recognized in accumulated other comprehensive income (loss):						
Net loss (gain)	1 206	N/A	N/A	(40)	N/A	N/A
Unrecognized transition liability	- -	N/A	N/A	139	N/A	N/A
Total recognized in other comprehensive income (loss)	1 206	N/A	N/A	99	N/A	N/A
Total recognized in net periodic						

benefit cost and other comprehensive income (loss)	$ 1 507	N/A	N/A	$ 157	N/A	N/A

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 $35 thousand. The estimated unrecognized transition liability for the other defined benefit postretirement plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $17 thousand.

Assumptions

	Pension Benefits			Postretirement Benefits		
	2006	2005	2004	2006	2005	2004
		(in thousands)			(in thousands)	
Weighted-average assumptions used to determine net periodic benefit cost:						
Discount rate	6.00%	6.50%	6.50%	6.00%	6.50%	6.75%
Expected return on plan assets	8.00%	8.50%	8.50%	- -	- -	- -
Rate of compensation increase	4.00%	4.00%	4.00%	3.00%	3.00%	3.00%
Weighted-average assumptions used to determine benefit obligations:						
Discount rate	6.00%	6.50%	6.50%	6.00%	6.00%	6.50%
Rate of compensation increase	4.00%	4.00%	4.00%	3.00%	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).

Asset Allocation

The pension plans weighted-average asset allocations at October 31, 2006 and 2005, by asset category are as follows:

Plan Assets at
October 3

	2006	2005
Asset Category		
Equities	63%	61%
Fixed income/cash	37%	39%
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 60% equities and 40% fixed income/cash. The trust fund allocation is reviewed on a quarterly basis and rebalanced back to the original weighting if the actual weighting varies by at least 5% from the target allocation. The investment manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance, for the implementation of the plans 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.

There is no company common stock included in the equity securities of the pension plan at December 31, 2006 and 2005.

Note 8. Employee Benefit Plans (Continued)

Cash Flow

The company expects to contribute $350 thousand to its pension plan in 2007 and $23 thousand to its postretirement plan in 2007.

The following benefit payments, which reflect future service, are expected to be paid:

	Pension Benefits	Other Benefits
	(in thousands)	
2007	$ 219	$ 23
2008	257	25
2009	265	27
2010	260	29
2011	319	31
2012-2016	2 025	160

For measurement purposes, an 8.5% annual rate of increase in per capita health care costs of covered benefits was assumed for 2006, 2005 and 2004, 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% Increase	1% Decrease
	(in thousands)	

Effect on the health care component of the accumulated postretirement benefit obligation	$ 19	$ (20)
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	2	(2)

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.

	December 31, 2006		December 31, 2005		December 31, 2004	
	Average Shares	Per Share Amount	Average Shares	Per Share Amount	Average Shares	Per Share Amount
Basic earnings per share	3 454 961	$1.17	3 460 984	$1.06	3 463 373	$.89
Effect of dilutive securities:						
Stock options	12 948		16 554		2 522	
Diluted earnings per share	3 467 909	$1.16	3 477 538	$1.05	3 465 895	$.89

Shares outstanding have been restated to reflect the 2% stock dividend in 2006 and the 100% stock dividend in 2005.

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 (shares have been restated to reflect the 2% stock dividend declared March 14, 2006 and the 100% stock dividend declared on February 8, 2005) of common stock.

A summary of option activity under the plan as of December 31, 2006, and changes during the year then ended is presented below:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value (in thousands)
Outstanding at beginning of year	75 848	$ 12.76		
Granted	45 889	17.25		
Exercised	- -	- -		
Forfeited	(5 998)	14.88		
	115 739	$ 14.31	8	$ 968

Outstanding at end of year						
Exercisable at end of year	56 540	$	13.86	8	$	520
Weighted average fair value of options granted	$	3.88				

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, 2006. This amount changes 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, 2006:

	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	34 662	7.0	$11.28	21 198	$11.28
14.00	41 186	8.0	14.00	20 052	14.00
17.25	39 891	9.0	17.25	15 290	17.25
	115 739			56 540	

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Note 11. Income Taxes

Net deferred tax assets consist of the following components as of December 31, 2006 and 2005:

	2006	2005
	(in thousands)	
Deferred tax assets:		
Reserve for loan losses	$ 669	$ 580
Accrued pension expense	519	89
Accrued postretirement benefits	175	132
Nonaccrual interest	5	1
Stock option expense	20	- -
Home equity closing costs	61	- -

Securities available for sale		79		142
	$	1 528	$	944
Deferred tax liabilities:				
Net loan origination costs		9		- -
Depreciation		130		123
	$	139	$	123
Net deferred tax assets	$	1 389	$	821

The provision for income taxes charged to operations for the years ended December 31, 2006, 2005 and 2004 consists of the following:

	2006	2005	2004
		(in thousands)	
Current tax expense	$ 2 496	$ 2 061	$ 1 742
Deferred tax expense (benefit)	(190)	(41)	(32)
	$ 2 306	$ 2 020	$ 1 710

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, 2006, 2005 and 2004 due to the following:

	2006	2005	2004
Computed expected tax expense	$ 2 156	$ 1 933	$ 1 632
Increase (decrease) in income taxes resulting from:			
Tax exempt income	(87)	(86)	(75)
State income taxes, net of federal income tax benefit	202	173	149
Other	35	- -	4
	$ 2 306	$ 2 020	$ 1 710

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 has approximately $377 thousand in deposits in other financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) at December 31, 2006.

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, 2006 and 2005, the aggregate amounts of daily average required balances were approximately $300 thousand for each time period.

Note 13. Retained Earnings

Transfers of funds from the banking subsidiary to the parent company in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. As of December 31, 2006, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company, without prior regulatory approval, totaled $6.5 million or 24.3% of the consolidated net assets.

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 contract or notional amounts of those instruments reflect the extent of involvement the company has in particular classes of financial instruments.

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

A summary of the contract or notional amount of the company's exposure to off-balance-sheet risk as of December 31, 2006 and 2005 (in thousands) is as follows:

	2006	2005
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 60 683	$ 63 747
Standby letters of credit	4 750	5 265

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. The majority of these lines of credit is collateralized and usually contains a specified maturity date and may not be drawn upon to the extent to which the company is committed.

Standby letters of credit are conditional commitments issued by the company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar 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, 2006, the company had no rate lock commitments to originate mortgage loans and loans held for sale in the amount of $405 thousand. The company enters into corresponding mandatory commitments, on a best-efforts basis, to sell loans that are held for sale. 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 of Financial Instruments and Interest Rate Risk

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Short-Term Investments

For those short-term instruments, the carrying amount is a reasonable estimate of fair value.

Securities

For securities held for investment purposes, fair values are based on quoted market prices or dealer quotes.

Loans

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

Loans Held for Sale

The carrying amount of loans held for sale approximates 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 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

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

At December 31, 2006 and 2005, the fair value of loan commitments and standby-letters of credit was immaterial.

Note 15. Fair Value of Financial Instruments and Interest Rate Risk (Continued)

The estimated fair values of the company's financial instruments are as follows:

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Cash	$ 6 581	$ 6 581	$ 8 115	$ 8 115
Securities purchased under agreements to resell and federal funds sold	345	345	357	357
Securities available for sale	42 706	42 706	46 951	46 951
Loans, net	227 646	226 928	208 274	206 838
Loans held for sale	405	405	- -	- -
Accrued interest receivable	1 431	1 431	1 152	1 152
Financial liabilities:				
Deposits	251 778	251 823	229 880	229 941
Repurchase agreements	10 526	10 526	19 557	19 557
FHLB advances	620	620	1 005	1 005
Accrued interest payable	672	672	331	331

The company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the company's overall interest rate risk.

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 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, 2006 and 2005, that the company and the bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2006, the most recent notification from the Federal Deposit Insurance Corporation 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. There are no conditions or events since that notification that management believes have changed the institution’s category.

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

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
As of December 31, 2006:						
Total capital (to risk-weighted assets):						
Consolidated	$ 30 154	13.82%	$ 17 455	8.0%	N/A	N/A
Bank of Charles Town	$ 29 695	13.64%	$ 17 421	8.0%	$ 21 776	10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	$ 27 731	12.71%	$ 8 728	4.0%	N/A	N/A
Bank of Charles Town	$ 27 272	12.52%	$ 8 710	4.0%	$ 13 066	6.0%
Tier 1 capital (to average assets):						
Consolidated	$ 27 731	9.34%	$ 11 882	4.0%	N/A	N/A
Bank of Charles Town	$ 27 272	9.20%	$ 11 863	4.0%	$ 14 829	5.0%
As of December 31, 2005:						
Total capital (to risk-weighted assets):						
Consolidated	$ 27 469	13.76%	$ 15 968	8.0%	N/A	N/A
	$ 27 148	13.62%	$ 15 946	8.0%	$ 19 932	10.0%

Bank of Charles Town								
Tier 1 capital (to risk-weighted assets):								
Consolidated	$	25 308	12.68%	$	7 984	4.0%	N/A	N/A
Bank of Charles Town	$	24 987	12.54%	$	7 973	4.0%	$ 11 959	6.0%
Tier 1 capital (to average assets):								
Consolidated	$	25 308	9.18%	$	11 030	4.0%	N/A	N/A
Bank of Charles Town	$	24 987	9.07%	$	11 019	4.0%	$ 13 773	5.0%

Note 17. Parent Company Only Financial Statements

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Balance Sheets
December 31, 2006 and 2005

		2006		2005
ASSETS				
Cash	$	25	$	40
Investment in subsidiary		26 258		24 711
Other assets		434		281
Total Assets	$	26 717	$	25 032
LIABILITIES AND STOCKHOLDERS EQUITY				
LIABILITIES, other	$	- -	$	- -
STOCKHOLDERS EQUITY				
Common stock	$	3 672	$	3 600
Surplus		3 661		2 400
Undivided profits		22 677		21 158
Accumulated other comprehensive (loss)		(1 014)		(276)
	$	28 996	$	26 882
Less cost of shares acquired for the treasury		2 279		1 850
Total Stockholders Equity	$	26 717	$	25 032
Total Liabilities and Stockholders Equity	$	26 717	$	25 032

POTOMAC BANCSHARES, INC.
(Parent Company Only)

Statements of Income
Years Ended December 31, 2006, 2005 and 2004

	2006	2005	2004
Income			
Dividends from subsidiary	$ 1 905	$ 1 487	$ 1 193
Interest income	1	- -	- -
Total Income	$ 1 906	$ 1 487	$ 1 193
Expenses			
Stock compensation expense	$ 112	$ - -	$ - -
Other professional fees	39	34	37
Other operating expenses	56	60	54
Total Expenses	$ 207	$ 94	$ 91
Income before Income Tax (Benefit) and Equity in Undistributed Income of Subsidiary	$ 1 699	$ 1 393	$ 1 102
Income Tax (Benefit)	(51)	(31)	(30)
Income before Equity in Undistributed Income of Subsidiary	$ 1 750	$ 1 424	$ 1 132
Equity in Undistributed Income of Subsidiary	2 285	2 240	1 958
Net Income	$ 4 035	$ 3 664	$ 3 090

Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2006, 2005 and 2004

	2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 4 035	$ 3 664	$ 3 090
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed (income) of subsidiary	(2 285)	(2 240)	(1 958)
Stock compensation expense	112	- -	- -
(Increase) in other assets	(153)	(251)	(5)
(Decrease) in other liabilities	- -	(3)	- -

Net cash provided by operating activities	$ 1 709	$ 1 170	$ 1 127
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash dividends	$ (1 295)	$ (1 137)	$ (1 002)
Purchase of treasury shares	(429)	- -	(141)
Net cash (used in) financing activities	$ (1 724)	$ (1 137)	$ (1 143)
Increase (decrease) in cash and cash equivalents	$ (15)	$ 33	$ (16)
CASH AND CASH EQUIVALENTS			
Beginning	40	7	23
Ending	$ 25	$ 40	$ 7

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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.

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.

Item 9B. Other Information.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information contained on pages 7-8 of the Proxy Statement dated March 26, 2007, for the April 24, 2007 Annual Meeting under the captions "Management Nominees to the Board of Potomac" and "Directors Continuing to Serve Unexpired Terms," and page 19 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	48	Employed by bank as of 1/1/01 as President and CEO.

David W. Irvin	Executive Vice President 2004	43	Employed at bank from 2001 to present as Commercial Loan Division Manager.
Gayle Marshall Johnson	Sr. Vice President & Chief Financial Officer 1994	57	Employed with the bank 1977-1985 and 1988-present; Vice President and Chief Financial Officer since 1990. Sr. Vice President since 2005.
Donald S. Smith	Vice President 1994	78	Employed at bank 1947 to 1991; President 1979 to 1991 (retired).

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 10-15 and page 17 of the Proxy Statement dated March 26, 2007, for the April 24, 2007 Annual Meeting under the captions "Compensation Discussion and Analysis of Executive Compensation," "Termination and Change in Control Payments," "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 8-10 of the Proxy Statement dated March 26, 2007, for the April 24, 2007 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 approved by shareholders			

May 13, 2003	115 739	$14.31	67 861

Item 13. Certain Relationships and Related Transactions.

The information contained on pages 17-18 of the Proxy Statement dated March 26, 2007, for the April 24, 2007 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 26, 2007, for the April 24, 2007 Annual Meeting under the caption Audit Committee Report is incorporated herein by reference.

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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 and incorporated by reference from the Registration Statement on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

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

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

10.1 2003 Stock Incentive Plan adopted by the Potomac Board February 20, 2003 and approved by the Company s shareholders on May 13, 2003 and incorporated by reference from Potomac s Form 10-KSB for the year ended December 31, 2003 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 Accountants*

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 2007 Annual Meeting for Potomac, portions are incorporated by reference in Form 10-K Annual Report*

* 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. March 26, 2007
Robert F. Baronner, Jr.
President & Chief Executive Officer

By /s/ Gayle Marshall Johnson March 26, 2007
Gayle Marshall Johnson
Sr. Vice President & Chief Financial Officer

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

	Signature & Title	Date
By	/s/ J. Scott Boyd J. Scott Boyd, Director	March 26, 2007
By	/s/ John P. Burns, Jr. John P. Burns, Jr., Director	March 26, 2007
By	/s/ Guy Gareth Chicchirichi Guy Gareth Chicchirichi, Director	March 26, 2007

By	/s/ Margaret Cogswell Margaret Cogswell, Director	March 26, 2007
By	/s/ Thomas C. G. Coyle Thomas C. G. Coyle, Director	March 26, 2007
By	/s/ William R. Harner William R. Harner, Director	March 26, 2007

Signature & Title		Date
By	/s/ E. William Johnson E. William Johnson, Director	March 26, 2007
By	/s/ Barbara H. Pichot Barbara H. Pichot, Director	March 26, 2007
By	/s/ John C. Skinner, Jr. John C. Skinner, Jr., Director	March 26, 2007
By	/s/ Donald S. Smith Donald S. Smith, Director	March 26, 2007
By	/s/ C. Larry Togans C. Larry Togans, Director	March 26, 2007