POTOMAC BANCSHARES INC
Form 10-K
March 31, 2010

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, 2009

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

For the transition period from __________ to __________

Commission File Number 0-24958

POTOMAC BANCSHARES, INC.
(Exact Name of Registrant as Specified in Its Charter)

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

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

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

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

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

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No XX

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes No XX

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes No

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K (§ 228.405) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ___

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

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

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

State the aggregate market value of the voting and non-voting common equity held by nonaffiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $26,258,640 as of June 30, 2009

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
3,390,178 as of March 12, 2010

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 2010 Annual Meeting of Shareholders which proxy statement will be filed on or about March 30, 2010.	Part III, Items 10, 11, 12, 13 and 14

Potomac Bancshares, Inc.
Annual Report on Form 10-K
For the Year Ended December 31, 2009

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* The information required by Items 10, 11, 12, 13 and 14, to the extent not included in this document, is incorporated herein by reference to the information included under the captions "Management Nominees to the Board of Potomac," "Directors Continuing to Serve Unexpired Terms," "Section 16(a) Beneficial Ownership Reporting Compliance," "Executive Compensation," "Employee Benefit Plans," "Compensation of Directors," "Ownership of Securities by Nominees, Directors and Officers," "Certain Transactions with Directors, Officers and Their Associates" and "Audit Committee Report" in the registrant's definitive proxy statement which is expected to be filed on or about March 30, 2010.

FORWARD-LOOKING STATEMENTS

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

The risks and uncertainties that may affect the operations, performance, development and results of the company's business include, but are not limited to, the growth of the economy, interest rate movements, the impact of competitive products, services and pricing, customer business requirements, the current economic environment posing significant challenges and affecting our financial condition and results of operations, the possibility of future FDIC assessments, Congressional legislation and similar matters. We caution readers of this report not to place undue reliance on forward-looking statements which are subject to influence by unanticipated future events. Actual results, accordingly, may differ

materially from management expectations.

PART I

Item 1. Business.

History and Operations

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

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

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

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

- Commercial credit lines, equipment loans, and construction financing,
- Real estate loans, secondary market and adjustable rate mortgages,
- Retail loan products including home equity lines of credit,
- Checking and savings accounts for businesses and individuals and
- Certificates of deposit and individual retirement accounts.

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

Lending Activities. 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 a balance between maximum yield and minimum risk. It is the bank’s policy to avoid concentrations of loans such as loans to one industry, loans to one borrower or guarantor or loans secured by similar collateral.

The bank's loan policy designates particular loan-to-value limits for real estate loans in accordance with recommendations in Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991. As stated in the loan policy, there may be certain lending situations not subject to these loan-to-value limits and from time to time 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 91.9% of the bank's loans are secured by real estate. These loans had an average delinquency rate of 2.92% and a loss rate of 2.04% during 2009. The average delinquency rate and loss rate are based on comparisons to 2009 average total loans.

As of December 31, 2009 aggregate dollar amounts (in thousands) in loan categories secured by real estate are as follows:

● Construction and land development	$	38 083
● Secured by farmland		1 419
● Secured by 1-4 family residential		102 290
● Secured by multifamily residential		2 070
● Secured by nonfarm nonresidential		71 916
	$	215 778

Commercial loans not secured by real estate with an aggregate balance of $9.7 million at December 31, 2009 make up approximately 4.1% 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 and the loss rate for commercial loans not secured by real estate were less than 1% during 2009 compared to 2009 average total loans.

Retail loans to individuals for personal expenditures are approximately 3.8% of the bank's total loans at December 31, 2009. The aggregate balance of these loans was $9 million at December 31, 2009. 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 0.06% and a loss rate of 0.07% in 2009 (based on comparisons to 2009 average total loans).

All other loans total $222 thousand (0.09% of total loans) at December 31, 2009. These loans had no delinquency rate and no average loss rate in 2009 compared to 2009 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 A or fully insured bonds or (4) obligations of states other than West Virginia and political subdivisions thereof with a rating of not less than A or fully insured bonds.

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

Deposit Activities. The bank offers noninterest-bearing and interest-bearing checking accounts and savings accounts. The bank offers automatically renewable certificates of deposit in various terms from 91 days to five years. The bank is also a participant in the CDARS program. The CDARS program offers certificates of deposit in various terms from four weeks 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 an account with a person at least 18 years of age.

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

Competition

As of March 1, 2010, there were 64 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, 2009, there were six banks in Jefferson County with 16 banking offices. The total deposits of these commercial banks as of June 30, 2009 were $667 million, and the bank ranked number one in total deposits with $216 million or 32.41 % of the total deposits in the market at that time. The bank has two branch offices in Berkeley County. Opening in July 2001 and June 2003, these branches have 4.28 % of the market share of deposits in Berkeley County where there are 11 banks with 31 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. 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, 2010, the bank had 91 full-time employees and 12 part-time employees.

Supervision and Regulation

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

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

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

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

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

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

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, 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, 2009, Potomac had capital in excess of all applicable requirements as shown below:

	Actual (in thousands)	Required	Excess
Tier 1 capital:			
Common stock	$ 3,672		
Surplus	3,898		
Retained earnings	21,931		
	29,501		
Less cost of shares acquired for the treasury	2,866		
Total tier 1 capital	$ 26,635	$ 9,144	$ 17,491
Tier 2 capital:			
Allowance for loan losses (1)	2893		
Total risk-based capital	$ 29,528	$ 18,289	$ 11,239
Risk-weighted assets	$ 228,607		
Tier 1 capital	$ 26,635	$ 12,181	$ 14,454
Average total assets	$ 304,527		
Capital ratios:			
Tier 1 risk-based capital ratio	11.65%	4.00%	7.65%
Total risk-based capital ratio	12.92%	8.00%	4.92%
Tier 1 capital to average total assets (leverage)	8.75%	4.00%	4.75%

(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 1930's. Under the Act, banks, insurance companies, securities firms and other service providers may now affiliate. In addition to broadening the powers of banks, the Act created a new form of entity, called a financial holding company, which may engage in any activity that is financial in nature or incidental or complementary to financial activities.

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

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

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

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

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

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

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

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

Effective August 29, 2002, as directed by Section 302(a) of Sarbanes-Oxley, Potomac's chief executive officer and chief financial officer are each required to certify that Potomac's Quarterly and Annual Reports do not contain any untrue statement of a material fact. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of Potomac's internal controls; they have made certain disclosures to Potomac's auditors and the audit committee of the Board of Directors about Potomac's internal controls; and they have included information in Potomac's Quarterly and Annual Reports about their evaluation and whether there have been significant changes in Potomac's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. Effective in 2010, Potomac will be subject to the Auditor's Opinion on internal control portion of Section 404 of Sarbanes-Oxley.

Troubled Asset Relief Program – Capital Purchase ProgramOn October 3, 2008, the Federal government enacted the Emergency Economic Stabilization Act of 2008 ("EESA"). EESA was enacted to provide liquidity to the U.S. financial system and lessen the impact of looming economic problems. The EESA included broad authority. The centerpiece of the EESA is the Troubled Asset Relief Program ("TARP"). EESA's broad authority was interpreted to allow the U.S. Treasury to purchase equity interests in both healthy and troubled financial institutions. The equity purchase program is commonly referred to as the Capital Purchase Program ("CPP"). Management and our Board of Directors have done a thorough evaluation of both the positive and negative aspects of the CPP. In the end, we came to the conclusion that based on our strong capital position, earnings capacity, and the fact that it would dilute the earnings of existing shareholders we have decided not to participate in the CPP.

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

Future Legislation. Various other legislative and regulatory initiatives, including proposals to overhaul the banking regulatory system and to limit the investments that a depository institution may make with insured funds, are from time to time introduced in Congress and state legislatures, as well as regulatory agencies. Such legislation may change banking statutes and the operating environment of the company and the bank in substantial and unpredictable ways, and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance depending upon whether any of this potential legislation will be enacted, and if enacted, the effect that it or any implementing regulations, would have on the financial condition or results of operations of the company or the bank. With the recent enactments of EESA and ARRA, the nature and extent of future legislative and regulatory changes affecting financial institutions is very unpredictable at this time. The company cannot determine the ultimate effect that such potential legislation, if enacted, would have upon its financial condition or operations.

New legislation proposed by Congress may give bankruptcy courts the power to reduce the increasing number of home foreclosures by giving bankruptcy judges the authority to restructure mortgages and reduce a borrower's payments. Property owners would be allowed to keep their property while working out their debts. Other similar bills placing additional temporary moratoriums on foreclosure sales or otherwise modifying foreclosure procedures to the benefit of borrowers and the detriment of lenders may be enacted by either Congress or the State of West Virginia in the future. These laws may further restrict our collection efforts on one-to-four single-family mortgage loans. Additional legislation proposed or under consideration in Congress would give current debit and credit card holders the chance to opt out of an overdraft protection program and limit overdraft fees, which could result in additional operational costs and a reduction in our non-interest income.

Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. In this regard, banking regulators are considering additional regulations governing compensation, which may adversely affect our ability to attract and retain employees. On June 17, 2009, the Obama Administration published a comprehensive regulatory reform plan that is intended to modernize and protect the integrity of the United States financial system. The President's plan contains several elements that would have a direct effect on us. The reform plan proposes the creation of a new federal agency, the Consumer Financial Protection Agency, which would be dedicated to protecting consumers in the financial products and services market. The creation of this agency could result in new regulatory requirements and raise the cost of regulatory compliance. In addition, legislation stemming from the reform plan could require changes in regulatory capital requirements, and compensation practices. If implemented, the foregoing regulatory reforms may have a material impact on our operations. However, because the legislation needed to implement the President's reform plan has not been introduced, and because the final legislation may differ significantly from the legislation proposed by the Administration, we cannot determine the specific impact of regulatory reform at this time.

Available Information. The company files annual, quarterly and current reports, proxy statements and other information with the SEC. The company’s SEC filings are filed electronically and are available to the public through the Internet at the SEC’s website at http://www.sec.gov. In addition, any document filed by the company with the SEC can be read and copied at the SEC’s public reference facilities at 100 F Street, NE, Washington, DC 20549. Copies of documents can be obtained at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Copies of documents can also be obtained free of charge by any shareholder by writing to Gayle Marshall Johnson, Sr. Vice President and Chief Financial Officer, Potomac Bancshares, Inc., PO Box 906, Charles Town, WV 25414.

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, Martinsburg and Hedgesville. The bank also owns a lot at the corner of Route 340 and Washington Street in Bolivar that may be used for future expansion or may be sold.

The main office property is located at 111 East Washington Street, Charles Town, West Virginia. This property consists of two separate two story buildings located side by side with adjoining corridors. During 2000, the construction of the newer of these two buildings was completed. The first floor of the new building houses the bank’s One Financial Center. The second floor of the new building houses certain administrative and loan offices. Both of these floors open into the older bank premises, constructed in 1967. In July of 2006, the bank completed the purchase of a property adjacent to the main office for future expansion. In early 2008, construction began on an addition to the main office facilities which was completed in 2009. The new addition houses a new drive through with five lanes (one ATM/night deposit lane and four transaction lanes), the call center, the Information Technology and Deposit Operations departments and certain administrative offices. Renovations to the existing two buildings were completed along with the addition. In September 2009, the Finance Department relocated from the leased space in Burr Industrial Park to a part of the renovated main office building.

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 provides record storage facilities and a business recovery site for the bank.

The Harpers Ferry branch office is located at 1366 W. Washington Street, Bolivar, West Virginia. The office is a one story brick building constructed in 1975 and renovated in 2005. There is another building on this property that existed at the time of the bank's purchase. This separate building is rented to an outside party by the bank.

The branch facility at 5480 Charles Town Road, Kearneysville, West Virginia was erected in 1985. This one story brick building opened for business in April of 1985. During 1993, an addition was constructed, doubling the size of this facility. Renovation of these facilities was completed in 2006.

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

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

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

Item 3. Legal Proceedings.

Currently Potomac is involved in no legal proceedings.

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

Item 4. (Removed and Reserved).

PART II

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

The following information reflects comparative per share data for the periods indicated for Potomac common stock for (a) trading values and (b) dividends. As of March 12, 2010, there were approximately 1,100 shareholders.

Trading of Potomac Bancshares, Inc. common stock is not extensive and cannot be described as a public trading market. Potomac Bancshares, Inc. is on the OTC Bulletin Board Market. To gather information about Potomac in this market use Potomac’s symbol PTBS.OB. Scott and Stringfellow, Inc., and Koonce Securities Inc. are market makers for Potomac’s stock. Market makers are firms that maintain a firm bid and ask price for a given number of shares at a given point in time in a given security by standing ready to buy or sell at publicly quoted prices. Information about sales of Potomac’s stock is available on the Internet through many of the stock information services using Potomac’s symbol. Shares of Potomac common stock are occasionally bought and sold by private individuals, firms or corporations, and, in most instances, Potomac does not have knowledge of the purchase price or the terms of the purchase. The trading values for 2008 and 2009 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	
2008	First Quarter	$ 13.75	$ 12.00	$ .1100
	Second Quarter	14.00	12.00	.1125
	Third Quarter	12.20	10.15	.1150
	Fourth Quarter	11.10	8.00	.1175
2009	First Quarter	$ 10.10	$ 7.50	$ .1175
	Second Quarter	9.50	6.60	.1175
	Third Quarter	8.00	5.35	.0300
	Fourth Quarter	6.34	5.75	.0000

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

Performance Graph

The following graph compares the yearly percentage change in Potomac’s cumulative total shareholder return on common stock for the five-year period ending December 31, 2009, with the cumulative total return of the Bank Holding Companies Index (SIC Code 6712) and the Morningstar Index. Shareholders may obtain a copy of the index by calling Morningstar, Inc. at telephone number (312) 384-4055. There is no assurance that Potomac’s stock performance will continue in the future with the same or similar trends as depicted in the graph.

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

COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN
AMONG POTOMAC BANCSHARES, INC., BANK HOLDING COMPANIES INDEX AND MORNINGSTAR INDEX

ASSUMES $100 WAS INVESTED ON JANUARY 1, 2005 AND ASSUMES DIVIDENDS WERE REINVESTED THROUGH FISCAL YEAR ENDING DECEMBER 31, 2009

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Programs	(d) Maximum Number of Shares that May Yet be Purchased Under the Program
October 1 through October 31	NONE	$ - -	283 553	62 515
November 1 through November 30	NONE	- -	283 553	62 515
December 1 through December 31	NONE	- -	283 553	62 515

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

Item 6. Selected Financial Data.

	2009	2008	2007	2006	2005
	(Dollars in Thousands Except Per Share Data)				
Summary of Operations					
Interest income	$ 14 913	$ 17 358	$ 19 691	$ 19 099	$ 15 424
Interest expense	5 121	6 477	8 161	6 932	4135
Net interest income	9 792	10 881	11 530	12 167	11 289
Provision for loan losses	6 690	2 934	678	331	330
Net interest income after provision for loan losses	3 102	7 947	10 852	11 836	10 959
Noninterest income	4 281	4 355	4 379	3 766	3 185
Noninterest expense	11 059	9 587	9 703	9 261	8 460
Income (loss) before income taxes	(3 676)	2 715	5 528	6 341	5 684
Income tax expense (benefit)	(1 436)	853	1 998	2 306	2 020
Net income (loss)	$ (2 240)	$ 1 862	$ 3 530	$ 4 035	$ 3 664
Per Share Data **					
Net income (loss), basic	$ (.66)	$ .55	$ 1.03	$ 1.17	$ 1.06
Net income (loss), diluted	(.66)	.55	1.03	1.16	1.05
Cash dividends declared	.27	.46	.42	.38	.33
Book value at period end	7.54	8.19	8.52	7.78	7.23
Weighted-average shares outstanding, basic	3 390 516	3 401 717	3 423 239	3 454 961	3 460 984
Weighted-average shares outstanding, diluted	3 390 516	3 403 265	3 430 764	3 467 918	3 477 538
Average Balance Sheet Summary					
Assets	$ 304 739	$ 303 749	$ 297 716	$ 289 303	$ 264 314
Loans	239 175	232 894	226 773	220 895	196 478
Securities	32 841	34 178	42 040	48 891	47 183
Deposits	261 233	259 536	252 908	243 833	217 307
Stockholders' equity	26 266	30 118	28 207	26 632	23 822
Performance Ratios					
Return (loss) on average assets	(0.74)%	0.61%	1.19%	1.39%	1.39%
Return (loss) on average equity	(8.53)%	6.18%	12.51%	15.15%	15.38%
Dividend payout ratio	(40.91)%	83.64%	40.78%	32.48%	31.13%
Capital Ratios					
Leverage ratio	8.75%	9.85%	9.99%	9.34%	9.18%
Risk-based capital ratios					
Tier 1 capital	11.65%	12.37%	13.01%	12.71%	12.68%
Total capital	12.92%	13.63%	14.23%	13.82%	13.76%

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

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.

	2009 Average Balances (in thousands)	Income/ Expense	Average Yield/Rate	2008 Average Balances (in thousands)	Income/ Expense	Average Yield/Rate	2007 Average Balances (in thousands)	Income/ Expense	Average Yield/Rate
ASSETS									
Loans									
Taxable	$ 238 493	$ 13 759	5.77%	$ 232 124	$ 15 151	6.53%	$ 225 876	$ 16 971	7.51%
Tax exempt	682	64	9.38%	770	73	9.48%	897	76	8.47%
Total loans	239 175	13 823	5.78%	232 894	15 224	6.54%	226 773	17 047	7.52%
Taxable securities	29 084	933	3.21%	31 286	1 415	4.52%	40 112	1 894	4.72%
Nontaxable securities	3 757	224	5.96%	2 892	167	5.77%	1 928	112	5.81%
Federal funds sold	4 049	7	0.17%	10 712	249	2.32%	8 226	435	5.29%
Other earning assets	3 125	24	0.77%	7 765	383	4.93%	4 616	267	5.78%
Total earning assets	279 190	$ 15 011	5.38%	285 549	$ 17 438	6.11%	281 655	$ 19 755	7.01%
Allowance for loan losses	(4 776)			(2 940)			(2 433)		
Cash and due from banks	6 850			4 396			5 140		
Premises and equipment, net	8 650			6 934			6 342		
Other assets	14 825			9 810			7 012		
Total assets	$ 304 739			$ 303 749			$ 297 716		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits									
Savings and interest-bearing demand deposits	$ 119 504	$ 1 016	0.85%	$ 120 853	$ 1 615	1.34%	$ 119 142	$ 2 713	2.28%
Time deposits	115 239	3 756	3.26%	111 574	4 547	4.08%	106 778	4 983	4.67%
Total interest-bearing deposits	234 743	4 772	2.03%	232 427	6 162	2.65%	225 920	7 696	3.41%
Securities sold under agreements to repurchase and federal funds purchased	9 212	148	1.61%	9 963	255	2.56%	10 959	441	4.02%
Advances from FHLB and FRB	4 336	201	4.64%	1 381	60	4.34%	416	24	5.77%
Total interest bearing liabilities	248 291	$ 5 121	2.06%	243 771	$ 6 477	2.66%	237 295	$ 8 161	3.44%
Noninterest-bearing demand deposits	26 490			27 109			28 988		
Other liabilities	3 692			2 751			3 226		
Stockholders' equity	26 266			30 118			28 207		
Total liabilities and stockholders' equity	$ 304 739			$ 303 749			$ 297 716		
Net interest income		$ 9 890			$ 10 961			$ 11 594	
Net interest spread			3.32%			3.45%			3.57%
Interest expense as a percent of average earning assets			1.83%			2.27%			2.90%
Net interest margin			3.54%			3.84%			4.12%

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) which requires that estimated losses be accrued when they are probable of occurring and (ii) 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 or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for 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

If management were to describe 2009 in one word that word would be "change." The company experienced plenty of change during the year. Our correspondent banks changed. Management and the board of directors were faced with situations they had not been accustomed to facing. Once again, the regulatory environment changed focus to respond to the most recent events that have affected the United States economy.

The bank's primary correspondent, Silverton Bank, was taken into receivership in May 2009 by the FDIC. The FDIC was unable to find a suitable company to take over operations, and Silverton Bank terminated operations in July 2009. Fortunately, after researching various possibilities, we were able to form a relationship with CenterState Bank, a strongly capitalized bank providing correspondent services. CenterState Bank now provides most all of the services we received from Silverton Bank with the exception of international wires. M & T Bank provides international wire service to the bank and may provide additional services in the future.

Management faced some new challenges during 2009. We expected foreclosures to increase during the year. However, the rate of foreclosures and expenses related to preparing the properties for sale were higher than originally anticipated. Management was aware of the large percentage of commercial loans that were tied to real estate and the risk involved. One of the most difficult scenarios to predict was the "trickle down" effect of the housing market to the mortgage side of our business. As the economy slowly worsened, so did the job market. With more people out of work for longer periods of time, the bank saw an unprecedented increase in mortgage foreclosures. These and other factors, such as tighter lending policies and lower housing values, affected income and capital. As a result, the board of directors decided to reduce and then suspend dividends during the third and fourth quarters of the year.

The Federal Reserve finally accumulated enough data to officially consider the economy in recession during 2009. The result has been a myriad of discussions as to how to bring the economy out of the recession. As is generally the case, the government has proposed and/or passed new regulations to fix the newest problems. The FDIC has become more focused on liquidity and capital. Currently, the company is well capitalized and the liquidity position has improved with the efforts and decision making of management and the board of directors. Currently, management is holding larger amounts in cash and liquid assets as opposed to longer term investments. Liquidity would have been even better except for the effect of the FDIC assessment prepayment. The FDIC decided to require banks to prepay their assessment for the next three years by December 30, 2009. This affected the cash position of the bank in that the cash paid could have been kept on hand or invested in liquid assets.

The following table sets forth selected quarterly results (with dollars in thousands) of the company for 2009 and 2008.

	2009 Three Months Ended				2008 Three Months Ended			
	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31
Interest income	$ 3 594	$ 3 704	$ 3 805	$ 3 810	$ 4 171	$ 4 198	$ 4 318	$ 4 671
Interest expense	1 208	1 228	1 300	1 385	1 462	1 464	1 644	1 907
Net interest income	2 386	2 476	2 505	2 425	2 709	2 734	2674	2 764
Provision for loan losses	13	3 540	1 560	1 577	1 371	1 134	276	153
Net interest income (loss) after provision for loan losses	2 373	(1 064)	945	848	1 338	1 600	2 398	2 611
Noninterest income	1 619	1 369	1 047	1 022	923	1 048	1 334	1 050
Noninterest expense	2 973	3 102	3 134	2 626	2 614	2 453	2 237	2 283
Income (loss) before taxes	1 019	(2 797)	(1 142)	(756)	(353)	195	1 495	1 378
Income tax expense (benefit)	614	(1 204)	(508)	(338)	(129)	23	472	487
Net income (loss)	$ 405	$ (1 593)	$ (634)	$ (418)	$ (224)	$ 172	$ 1 023	$ 891
Earnings (loss) per share, basic and diluted	$ .12	$ (.47)	$ (.19)	$ (.12)	$ (.07)	$ .05	$ .30	$ .26

NET INTEREST INCOME

The economic downturn in 2008 turned into a recession in 2009. Overall, interest and dividend income was 14% lower in 2009 when compared with 2008 results, due in part to some lowering of balances of all interest earning assets, but due more to the interest rates remaining historically low throughout the year. Earning assets include loans, securities, federal funds sold and other investments. We have not received dividends on Federal Home Loan Bank stock since the third quarter of 2008. Interest income on tax exempt bonds did increase in 2009 predominantly as a result of a larger investment in municipal bonds compared to 2008.

The economy worsened, as expected, during 2008. In spite of the economy, the loan portfolio (net of reserves) increased 9% on the strength of increases mainly in the commercial loan area. The bulk of the increase was related to participations and other portfolio loans as a result of our relationship with BlueRidge Bank. Still, net interest income decreased 6% as the interest rates continued to drop throughout 2008. Interest on tax exempt securities and other interest and dividends showed increases. The tax exempt securities portfolio increased through new purchases at the end of 2007 and in 2008 and other interest benefited from interest on loans held to sell to BlueRidge Bank during the time they were waiting to receive their charter.

Interest expense decreased 21% in 2009 compared to 2008. Coincidentally, this is the same percentage of decrease in interest expense from 2007 to 2008. The decreased expense for 2009 and 2008 results from lower interest rates as balances in deposit accounts have not changed materially during that time period. The continuance of low rates is precipitated by the rates enacted by the Federal Reserve during the period.

Calendar year 2009 ended with just as much uncertainty as 2008. The housing market is showing some signs of improvement. However, the recovery is expected to continue at a very slow pace. Unemployment is probably the biggest concern as we look toward 2010. Interest rates are expected to remain at current levels throughout most of 2010. Management is hopeful that interest rates and the volume of affordable housing will entice buyers back into the loan market during 2010.

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.

	2009 Compared to 2008 (in thousands)			2008 Compared to 2007 (in thousands)		
	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect
INTEREST INCOME						
Taxable loans	$ (1 392)	$ 430	$ (1 822)	$ (1 820)	$ 490	$ (2 310)
Tax exempt loans	(9)	(8)	(1)	(3)	(19)	16
Taxable securities	(482)	(95)	(387)	(479)	(402)	(77)
Nontaxable securities	57	52	5	55	56	(1)
Federal funds sold	(242)	(97)	(145)	(186)	217	(403)
Other earning assets	(359)	(149)	(210)	116	148	(32)
TOTAL	$ (2 427)	$ 133	$ (2 560)	$ (2 317)	$ 490	$ (2 807)
INTEREST EXPENSE						
Savings and interest-bearing demand deposits	$ (599)	$ (18)	$ (581)	$ (1 098)	$ 40	$ (1 138)
Time deposits	(791)	155	(946)	(436)	241	(677)
Securities sold under agreements to repurchase and federal funds purchased	(107)	(18)	(89)	(186)	(37)	(149)
Advances from FHLB and FRB	141	137	4	36	40	(4)
TOTAL	$ (1 356)	$ 256	$ (1 612)	$ (1 684)	$ 284	$ (1 968)
NET INTEREST INCOME	$ (1 071)	$ (123)	$ (948)	$ (633)	$ 206	$ (839)

NONINTEREST INCOME AND EXPENSE

As in prior years, fees generated through the bank’s overdraft protection plan continue to be the largest single contributor to the bank’s noninterest income. These fees are included in the service charges on deposit accounts category which totaled $2.2 million for 2009, $2.3 million for 2008 and $2.1 million for 2007. Trust and financial services income, generally the second largest single contributor to noninterest income, decreased slightly in 2009 compared to 2008 due to lower market values which are the basis for fees. VISA/MC fees, typically the third largest single contributor to noninterest income, increased 9.1% in 2009 compared to 2008 due to continuing consumer comfort with electronic transactions and more customers using the Smart Checking product.

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 $167 thousand in 2009, $93 thousand in 2008 and $197 thousand in 2007.

Salaries and employee benefits of $5.4 million are about 45% of the total noninterest expense for 2009, a percentage about 9% less when compared to 2008 and 2007. This decrease in salaries and benefits as a percentage of total noninterest expense is due to the increase in total noninterest expense resulting from foreclosures and other real estate related expenses. 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 2010, salaries and employee benefits are expected to stay steady or decrease slightly. Some decrease may occur through retirement and attrition. As employees leave, their positions may not be replaced based on management’s assessment of personnel. Due to freezing the pension plan as of October 31, 2009, pension expense will be reduced in 2010 since no further service costs or salary increases for employees are taken into consideration from October 31, 2009 forward. Group health insurance expense is expected to increase slightly and 401(k) expenses will increase as a result of an increased employer match happening in conjunction with the freezing of the pension plan.

Expenses related to premises and furniture and equipment have increased slightly. The increase is attributable to completion of the Donald S. Smith Financial Center addition to the main branch facility. Advertising and marketing expense decreased 33.8% during 2009. The decrease is in line with management's effort to control costs. The FDIC assessment increased due to the special assessment and to the current risk based assessment procedures. Foreclosed property expense increased significantly in 2009 as a result of increased numbers of properties, expenses to prepare these properties for selling and holding costs for properties that have not sold.

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

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, 2009 (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	$ 36 919	$ 15 315	$ 90 041	$ 92 436	$ - -
Securities	- -	1 005	28 416	3 792	1 100
Federal funds sold	5 950	- -	- -	- -	- -
Other earning assets	53	- -	- -	- -	- -
Total	$ 42 922	$ 16 320	$ 118 457	$ 96 228	$ 1 100
Interest-Bearing Liabilities:					
Time deposits $100,000 and over	$ 4 607	$ 9 020	$ 31 090	$ - -	$ - -
Other time deposits	9 684	29 850	30 304	- -	- -
Interest bearing demand deposits	49 000	- -	- -	- -	34 516
Savings accounts	- -	- -	- -	- -	38 443
Securities sold under agreements to repurchase	7 340	- -	- -	- -	- -
Federal Home Loan Bank advances	237	727	2 892	- -	- -
Total	$ 70 868	$ 39 597	$ 64 286	$ - -	$ 72 959
Rate Sensitivity Gap	$ (27 946)	$ (23 277)	$ 54 171	$ 96 228	
Cumulative Gap	$ (27 946)	$ (51 223)	$ 2 948	$ 99 176	

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.

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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 2010, $27.9 million more liabilities may reprice or will mature than assets. During April through December of 2010, $23.3 million more liabilities may reprice or will mature than assets. The total effect for 2010 is that $51.2 million more liabilities may reprice or mature than assets. Since rates are not expected to change much during 2010, the management will hold deposit rates steady for the most part and insert floors in loans to help guard the bank's income.

LOAN PORTFOLIO

Loans at December 31 (in thousands) for each of the five years in the period ended 2009.

	2009	2008	2007	2006	2005
Commercial, financial and agricultural	$ 9 700	$ 9 671	$ 4 987	$ 4 247	$ 6 046
Mortgage loans on real estate:					
Construction and land development	38 083	55 843	55 042	53 801	41 174
Secured by farm land	1 419	1 380	1 328	1 557	2 381
Secured by 1-4 family residential	102 290	101 253	98 864	103 983	98 408
Secured by multifamily residential	2 070	1 937	1 749	3 733	3 486
Secured by nonfarm nonresidential	71 916	63 943	47 726	46 367	43 019
Consumer loans	9 011	11 970	14 718	16 089	15 549
All other loans	222	457	193	292	372
	$ 234 711	$ 246 454	$ 224 607	$ 230 069	$ 210 435

Due in large part to the state of the real estate market and the resulting economic conditions, the loan portfolio decreased in 2009 compared to the balance at the end of 2008. Guidelines for granting credit have tightened, property appraisals, in many cases, came in lower than expected and a very tentative buyers' market have all contributed to the decline in loans.

The bank is projecting and thus has budgeted for an additional decrease in loans during 2010. The economy is expected to continue recovering at a slow pace and unemployment may be the biggest problem in 2010.

There were no categories of loans that exceeded 10% of outstanding loans at December 31, 2009 that were not disclosed in the table above.

REMAINING MATURITIES OF SELECTED LOANS (in thousands)

At December 31, 2009	Commercial, Financial and Agricultural	Real Estate- Construction
Loans maturing within one year	$ 2 106	$ 19 814
Variable rate loans due after one year	1 182	6 686
Fixed rate loans due after one year through five years	6 296	7 070
Fixed rate loans due after five years	116	4 513
Total maturities	$ 9 700	$ 38 083

ALLOWANCE FOR LOAN LOSSES

The table shown on the next page 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. Increases to the allowance were made in 2008 based on the increased risks assessed in the loan portfolio as a result of the housing market conditions and the economic slowdown. Substantial increases were again made to the allowance in 2009, as assessments of the loan portfolio continued to show increased risks. During 2009 and much of 2008, management has monitored the risk in the portfolio almost continually with reporting on a monthly basis compared to the quarterly reporting done previously. Based on experience, the loan policies and the current monitoring program, management believes the allowance for loan losses is adequate but continues to monitor closely and to prepare reporting monthly.

	2009 (in thousands)	2008	2007	2006	2005
Balance at beginning of period	$ 4 079	$ 2 779	$ 2 423	$ 2 161	$ 1 966
Charge-offs:					
Commercial, financial and agricultural	23	21	14	- -	30
Real estate – construction	3 957	269	32	- -	- -
Real estate – mortgage	920	1 102	206	- -	- -
Consumer	383	441	252	207	218
Total charge-offs	5 283	1 833	504	207	248
Recoveries:					
Commercial, financial and agricultural	5	- -	30	- -	- -
Real estate – construction	- -	- -	- -	- -	- -
Real estate – mortgage	2	17	- -	- -	- -
Consumer	225	182	152	138	113
Total recoveries	232	199	182	138	113
Net charge-offs	5 051	1 634	322	69	135
Additions charged to operations	6 690	2 934	678	331	330
Balance at end of period	$ 5 718	$ 4 079	$ 2 779	$ 2 423	$ 2 161
Ratio of net charge-offs during the period to average loans outstanding during the period	2.11%	0.70%	0.14%	0.03%	0.07%

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.

	2009 Allowance (in thousands)	% Loans in Category to Total Loans	2008 Allowance (in thousands)	% Loans in Category to Total Loans	2007 Allowance (in thousands)	% Loans in Category to Total Loans	2006 Allowance (in thousands)	% Loans in Category to Total Loans	2005 Allowance (in thousands)	% Loans in Category to Total Loans
Commercial, financial and agricultural	$ 425	4.13%	$ 69	3.92%	$ 35	2.22%	$ 71	1.85%	$ 94	2.87%
Mortgage loans on real estate:										
Construction and land development	2 328	16.23%	2 182	26.63%	1 025	24.50%	820	23.38%	538	19.57%
Secured by farm land	107	.60%	76	.56%	9	.59%	12	.68%	17	1.13%
Secured by 1-4 family residential	1 255	43.58%	845	39.38%	924	44.02%	753	45.20%	696	46.76%
Secured by multi-family residential	20	.88%	16	.79%	13	.78%	27	1.62%	25	1.66%
Secured by nonfarm nonresidential	1 275	30.64%	727	23.67%	661	21.25%	478	20.15%	477	20.44%
Consumer loans	146	3.84%	90	4.86%	111	6.55%	248	6.99%	261	7.39%
All other loans	- -	.10%	4	.19%	1	.09%	1	.13%	2	.18%
Unallocated	162	- -	70	- -	--	- -	13	- -	51	- -
	$ 5 718	100.00%	$ 4 079	100.00%	$ 2 779	100.00%	$ 2 423	100.00%	$ 2 161	100.00%

RISK ELEMENTS IN THE LOAN PORTFOLIO

	2009 (in thousands)	2008	2007	2006	2005
Nonaccrual loans	$ 3 819	$ 2 669	$ 1 584	$ 144	$ 122
Restructured loans	- -	- -	- -	- -	- -
Foreclosed properties	5 632	1 644	430	- -	- -
Total nonperforming assets	$ 9 451	$ 4 313	$ 2 014	$ 144	$ 122
Loans past due 90 days accruing interest	$ - -	$ 1 263	$ 21	$ - -	$ 65
Allowance for loan losses to period end loans	2.44%	1.66%	1.24%	1.05%	1.03%
Nonperforming assets to period end loans and foreclosed properties	3.93%	1.74%	.89%	.06%	.06%

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.

At December 31, 2009, other potential problem loans totaled $6.7 million. Loans are viewed as potential problem loans according to the ability of such borrowers to comply with current repayment terms. These loans are subject to constant management attention, and their status is reviewed on a regular basis.

SECURITIES PORTFOLIO

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

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

	2009 Carrying Value (in thousands)	Weighted Average Yield	2008 Carrying Value (in thousands)	Weighted Average Yield	2007 Carrying Value (in thousands)	Weighted Average Yield
Securities available for sale						
Obligations of U.S. Government agencies:						
Maturing within one year	$ 1 005	1.25%	$ 5 600	5.03%	$ 10 501	4.38%
Maturing after one year but within five years	27 418	2.69%	18 889	4.13%	26 200	5.00%
Municipal obligations:						
Maturing within one year	- -		147	3.04%	- -	
Maturing after one year but within five years	999	3.73%	879	3.82%	1 029	3.71%
Maturing after five years	3 791	4.14%	1 963	3.86%	1 842	3.87%
Equity securities with no stated maturity	1 100	.46%	1 217	.12%	382	.35%
Total securities available for sale	$ 34 313		$ 28 695		$ 39 954	

DEPOSITS

Deposits increased 4% in 2009. The bank does have some noncore funding included in the deposit portfolio. The portfolio holds approximately $13 million in brokered certificates of deposit, and as participants in the CDARS program the portfolio holds approximately $10 million in certificates of deposit through that program. Even with only a slight increase in deposits, the bank has increased market share percentages in both Jefferson and Berkeley Counties of West Virginia as of June 30, 2009. We have 32.41% of total deposits in Jefferson County compared to 31.05% in 2008 and 4.28% of total deposits in Berkeley County compared to 4.21% in 2008.

Schedule of Average Deposits and Average Rates Paid

	Year Ended December 31 (average balances in thousands)					
	2009		2008		2007	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing demand deposits	$ 26 490		$ 27 109		$ 28 988	
Interest-bearing demand deposits	80 842	0.94%	79 591	1.41%	83 916	2.41%
Savings deposits	38 662	0.65%	41 262	1.20%	35 226	1.96%
Time deposits	115 239	3.26%	111 574	4.08%	106 778	4.67%
Total interest-bearing deposits	234 743	2.03%	232 427	2.65%	225 920	3.41%
Total deposits	$ 261 233		$ 259 536		$ 254 908	

At December 31, 2009, time deposits of $100 thousand or more were 16.91% of total deposits compared with 12.50% at December 31, 2008. Maturities of time deposits of $100 thousand or more (in thousands) at December 31, 2009 are as follows:

Within three months	$ 4 607
Over three through six months	1 684
Over six months through twelve months	7 336
Over twelve months	31 090
Total	$ 44 717

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 12.92% and a ratio of Tier 1 capital to risk-weighted assets of 11.65% at December 31, 2009. Both ratios exceed the capital requirements adopted by the federal regulatory agencies.

	2009 (In thousands)	2008	2007
Tier 1 capital:			
Common stock	$ 3 672	$ 3 672	$ 3 672
Surplus	3 898	3 851	3 771
Retained earnings	21 931	25 070	24 787
	29 501	32 593	32 230
Less cost of shares acquired for the treasury	2 866	2 837	2 701
Total tier 1 capital	$ 26 635	$ 29 756	$ 29 529
Tier 2 capital:			
Allowance for loan losses (1)	2 893	3 019	2 779
Total risk-based capital	$ 29 528	$ 32 775	$ 32 308
Risk-weighted assets	$ 228 607	$ 240 471	$ 227 013
Capital ratios:			
Tier 1 risk-based capital ratio	11.65%	12.37%	13.01%
Total risk-based capital ratio	12.92%	13.63%	14.23%
Leverage ratio	8.75%	9.85%	9.99%

(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 2009 is detailed in the statement of cash flows included in the financial statements.

Operating Activities. The company’s net income usually provides cash from the bank’s operating activities. The net income figure is adjusted for certain noncash transactions such as depreciation expense that reduces net income but does not require a cash outlay. During 2009, the net loss as adjusted has provided cash of $773 thousand. Interest income earned on loans and investment securities is the company’s major income source.

Investing Activities. Customer core deposits and company noncore funding provide the funds used to invest in loans and investment securities. In addition, the principal portion of loan payments, loan payoffs and maturity of investment securities provide cash flow. Purchases of bank premises and equipment are an investing activity. As mentioned in the section on deposits, we have taken advantage of our noncore funding capabilities since deposit growth is not always sufficient. The net amount of cash used in investing activities in 2009 is $4 million.

Financing Activities. Customer core deposits and company noncore funding provide the financing for the investing activities as stated above. If the company has an excess of funds on any given day, the bank will sell these funds to make additional interest income to fund activities. Likewise, if the company has a shortage of funds on any given day it will purchase funds and pay interest for the use of these funds. Financing activities also include payment of dividends to shareholders, purchase of shares of the company’s common stock for the treasury and repayment of any noncore funding. The net amount of cash provided by financing activities in 2009 is $7.5 million.

At December 31, 2009, 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 $42.4 million.

Noncore funding capabilities, including borrowing, provide additional liquidity. The subsidiary bank maintains a federal funds line with one financial institution and is a member of the Federal Home Loan Bank of Pittsburgh. In September 2008, the subsidiary bank borrowed $5 million amortized over five years from the Federal Home Loan Bank. In July 2009 the subsidiary bank secured a credit line with the Federal Reserve discount window. At December 31, 2009, the subsidiary bank has total credit available through these institutions of approximately $19.5 million.

Financial Instruments With Off-Balance-Sheet Risk. The company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. Those financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The 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, 2009 and 2008 is as follows (in thousands):

	2009	2008
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 29 275	$ 48 726
Standby letters of credit	1 646	2 467

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, 2009, the company had $820 thousand in rate lock commitments to originate mortgage loans.

Short-Term Borrowings. At December 31, 2009 and 2008, short-term borrowings consist of securities sold under agreements to repurchase that are secured transactions with customers. The total of short-term borrowings was $7.3 million on December 31, 2009 and $8.4 million on December 31, 2008.

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

	December 31	
	2009	2008
Balance outstanding at year end	$ 7 340	$ 8 352
Maximum balance at any month-end during the year	$ 11 311	$ 10 868
Average balance for the year	$ 9 218	$ 9 963
Weighted average rate for the year	1.61%	2.56%
Weighted average rate at year end	1.61%	2.56%

Estimated fair value	$ 7 340	$ 8 352

Contractual Obligations. The table below presents the contractual obligations of the company as of December 31, 2009:

	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	$ 3 856	$ 964	$ 2 067	$ 825
Lease Obligations for Real Estate	$ 28	$ 28	$ - -	$ - -
Lease Obligations for Equipment	$ 24	$ 24	$ - -	$ - -

Item 8. Financial Statements and Supplementary Data.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Potomac Bancshares, Inc. and Subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Potomac Bancshares, Inc. and Subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of Potomac Bancshares, Inc. and Subsidiary's internal control over financial reporting as of December 31, 2009, included in the accompanying Report of Management's Assessment of Internal Control Over Financial Reporting and, accordingly, we do not express an opinion thereon.

Winchester, Virginia
March 30, 2010

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2009 and 2008
(in thousands, except share data)

	2009		2008	
ASSETS				
Cash and due from banks	$	6 620	$	3 754
Interest-bearing deposits in other financial institutions		53		1 282
Federal funds sold		5 950		3 313
Securities available for sale, at fair value		34 313		28 695
Loans held for sale		97		329
Loans, net of allowance for loan losses of $5,718 in 2009 and $4,079 in 2008		228 993		242 375
Premises and equipment, net		8 726		8 015
Other real estate owned, net of valuation allowance of $303 in 2009 and $0 in 2008		5 632		1 644
Accrued interest receivable		952		1 108
Federal Home Loan Bank of Pittsburgh stock		805		725
Other assets		11 048		9 141
Total Assets	$	303 189	$	300 381
LIABILITIES AND STOCKHOLDERS' EQUITY				
LIABILITIES				
Deposits				
Noninterest-bearing	$	27 953	$	25 469
Interest-bearing		236 514		228 619
Total Deposits	$	264 467	$	254 088
Securities sold under agreements to repurchase		7 340		8 352
Federal Home Loan Bank advances		3 856		4 776
Accrued interest payable		405		481
Other liabilities		1 549		4 880
Commitments and contingent liabilities		- -		- -
Total Liabilities	$	277 617	$	272 577
STOCKHOLDERS' EQUITY				
Common stock, $1 per share par value; 5,000,000 shares authorized; 3,671,691 shares issued	$	3 672	$	3 672
Surplus		3 898		3 851
Undivided profits		21 931		25 070
Accumulated other comprehensive (loss), net		(1 063)		(1 952)
	$	28 438	$	30 641
Less cost of shares acquired for the treasury, 2009, 281,513 and 2008, 278,086 shares		2 866		2 837
Total Stockholders' Equity	$	25 572	$	27 804
Total Liabilities and Stockholders' Equity	$	303 189	$	300 381

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2009, 2008 and 2007
(in thousands, except per share data)

	2009	2008	2007
Interest and Dividend Income:			
Interest and fees on loans	$ 13 801	$ 15 201	$ 17 093
Interest on securities available for sale - taxable	933	1 415	1 894
Interest on securities available for sale - nontaxable	148	110	74
Interest on federal funds sold	7	249	435
Other interest and dividends	24	383	195
Total Interest and Dividend Income	$ 14 913	$ 17 358	$ 19 691
Interest Expense:			
Interest on deposits	$ 4 772	$ 6 162	$ 7696
Interest on securities sold under agreements to repurchase and federal funds purchased	148	255	441
Interest on Federal Home Loan Bank and Federal Reserve Bank advances	201	60	24
Total Interest Expense	$ 5 121	$ 6 477	$ 8 161
Net Interest Income	$ 9 792	$ 10 881	$ 11 530
Provision for Loan Losses	6 690	2 934	678
Net Interest Income after Provision for Loan Losses	$ 3 102	$ 7 947	$ 10 852
Noninterest Income:			
Trust and financial services	$ 758	$ 807	$ 1 085
Service charges on deposit accounts	2 205	2 340	2 102
Visa/MC Fees	563	516	453
Cash surrender value of life insurance	238	240	189
Miscellaneous income	4	246	8
Loss on sale of real estate	- -	(185)	- -
Gain on sale of securities	42	- -	- -
Other operating income	471	391	542
Total Noninterest Income	$ 4 281	$ 4 355	$ 4 379
Noninterest Expenses:			
Salaries and employee benefits	$ 5 351	$ 5 146	$ 5 252
Net occupancy expense of premises	570	542	563
Furniture and equipment expenses	948	933	925
Advertising and marketing	176	266	246
FDIC assessment	711	84	30
Printing, stationery and supplies	207	181	212
Foreclosed property expense	759	167	46
ATM and check card expense	326	313	328
Other operating expenses	2 011	1 955	2 101
Total Noninterest Expenses	$ 11 059	$ 9 587	$ 9 703
Income (Loss) Before Income Tax Expense (Benefit)	$ (3 676)	$ 2 715	$ 5 528
Income Tax Expense (Benefit)	(1 436)	853	1 998
Net Income (Loss)	$ (2 240)	$ 1 862	$ 3 530
Earnings (Loss) Per Share, basic and diluted	$ (.66)	$ .55	$ 1.03

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2009, 2008 and 2007
(in thousands, except per share data)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Accumulated Other Comprehensive (Loss)	Comprehensive Income (Loss)	Total
Balances, December 31, 2006	$ 3 672	$ 3 661	$ 22 677	$ (2 279)	$ (1 014)		$ 26 717
Comprehensive income							
Net income – 2007	- -	- -	3 530	- -	- -	$ 3 530	3 530
Other comprehensive income:							
Unrealized holding gains arising during the period (net of tax, $159)	- -	- -	- -	- -	306	306	306
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, $97)	- -	- -	- -	- -	194	194	194
Total other comprehensive income						500	
Total comprehensive income						$ 4 030	
Purchase of treasury shares: 28,083 shares	- -	- -	- -	(422)	- -		(422)
Stock-based compensation expense	- -	110	- -	- -	- -		110
Cash dividends – 2007 ($.42 per share)	- -	- -	(1 420)	- -	- -		(1 420)
Balances, December 31, 2007	$ 3 672	$ 3 771	$ 24 787	$ (2 701)	$ (514)		$ 29 015
Comprehensive income							
Net income – 2008	- -	- -	1 862	- -	- -	$ 1 862	1 862
Other comprehensive (loss):							
Unrealized holding gains arising during the period (net of tax, $40)	- -	- -	- -	- -	77	77	77
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, $780)	- -	- -	- -	- -	(1 515)	(1 515)	(1 515)
Total other comprehensive (loss)						(1 438)	
Total comprehensive income						$ 424	
Purchase of treasury shares: 13,935 shares	- -	- -	- -	(149)	- -		(149)
Sale of treasury shares: 2,040 shares	- -	10	- -	13	- -		23
Stock-based compensation expense	- -	70	- -	- -	- -		70
Reduction due to change in pension measurement date (net of tax, $16)	- -	- -	(31)	- -	- -		(31)
Cash dividends – 2008 ($.42 per share)	- -	- -	(1 548)	- -	- -		(1 548)
Balances, December 31, 2008	$ 3 672	$ 3 851	$ 25 070	$ (2 837)	$ (1 952)		$ 27 804

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (CONTINUED)
Years Ended December 31, 2009, 2008 and 2007
(in thousands, except per share data)

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

See Notes to Consolidated Financial Statements.

POTOMAC BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2009, 2008 and 2007
(in thousands)

	2009	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	$ (2 240)	$ 1 862	$ 3 530
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:			
Provision for loan losses	6 690	2 934	678
Depreciation	573	532	568
Deferred tax (benefit)	(609)	(474)	(250)
(Discount accretion) and premium amortization on securities, net	129	(21)	(63)
(Gain) on sale of securities	(42)	- -	- -
(Gain) loss on sale of other real estate	(473)	185	15
Loss on disposal of premises and equipment	4	5	12
Stock-based compensation expense	47	70	110
Proceeds from sale of loans	8 703	12 153	11 002
Origination of loans for sale	(8 471)	(4 349)	(18 730)
Changes in assets and liabilities:			
Decrease in accrued interest receivable	156	258	65
(Increase) in other assets	(1 717)	(418)	(2 212)
(Decrease) increase in accrued interest payable	(76)	(276)	85
(Decrease) increase in other liabilities	(1 901)	304	9
Net cash provided by (used in) operating activities	$ 773	$ 12 765	$ (5 181)
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from maturity of securities available for sale	$ 5 645	$ 5 500	$ 14 470
Proceeds from call of securities available for sale	18 000	22 000	10 035
Proceeds from sale of securities available for sale	3 042	- -	- -
Purchases of securities available for sale	(32 594)	(15 267)	(20 842)
Net (increase) decrease in loans	(2 425)	(26 719)	4 709
Purchases of premises and equipment	(1 288)	(2 315)	(384)
Proceeds from sale of other real estate	5 602	1 815	61
Net cash (used in) provided by investing activities	$ (4 018)	$ (14 986)	$ 8 049
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase (decrease) in noninterest-bearing deposits	$ 2 484	$ (2 525)	$ (1 879)
Net increase in interest-bearing deposits	7 895	3 239	3 475
Net (repayment) proceeds of securities sold under agreements to repurchase	(1 012)	(4 185)	2 011
Net (repayment) proceeds of Federal Home Loan Bank advances	(920)	4 564	(408)
Purchase of treasury shares	(29)	(149)	(422)
Sale of treasury shares	- -	23	- -
Cash dividends	(899)	(1 548)	(1 420)
Net cash provided by (used in) financing activities	$ 7 519	$ (581)	$ 1 357
Increase (decrease) in cash and cash equivalents	$ 4 274	$ (2 802)	$ 4 225
CASH AND CASH EQUIVALENTS			
Beginning	8 349	11 151	6 926
Ending	$ 12 623	$ 8 349	$ 11 151
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash payments for:			
Interest	$ 5 197	$ 6 753	$ 8 076
Income taxes	$ 41	$ 1 642	$ 2 368
SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES			

Unrealized (loss) gain on securities available for sale	$	(83)	$	117	$	465
Change in benefit obligations and plan assets for pension and other postretirement benefits	$	1 430	$	(2 295)	$	291
Loans transferred to OREO	$	8 814	$	3 238	$	506
Loans made on sale of other real estate owned	$	1 568	$	775	$	- -

See Notes to Consolidated Financial Statements.

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

Note 1. Nature of Banking Activities and Significant Accounting Policies

Potomac Bancshares, Inc. and Subsidiary (the company) grant commercial, financial, agricultural, residential and consumer loans to customers, primarily in Berkeley County and Jefferson County, West Virginia. The company's 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

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

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (1) the company intends to sell the security or (2) it is more-likely-than-not that the company will be required to sell the security before recovery of its amortized cost basis. If, however, the company does not intend to sell the security and it is no more-likely-than-not that it will be required to sell the security before recovery, the company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is credit loss, the loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on the company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. Management regularly reviews each investment security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, its intention with regard to holding the security to maturity and the likelihood that the company would be required to sell the security before recovery.

Loans

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

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

Loans (Continued)

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 and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

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 is based on two basic principles of accounting: (1) losses be accrued when they are probable of occurring and are capable of estimation and (2) losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability 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 or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified and special mention 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.

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

Allowance for Loan Losses (Continued)

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 on the straight-line method. Estimated useful lives range from five to forty years for premises and improvements and three to twenty-five years for furniture and equipment.

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

Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value net of estimated selling costs at the date of foreclosure, establishing a new cost basis. 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

Summaries of company employee benefit plans are given below:

- The noncontributory, defined benefit pension plan covering employees meeting certain age and service requirements was frozen at October 31, 2009, the end of the plan year. No more participants may enter the plan, and there will be no further increase in benefits due to increases in salaries and years of service.
- A postretirement life insurance plan covers current and future retirees with 25 years of service over the age of 60.
- A postretirement life insurance plan covers certain current retirees who met certain requirements. This plan is not available for future retirees.
- A health care plan covers current retirees who met certain eligibility requirements. This plan is not available for future retirees.
- A 401(k) retirement savings plan is available to all employees meeting certain age and service requirements. The employer match for this plan has been increased with the freezing of the defined benefit plan as described above. Under this plan, the employer may make a discretionary matching contribution each plan year and may also make other discretionary contributions to the plan.

Earnings Per Share

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

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

Income Taxes

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

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

Cash and Cash Equivalents

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

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 consolidated financial statements.

Use of Estimates

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

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 and changes in pension and postretirement benefit obligations, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

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

Fair Value of Financial Instruments

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

Stock-Based Compensation Plan

The 2003 Stock Incentive Plan was approved by stockholders on May 13, 2003. This is the first stock incentive plan adopted by the company. Under the plan, the option price cannot be less than the fair market value of the stock on the date granted. An option’s maximum term is ten years from the date of grant. Options granted under the plan may be subject to a graded vesting schedule.

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

Stock option compensation expense is the estimated fair value of options granted, and is amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award. There were no options granted in 2008 and 2009. The weighted average estimated fair value of stock options granted in the year ended December 31, 2007 was $3.76. Fair value is estimated using the Black-Scholes option-pricing model with the following assumptions for grants during 2007: option term until exercise of 10 years, expected volatility of 19.56%, risk-free interest rate of 4.66%, and expected dividend yield of 2.74%. Expected volatility is based on the historic volatility of the company’s stock price over the expected life of the options. We have determined that the expected term for options is their contractual life of 10 years. The risk-free interest rate is the U. S. Treasury zero-coupon issue with a remaining term equal to the expected term of the options granted. The dividend yield is estimated as the ratio of the company’s historical dividends paid per share of common stock to the stock price on the date of grant.

Reclassifications

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

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued new accounting guidance related to U.S. GAAP (FASB ASC 105, Generally Accepted Accounting Principles). This guidance establishes FASB Accounting Standards Codification (ASC) as the source of authoritative U.S. GAAP recognized by FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. FASB ASC supersedes all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in FASB ASC has become non-authoritative. FASB will no longer issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates (ASUs), which will serve to update FASB ASC, provide background information about the guidance and provide the basis for conclusions on the changes to FASB ASC. FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC.

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

Recent Accounting Pronouncements (Continued)

The company adopted new guidance impacting FASB Topic 805: Business Combinations (Topic 805) on January 1, 2009. This guidance requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. The adoption of the new guidance did not have a material impact on the company's consolidated financial statements.

In April 2009, the FASB issued new guidance impacting Topic 805. This guidance addresses application issues raised by preparers, auditors, and members of the legal profession on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. This guidance was effective for business combinations entered into on or after January 1, 2009. This guidance did not have a material impact on the company's consolidated financial statements.

In December 2008, the FASB issued new guidance impacting FASB Topic 715-20: Compensation Retirement Benefits – Defined Benefit Plans – General. The objectives of this guidance are to provide users of the financial statements with more detailed information related to the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets and the effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period, as well as how investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies. The disclosures about plan assets required by this guidance are included in Note 8 of the company's consolidated financial statements.

In April 2009, the FASB issued new guidance impacting FASB Topic 820: Fair Value Measurements and Disclosures. This interpretation provides additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased. This also includes guidance on identifying circumstances that indicate a transaction is not orderly and requires additional disclosures of valuation inputs and techniques in interim periods and defines the major security types that are required to be disclosed. This guidance was effective for interim and annual periods ending after June 15, 2009, and should be applied prospectively. The adoption of the standard did not have a material impact on the company's consolidated financial statements.

In April 2009, the FASB issued new guidance impacting FASB Topic 320-10: Investments – Debt and Equity Securities. This guidance amends GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This guidance was effective for interim and annual periods ending after June 15, 2009, with earlier adoption permitted for periods ending after March 15, 2009. The company did not have any cumulative effect adjustment related to the adoption of this guidance.

In May 2009, the FASB issued new guidance impacting FASB Topic 855: Subsequent Events. This update provides guidance on management's assessment of subsequent events that occur after the balance sheet date through the date that the financial statements are issued. This guidance is generally consistent with current accounting practice. In addition, it requires certain additional disclosures. This guidance was effective for periods ending after June 15, 2009 and had no impact on the company's consolidated financial statements.

In August 2009, the FASB issued new guidance impacting Topic 820. This guidance is intended to reduce ambiguity in financial reporting when measuring the fair value of liabilities. This guidance was effective for the first reporting period including interim periods after issuance and had no impact on the company's consolidated financial statements.

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

Recent Accounting Pronouncements (Continued)

In October 2009, the Securities and Exchange Commission issued Release No. 33-99072, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers. Release No. 33-99072 delays the requirement for non-accelerated filers to include an attestation report of their independent auditor on internal control over financial reporting with their annual report until the fiscal year ending on or after June 15, 2010.

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140, was adopted into Codification in December 2009 through the issuance of ASU 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. The company will adopt the new guidance in 2010 and does not expect the adoption to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the variable interest entities. The new guidance, which was issued as SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 is effective as of January 1, 2010. The company does not expect the adoption of the new guidance to have a material impact on its consolidated financial statements.

In September 2009, the FASB issued new guidance impacting Topic 820. This creates a practical expedient to measure the fair value of an alternative investment that does not have a readily determinable fair value. This guidance also requires certain additional disclosures. This guidance is effective for interim and annual periods ending after December 15, 2009. The adoption of the new guidance did not have a material impact on the consolidated financial statements.

In January 2010, the FASB issued ASU 2010-02, Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary – a Scope Clarification. ASU 2010-02 amends Subtopic 810-10 to address implementation issues related to changes in ownership provisions including clarifying the scope of the decrease in ownership and additional disclosures. ASU 2010-02 is effective beginning in the period that an entity adopts Statement 160. If an entity has previously adopted Statement 160, ASU 2010-02 is effective beginning in the first interim or annual reporting period ending on or after December 15, 2009 and should be applied retrospectively to the first period Statement 160 was adopted. The company does not expect the adoption of ASU 2010-02 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, Accounting for Various Topics – Technical Corrections to SEC Paragraphs. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residual method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The company does not expect the adoption of ASU 2010-04 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The company does not expect the adoption of ASU 2010-06 to have a material impact on its consolidated financial statements.

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

Recent Accounting Pronouncements (Continued)

In February 2010, the FASB issued ASU 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The company does not expect the adoption of ASU 2010-08 to have a material impact on its consolidated financial statements.

Note 2. Securities

There were no securities held to maturity as of December 31, 2009 and 2008.

The amortized cost and fair value of securities available for sale as of December 31, 2009 and 2008 (in thousands) are as follows:

	2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government agencies	$ 28 159	$ 279	$ (15)	$ 28 423
State and municipal obligations	4 789	56	(55)	4 790
Equity securities	1 100	- -	- -	1 100
	$ 34 048	$ 335	$ (70)	$ 34 313

	2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government agencies	$ 23 996	$ 493	$ - -	$ 24 489
State and municipal obligations	3 132	8	(151)	2 989
Equity securities	1 217	- -	- -	1 217
	$ 28 345	$ 501	$ (151)	$ 28 695

The amortized cost and fair value of the securities available for sale as of December 31, 2009 (in thousands), by contractual maturity, are shown below. The equity securities have no stated maturities.

	Amortized Cost	Fair Value
Due in one year or less	$ 1 000	$ 1 005
Due after one year through five years	28 139	28 417
Due after five years	3 809	3 791
Equity securities	1 100	1 100
	$ 34 048	$ 34 313

The gross realized gain from the sale of one security was $42 thousand as of December 31, 2009. There were no sales of securities during 2008 or 2007.

Note 2. Securities (Continued)

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 14 accounts in the consolidated portfolio that have losses at December 31, 2009. The primary cause of the temporary impairments in the company's investments in debt securities was fluctuations in interest rates. Because the company intends to hold these investments in debt securities to maturity and it is more likely than not that the company will not be required to sell these investments before a recovery of unrealized losses, the company does not consider these investments to be other-than-temporarily impaired at December 31, 2009 and no impairment has been recognized.

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, 2009 and 2008 (in thousands).

	December 31, 2009					
	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	$ 4 987	$ (15)	$ - -	$ - -	$ 4 987	$ (15)
State and municipal obligations	2 746	(55)	- -	- -	2 746	(55)
	$ 7 733	$ (70)	$ - -	$ - -	$ 7 733	$ (70)

	December 31, 2008					
	Less than 12 months		More than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
State and municipal obligations	$ 2 077	$ (151)	$ - -	$ - -	$ 2 077	$ (151)

Securities with a carrying value of $23.6 million and $18.4 million at December 31, 2009 and 2008 were pledged to secure public funds and other balances as required by law.

The company's investment in Federal Home Loan Bank (FHLB) stock totaled $805 thousand at December 31, 2009. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. Despite the FHLB's temporary suspension of repurchases of excess capital stock in 2009, the company does not consider this investment to be other-than-temporarily impaired at December 31, 2009 and no impairment has been recognized. FHLB stock is shown as a separate line item on the balance sheet and is not a part of the available for sale securities portfolio.

Note 3. Loans and Related Party Transactions

The loan portfolio is composed of the following:

	December 31			
	2009 (in thousands)		2008	
Mortgage loans on real estate:				
Construction and land development	$	38 083	$	65 643
Secured by farm land		1 419		1 380
Secured by 1-4 family residential		102 290		97 064
Secured by multifamily residential		2 070		1 937
Secured by nonfarm nonresidential		71 916		58 332
Commercial loans (except those secured by real estate)		9 700		9 671
Consumer loans		9 011		11 970
All other loans		222		457
Total loans	$	234 711	$	246 454
Less: allowance for loan losses		5 718		4 079
	$	228 993	$	242 375

At December 31, 2009 and 2008, overdraft demand deposits reclassified to loans totaled $222 thousand and $457 thousand, respectively.

Loans to directors and executive officers of the company or to their associates at December 31, 2009 and 2008 totaled $3.1 million and $3.1 million, respectively. Such loans were made on substantially the same terms as those prevailing for comparable transactions with similar risks. During 2009, total principal additions were $849 thousand and total principal payments were $844 thousand.

Note 4. Allowance for Loan Losses

The following is a summary of transactions in the allowance for loan losses for 2009, 2008 and 2007 (in thousands):

	2009		2008		2007	
Balances at beginning of year	$	4 079	$	2 779	$	2 423
Provision charged to operating expense		6 690		2 934		678
Recoveries added to the allowance		232		199		182
Loan losses charged to the allowance		(5 283)		(1 833)		(504)
Balances at end of year	$	5 718	$	4 079	$	2 779

Note 4. Allowance for Loan Losses (Continued)

The following is a summary of information pertaining to impaired loans as of December 31 for each of the years presented (in thousands):

	2009		2008	
Impaired loans without a valuation allowance	$	12 397	$	7 469
Impaired loans with a valuation allowance		14 985		4 245
Total impaired loans	$	27 382	$	11 714
Valuation allowance related to impaired loans	$	3 799	$	1 302
Total nonaccrual loans	$	3 819	$	2 669
Total loans past due ninety days or more and still accruing	$	- -	$	1 263

	2009		2008		2007	
Average investment in impaired loans	$	16 262	$	7 770	$	1 163
Interest income recognized on impaired loans	$	1 233	$	471	$	48
Interest income recognized on a cash basis on impaired loans	$	68	$	4	$	- -

No additional funds are committed to be advanced in connection with impaired loans. Nonaccrual loans excluded from impaired loans at December 31, 2009 and 2008 totaled $1.3 million and $607 thousand, respectively. If interest had been accrued on these nonaccrual loans, such income would have approximated $58 thousand in 2009 and $36 thousand in 2008.

Note 5. Premises and Equipment, Net

Premises and equipment consists of the following:

	December 31			
	2009		2008	
	(in thousands)			
Premises and improvements	$	9 516	$	8 676
Furniture and equipment		4 630		4 539
	$	14 146	$	13 215
Less accumulated depreciation		5 420		5 200
	$	8 726	$	8 015

Depreciation included in operating expense for 2009, 2008 and 2007 was $573 thousand, $532 thousand and $568 thousand, respectively.

Note 6. Deposits

The aggregate amount of time deposits with a balance of $100,000 or more was $44.7 million and $31.8 million at December 31, 2009 and 2008, respectively.

At December 31, 2009, the scheduled maturities of all time deposits (in thousands) are as follows:

2010	$	53 100
2011		38 678
2012		12 878
2013		4 498
2014		5 401
	$	114 555

Note 6. Deposits (Continued)

Brokered deposits (all in the form of certificates of deposit) totaled $12.9 million and $9.6 million at December 31, 2009 and 2008, respectively.

Deposits of the company's directors, executive officers and associates totaled $2.2 million and $1.6 million at December 31, 2009 and 2008, respectively.

Deposits of one public funds entity exceed 5% of the bank's total deposits.

Note 7. Borrowings

Short-term borrowings consist of securities sold under agreements to repurchase, which totaled $7.3 million and $8.4 million as of December 31, 2009 and 2008, respectively.

During 2008, the bank incurred fixed rate long term debt consisting of a Federal Home Loan Bank, five year loan, with an original balance of $5 million and monthly payments of interest and principal with an interest rate of 4.61%.

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

2010	$	964
2011		1 010
2012		1 057
2013		825
	$	3 856

The company has unused lines of credit with the Federal Home Loan Bank and other financial institutions totaling approximately $19.5 million at December 31, 2009.

Note 8. Employee Benefit Plans

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

The company sponsors an unfunded postretirement life insurance plan covering 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 sponsors a health care plan covering current retirees who met certain eligibility requirements. This plan is not available for future retirees.

The company sponsors a 401(k) retirement savings plan available to all employees meeting certain age and service requirements. Employees become eligible to participate in the plan upon reaching age 21 and completing one year of service. Entry dates are January 1, April 1, July 1 and October 1. Employees can make a salary deferral election authorizing the employer to withhold up to the amount allowed by law each calendar year. The company may make a discretionary matching contribution each plan year. The company may also make other discretionary contributions to the plan. The company's match for this plan has been increased with the freezing of the defined benefit plan as described above. The company made 401(k) matching contributions of $111 thousand, $100 thousand and $92 thousand in 2009, 2008 and 2007, respectively.

The company has entered into contracts with three retirees where the company agrees to pay the participant's beneficiaries $50,000 upon the participant's death. The present value of this postretirement benefit has been accrued as of December 31, 2009 in the amount of $131 thousand. While these liabilities are unfunded, life insurance has been obtained by the company to help offset these payments.

Note 8. Employee Benefit Plans (Continued)

Obligations and funded status:

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
	(in thousands)		(in thousands)	
Change in benefit obligation:				
Benefit obligation, beginning	$ 7 401	$ 6 374	$ 547	$ 536
Service cost	266	344	11	12
Interest cost	447	474	32	30
Actuarial (gain) loss	210	514	1	(6)
Benefits paid	(308)	(305)	(23)	(25)
Curtailment	(1 054)	- -	- -	- -
Benefit obligation, ending	$ 6 962	$ 7 401	$ 568	$ 547
Change in plan assets:				
Fair value of plan assets, beginning	$ 4 026	$ 5 303	$ - -	$ - -
Actual return on plan assets	785	(1 457)	- -	- -
Employer contributions	1 118	485	23	25
Benefits paid	(308)	(305)	(23)	(25)
Fair value of plan assets, ending	$ 5 621	$ 4 026	$ - -	$ - -
Funded status at end of year	$ (1 341)	$ (3 375)	$ (568)	$ (547)
Unrecognized net (gain)	- -	- -	(52)	(53)
Unrecognized transition asset	- -	- -	87	105
Accounts recognized on consolidated balance sheet as:				
Accrued benefit liabilities	$ (1 341)	$ (3 375)	$ (533)	$ (495)
Amounts recognized in accumulated other comprehensive loss consist of:				
Net loss (gain)	$ 1 841	$ 3 255	$ (52)	$ (53)
Transition liability	- -	- -	87	104
Deferred tax asset	(626)	(1 107)	(12)	(17)
	$ 1 215	$ 2 148	$ 23	$ 34

The accumulated benefit obligation for the defined benefit pension plan was $7.0 million and $7.4 million at December 31, 2009 and 2008, respectively.

Note 8. Employee Benefit Plans (Continued)

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

	Pension Benefits			Other Postretirement Benefits		
	2009	2008	2007	2009	2008	2007
	(in thousands)			(in thousands)		
Components of net periodic benefit cost:						
Service cost	$ 266	$ 301	$ 254	$ 12	$ 12	$ 11
Interest cost	447	410	362	32	30	30
Expected return on plan assets	(373)	(313)	(356)	- -	- -	- -
Amortization of net obligation at transition	- -	- -	- -	17	17	17
Recognized actuarial loss	159	71	40	- -	- -	- -
Net periodic benefit cost	$ 499	$ 469	$ 300	$ 61	$ 59	$ 58
Other changes in plan assets and benefit obligations recognized in accumulated other comprehensive loss:						
Net loss (gain)	$ (201)	$ 2 319	(274)	$ 1	$ (6)	- -
Transition liability	- -	- -	- -	(17)	(18)	(17)
Deferred tax	481	(789)	91	5	9	6
Amortization of net (gain) loss	(159)	- -	- -	- -	- -	- -
Adjustment to (gain) for curtailment	(1 054)	- -	- -	- -	- -	- -
Total recognized in accumulated other comprehensive loss	$ (933)	$ 1 530	$ (183)	$ (11)	$ (15)	$ (11)
Total recognized in net periodic benefit cost and accumulated other comprehensive loss	$ (434)	$ 1 999	$ 117	$ 50	$ 44	$ 47

Adjustment (in thousands) to retained earnings due to change in measurement date for the year ended December 31, 2008:	
Service cost	$ 42
Interest cost	64
Expected return on plan assets	(66)
Deferred tax benefit	(16)
Amortization of loss	7
Net period benefit cost	$ 31

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 $159 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.

Note 8. Employee Benefit Plans (Continued)

Assumptions

	Pension Benefits			Other Postretirement Benefits		
	2009	2008	2007	2009	2008	2007
Weighted-average assumptions used to determine net periodic benefit cost:						
Discount rate	6.30%	6.00%	6.00%	6.00%	6.00%	6.00%
Expected return on plan assets	8.00%	6.00%	7.50%	- -	- -	- -
Rate of compensation increase	3.00%	3.50%	4.50%	3.00%	3.00%	3.00%
Weighted-average assumptions used to determine benefit obligations:						
Discount rate	6.08%	6.00%	6.00%	6.00%	6.00%	6.00%
Rate of compensation increase	N/A	3.50%	4.50%	3.00%	3.00%	3.00%

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).

The fair value (in thousands) of the company's pension plan assets at December 31, 2009, by asset category is as follows:

		Fair Value Measurement at December 31, 2009		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 194	$ 194	$ - -	$ - -
Equity securities				
U.S. companies	2 749	2 749	- -	- -
International companies	657	657	- -	- -
U. S. Treasury securities	1 175	1 175	- -	- -
Corporate bonds	846	846	- -	- -
Total	$ 5 621	$ 5 621	$ - -	$ - -

Note 8. Employee Benefit Plans (Continued)

Asset Allocation

The pension plan's weighted-average asset allocations at December 31, 2009 and 2008 by asset category are as follows:

	Plan Assets at December 31	
	2009	2008
Asset Category		
Equities	61%	57%
Fixed income/cash	39%	43%
Total	100%	100%

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 50% equities and 50% fixed income/cash and acceptable ranges within these categories of 40% to 60%. The trust fund allocation is reviewed on a monthly basis and rebalanced to within the acceptable ranges as needed. After review of the December 2009 allocations shown above, the funds were rebalanced and within acceptable ranges at January 31, 2010. The investment manager selects investment fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the plan's investment strategy. The investment manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

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

There is no company common stock included in the equity securities of the pension plan at December 31, 2009 and 2008.

Cash Flow

The company expects to contribute $345 thousand to its pension plan in 2010 and $27 thousand to its postretirement plan in 2010.

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

	Pension Benefits	Other Postretirement Benefits
	(in thousands)	
2010	$ 329	$ 27
2011	356	28
2012	385	30
2013	402	31
2014	421	33
2015-2019	2 401	176

For measurement purposes, a 6.85%, 7.10% and 7.35% annual rate of increase in per capita health care costs of covered benefits was assumed for the retiree health care plan for 2009, 2008 and 2007, with such annual rate of increase gradually declining to 5% in 2013.

Note 8. Employee Benefit Plans (Continued)

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	$ 62	$ (59)
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	3	(4)

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

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

	2009		2008		2007	
	Average Shares (in thousands)	Per Share Amount	Average Shares (in thousands)	Per Share Amount	Average Shares (in thousands)	Per Share Amount
Basic (loss) earnings per share	3 391	$ (.66)	3 402	$ .55	3 423	$ 1.03
Effect of dilutive securities:						
Stock options	- -		2		8	
Diluted (loss) earnings per share	3 391	$ (.66)	3 404	$ .55	3 431	$ 1.03

Stock options for 126,224, 132,620 and 120,534 shares of common stock were not considered in computing diluted earnings per common share for 2009, 2008 and 2007, respectively, because they were anti-dilutive.

Note 10. Stock-Based Compensation

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

A summary of option activity under the plan as of December 31, 2009, and changes during the year then ended is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value (in thousands)
Outstanding at beginning of year	132 620	$ 14.75		
Granted	- -	- -		
Exercised	- -	- -		
Forfeited	(6 396)	14.75		
Outstanding at end of year	126 224	$ 14.75	6	$ - -
Exercisable at end of year	100 323	$ 14.45	5	$ - -

50

Note 10. Stock-Based Compensation (Continued)

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, 2009. The 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, 2009:

	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	25 826	4.0	$ 11.28	25 826	$ 11.28
14.00	34 124	5.0	14.00	29 801	14.00
17.25	35 867	6.0	17.25	26 523	17.25
15.60	30 407	7.0	15.60	18 173	15.60
	126 224			100 323	

As of December 31, 2009, there was $50 thousand of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period. The unrecognized compensation expense has a weighted average life of two years.

Note 11. Income Taxes

The company files income tax returns in the U. S. Federal jurisdiction and the state of West Virginia. With few exceptions, the company is no longer subject to U. S. Federal, state and local income tax examinations by tax authorities for years prior to 2006.

Net deferred tax assets (in thousands) consist of the following components as of December 31, 2009 and 2008:

	2009	2008
Deferred tax assets:		
Reserve for loan losses	$ 1 504	$ 1 229
Accrued pension expense	456	1 148
Accrued postretirement benefits	238	229
Nonaccrual interest	58	80
Stock option expense	35	35
Home equity closing costs	44	64
Net loan origination fees	50	35
OREO expense	102	11
OREO valuation allowance	103	- -
OREO built in gain	358	- -
	$ 2 948	$ 2 831
Deferred tax liabilities:		
Depreciation	$ 108	$ 114
Securities available for sale	90	119
	$ 198	$ 233
Net deferred tax assets	$ 2 750	$ 2 598

Note 11. Income Taxes (Continued)

The provision for income taxes charged to operations for the years ended December 31, 2009, 2008 and 2007 consists of the following:

	2009 (in thousands)	2008	2007
Current tax (benefit) expense	$ (827)	$ 1 327	$ 2 248
Deferred tax (benefit)	(609)	(474)	(250)
	$ (1 436)	$ 853	$ 1 998

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, 2009, 2008 and 2007 due to the following (in thousands):

	2009	2008	2007
Computed "expected" tax (benefit) expense	$ (1 250)	$ 923	$ 1 880
Increase (decrease) in income taxes resulting from:			
Tax exempt income	(146)	(217)	(107)
State income tax (benefit) expense	(163)	123	191
Other	123	24	34
	$ (1 436)	$ 853	$ 1 998

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 $135 thousand in deposits in other financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) at December 31, 2009.

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, 2009 and 2008, the aggregate amounts of daily average required balances were approximately $300 thousand for each time period.

The table below presents the contractual obligations of the company as of December 31, 2009 not disclosed in other notes:

	Payments (in thousands) Due By Period			
	Total	Less than 1 Year	Over 1 Year through 3 Years	Over 3 Years through 5 Years
Lease Obligations for Real Estate	$ 28	$ 28	$ - -	$ - -
Lease Obligations for Equipment	$ 24	$ 24	$ - -	$ - -

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 limited by federal and state regulatory authorities.

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, 2009 and 2008 (in thousands) is as follows:

	2009	2008
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 29 275	$ 48 726
Standby letters of credit	1 646	2 467

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 are collateralized and usually contain a specified maturity date and may not be drawn upon to the extent to which the company is committed.

Standby letters of credit are conditional commitments issued by the company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar 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, 2009, the company had rate lock commitments to originate mortgage loans amounting to $820 thousand and mortgage loans held for sale in the amount of $97 thousand. The company enters into corresponding mandatory commitments, on a best-efforts basis, to sell the loans. These commitments to sell loans are designed to eliminate the company's exposure to fluctuations in interest rates in connection with rate lock commitments and loans held for sale.

Note 15. Fair Value Measurements

Determination of Fair Value

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

Note 15. Fair Value Measurements (Continued)

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

Fair Value Hierarchy

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

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

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

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

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

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

Cash and Short-Term Investments

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

Securities

Where quoted prices are available in an active market, we classify the securities within Level 1 of the valuation hierarchy. Securities are defined as both long and short positions. Level 1 securities include highly liquid government bonds and exchange traded equities. Instruments generally classified within Level 2 include GSE obligations, corporate bonds, and other securities.

Loans

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

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.

Note 15. Fair Value Measurements (Continued)

Short-Term Borrowings

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

FHLB Advances

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Off-Balance Sheet Financial Instruments

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, 2009 and 2008, the fair value of loan commitments and standby-letters of credit was immaterial. Therefore, they have not been included in the following table.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

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

The following table presents the balances (in thousands) of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 and 2008:

		Fair Value Measurements at December 31		
Description	Balance as of December 31	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
2009	$ 34 313	$ - -	$ 34 313	$ - -
2008	28 695	- -	28 695	- -

Note 15. Fair Value Measurements (Continued)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

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

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

Loans held for sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2009 and 2008. Gains and losses on the sale of loans are recorded within other operating income on the consolidated statements of operations.

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

Other Real Estate Owned: Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell.

The following table summarizes the company's financial assets that were measured at fair value (in thousands) on a nonrecurring basis as of December 31, 2009 and 2008.

		Carrying Value at December 31		
Description	Balance as of December 31	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Input (Level 3)
Assets				
Impaired Loans				
2009	$ 11 186	$ - -	$ 3 311	$ 7 875
2008	2 943	- -	2 943	- -
OREO				
2009	$ 5 632	$ - -	$ 5 632	$ - -
2008	1 644	- -	1 644	- -

Note 15. Fair Value Measurements (Continued)

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

	2009 Carrying Amount (in thousands)	Fair Value	2008 Carrying Amount (in thousands)	Fair Value
Financial assets:				
Cash	$ 6 673	$ 6 673	$ 5 036	$ 5 036
Federal funds sold	5 950	5 950	3 313	3 313
Securities available for sale	34 313	34 313	28 695	28 695
Loans, net	228 993	236 838	242 375	244 138
Loans held for sale	97	97	329	329
Accrued interest receivable	952	952	1 108	1 108
Financial liabilities:				
Deposits	264 467	260 915	254 088	252 521
Securities sold under agreements to repurchase	7 340	7 340	8 352	8 352
FHLB advances	3 856	4 012	4 776	5 034
Accrued interest payable	405	405	481	481

Note 16. Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the company and the bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2009 and 2008, that the company and the bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2009, 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.

Note 16. Regulatory Matters (Continued)

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	
	Amount (in thousands)	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2009:						
Total capital (to risk-weighted assets):						
Consolidated	$ 29 528	12.92%	$ 18 289	8.0%	N/A	N/A
Bank of Charles Town	$ 28 293	12.44%	$ 18 190	8.0%	$ 22 737	10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	$ 26 635	11.65%	$ 9 144	4.0%	N/A	N/A
Bank of Charles Town	$ 25 415	11.18%	$ 9 095	4.0%	$ 13 642	6.0%
Tier 1 capital (to average assets):						
Consolidated	$ 26 635	8.75%	$ 12 181	4.0%	N/A	N/A
Bank of Charles Town	$ 25 415	8.38%	$ 12 133	4.0%	$ 15 166	5.0%
As of December 31, 2008:						
Total capital (to risk-weighted assets):						
Consolidated	$ 32 775	13.63%	$ 19 238	8.0%	N/A	N/A
Bank of Charles Town	$ 31 423	13.14%	$ 19 133	8.0%	$ 23 917	10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	$ 29 756	12.37%	$ 9 619	4.0%	N/A	N/A
Bank of Charles Town	$ 28 420	11.88%	$ 9 567	4.0%	$ 14 350	6.0%
Tier 1 capital (to average assets):						
Consolidated	$ 29 756	9.85%	$ 12 081	4.0%	N/A	N/A
Bank of Charles Town	$ 28 420	9.45%	$ 12 030	4.0%	$ 15 038	5.0%

Note 17. Parent Company Only Financial Statements

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Balance Sheets
December 31, 2009 and 2008
(in thousands)

	2009		2008	
ASSETS				
Cash	$	1	$	48
Investment in subsidiary		24 352		26 468
Other assets		1 220		1 288
Total Assets	$	25 573	$	27 804
LIABILITIES AND STOCKHOLDERS' EQUITY				
LIABILITIES				
Other liabilities	$	1	$	- -
Total Liabilities	$	1	$	- -
STOCKHOLDERS' EQUITY				
Common stock	$	3 672	$	3 672
Surplus		3 898		3 851
Undivided profits		21 931		25 070
Accumulated other comprehensive (loss), net		(1 063)		(1 952)
	$	28 438	$	30 641
Less cost of shares acquired for the treasury		2 866		2 837
Total Stockholders' Equity	$	25 572	$	27 804
Total Liabilities and Stockholders' Equity	$	25 573	$	27 804

Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Statements of Operations
Years Ended December 31, 2009, 2008 and 2007
(in thousands)

	2009	2008	2007
Income			
Dividends from subsidiary	$ 977	$ 2 582	$ 1 942
Interest income	1	3	1
Total Income	$ 978	$ 2 585	$ 1 943
Expenses			
Stock-based compensation expense	$ 47	$ 70	$ 110
Transfer agent expense	15	11	9
Legal fees	11	9	20
Other professional fees	63	43	57
Printing, stationery and supplies	16	14	16
Other operating expenses	145	24	20
Total Expenses	$ 297	$ 171	$ 232
Income before Income Tax (Benefit) and Equity in Undistributed (Loss) Income of Subsidiary	$ 681	$ 2 414	$ 1 711
Income Tax (Benefit)	(84)	(32)	(56)
Income before Equity in Undistributed (Loss) Income of Subsidiary	$ 765	$ 2 446	$ 1 767
Equity in Undistributed (Loss) Income of Subsidiary	(3 005)	(584)	1 763
Net (Loss) Income	$ (2 240)	$ 1 862	$ 3 530

Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.
(Parent Company Only)
Statements of Cash Flows
Years Ended December 31, 2009, 2008 and 2007
(in thousands)

	2009	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	$ (2 240)	$ 1 862	$ 3 530
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Equity in undistributed loss (income) of subsidiary	3 005	584	(1 763)
Stock-based compensation expense	47	70	110
Decrease (increase) in other assets	68	(830)	(24)
Increase in other liabilities	1	- -	- -
Net cash provided by operating activities	$ 881	$ 1 686	$ 1 853
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash dividends	$ (899)	$ (1 548)	$ (1 420)
Purchase of treasury shares	(29)	(149)	(422)
Sale of treasury shares	- -	23	- -
Net cash (used in) financing activities	$ (928)	$ (1 674)	$ (1 842)
(Decrease) increase in cash and cash equivalents	$ (47)	$ 12	$ 11
CASH AND CASH EQUIVALENTS			
Beginning	48	36	25
Ending	$ 1	$ 48	$ 36

Note 18. Subsequent Events

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

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

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

Not Applicable.

Item 9A(T). 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.

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

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

Management's Report on Internal Control Over Financial Reporting

To the Stockholders:

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

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

In order to ensure that the company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2009. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management has concluded that the internal control over financial reporting was effective as of December 31, 2009.

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

Item 9B. Other Information.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information contained on pages 7-10 of the Proxy Statement dated April 9, 2010, for the May 18, 2010 Annual Meeting under the captions “Management Nominees to the Board of Potomac” and “Directors Continuing to Serve Unexpired Terms,” and page 17 under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” is incorporated herein by reference.

The Executive Officers are as follows:

Name	Position Since	Age	Principal Occupation
Robert F. Baronner, Jr.	President & CEO 2001	51	Employed by bank as of 1/1/01 as President and CEO.
David W. Irvin	Executive Vice President 2004	46	Employed at bank from 2001 to present as Commercial Loan Division Manager.
Gayle Marshall Johnson	Sr. Vice President & Chief Financial Officer 1994	60	Employed with the bank 1977-1985 and 1988-present; Vice President and Chief Financial Officer since 1990. Sr. Vice President since 2005.

The bank has adopted a Code of Ethics that applies to all employees, including Potomac’s and the bank’s chief executive officer and chief financial officer and other senior officers. Additionally, there is a Code of Ethics for Senior Financial Officers which applies to Potomac’s and the bank’s chief executive officer and chief financial officer. These Codes of Ethics are attached to this document as Exhibits 14.1 and 14.2. If we make any substantive amendments to this code or grant any waiver from a provision of the code to our chief executive officer or chief financial officer, we will disclose the amendment or waiver in a report on Form 8-K.

Item 11. Executive Compensation.

The information contained on pages 12-16 of the Proxy Statement dated April 9, 2010, for the May 18, 2010 Annual Meeting under the captions “Executive Compensation,” “Employee Benefit Plans,” “Employment Agreement,” and “Compensation of Directors” is incorporated herein by reference.

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

The information contained on pages 10-11 of the Proxy Statement dated April 9, 2010, for the May 18, 2010 Annual Meeting under the caption “Ownership of Securities by Nominees, Directors and Officers” is incorporated herein by reference.

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

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
2003 Stock Incentive Plan amended by shareholders April 24, 2007	126,224	$14.75	305,336

Item 13. Certain Relationships and Related Transactions.

The information contained on page 16 of the Proxy Statement dated April 9, 2010, for the May 18, 2010 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 April 9, 2010, for the May 18, 2010 Annual Meeting under the caption "Audit Committee Report" is incorporated herein by reference.

Item 15. Exhibits and Financial Statement Schedules.

(a)	(1)	Financial Statements. Reference is made to Part II, Item 8 of this Annual Report on Form 10-K.
	(2)	Financial Statement Schedules. These schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.
	(3)	Exhibits. See below.

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

3.1 Articles of Incorporation of Potomac Bancshares, Inc. filed with the Registration Statement on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092. Amendments to Articles of Incorporation of Potomac Bancshares, Inc. adopted by shareholders on April 25, 1995 and filed with the West Virginia Secretary of State on May 23, 1995.

3.2 Amended and Restated Bylaws of Potomac Bancshares, Inc. and subsequent amendments thereto.

10.1 2003 Stock Incentive Plan adopted by the Potomac Board February 20, 2003 and approved by the company's shareholders on May 13, 2003, amended by the company's shareholders on April 24, 2007 and incorporated by reference from Potomac's Form 10-K for the year ended December 31, 2006 and filed with the Securities and Exchange Commission, File No. 0-24958.

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

14.1 Code of Ethics (for all employees)*

14.2 Code of Ethics for Senior Financial Officers*

21 Subsidiaries of the Registrant*

23.1 Consent of Independent Registered Public Accounting Firm*

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

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

32.1 Section 1350 Certification of Chief Executive Officer*

32.2 Section 1350 Certification of Chief Financial Officer*

99.1 Proxy Statement for the 2010 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 30, 2010
Robert F. Baronner, Jr.
President & Chief Executive Officer

By /s/ Gayle Marshall Johnson March 30, 2010
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/ Dr. Keith Berkeley Dr. Keith Berkeley, Director	March 30, 2010
By	/s/ J. Scott Boyd J. Scott Boyd, Director	March 30, 2010
By	/s/ John P. Burns, Jr. John P. Burns, Jr., Director	March 30, 2010
By	/s/ Guy Gareth Chicchirichi Guy Gareth Chicchirichi, Director	March 30, 2010
By	/s/ Margaret Cogswell Margaret Cogswell, Director	March 30, 2010
By	/s/ Mary Clare Eros Mary Clare Eros, Director	March 30, 2010
By	/s/ William R. Harner William R. Harner, Director	March 30, 2010

By	/s/ Barbara H. Pichot Barbara H. Pichot, Director	March 30, 2010

By /s/ John C. Skinner, Jr. John C. Skinner, Jr., Director	March 30, 2010
By /s/ C. Larry Togans C. Larry Togans, Director	March 30, 2010