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**ANNUAL AUDITED REPORT
FORM X-17A-5
PART III**

SEC FILE NUMBER
8- 30830

FACING PAGE

**Information Required of Brokers and Dealers Pursuant to Section 17 of the
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder**

REPORT FOR THE PERIOD BEGINNING 1/1/04 AND ENDING 12/31/04
MM/DD/YY MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER: Potomac Investment Company

OFFICIAL USE ONLY

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

FIRM I.D. NO.

5600 Wisconsin Avenue, Apt. 108

(No. and Street)

Chevy Chase

Maryland

20815

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

(Area Code - Telephone Number)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*

Freidkin, Matrone & Horn, P.A.

(Name - if individual, state last, first, middle name)

6163 Executive Blvd.

Rockville, MD

20852

(Address)

(City)

(State)

(Zip Code)

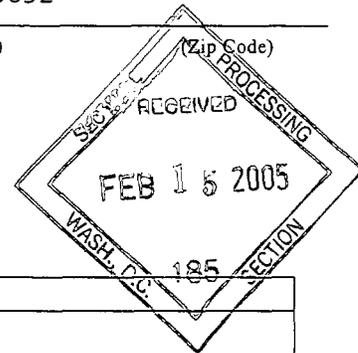
CHECK ONE:

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

PROCESSED

FEB 22 2005

THOMSON
FINANCIAL



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*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

SEC 1410 (06-02)

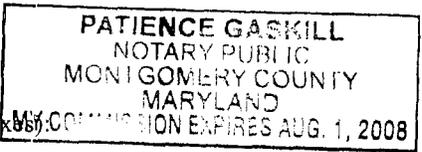
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OATH OR AFFIRMATION

I, Carol Greenwald, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Potomac Investment Company, as of December 31,, 20 04, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

Carol Greenwald 2/11/05
Signature
President
Title

Patience Gaskill
Notary Public 02/11/05



- This report ** contains (check all applicable boxes)
- (a) Facing Page.
 - (b) Statement of Financial Condition.
 - (c) Statement of Income (Loss).
 - (d) Statement of Changes in Financial Condition.
 - (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietors' Capital.
 - (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
 - (g) Computation of Net Capital.
 - (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
 - (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
 - (j) A Reconciliation, including appropriate explanation of the Computation of Net Capital Under Rule 15c3-3 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
 - (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
 - (l) An Oath or Affirmation.
 - (m) A copy of the SIPC Supplemental Report.
 - (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

**For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

POTOMAC INVESTMENT COMPANY

YEAR ENDED DECEMBER 31, 2004

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Potomac Investment Company
Chevy Chase, Maryland

We have audited the accompanying statement of financial condition of Potomac Investment Company (an S Corporation) as of December 31, 2004, and the related statements of income, changes in shareholder's equity and cash flows for the year then ended that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. 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 audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards. 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Potomac Investment Company at December 31, 2004, and the results of its operations and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements, taken as a whole. The information contained in Schedules I(a)-I(d) is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Freidkin, Matrone & Horn, P.A.

January 14, 2005

POTOMAC INVESTMENT COMPANY

STATEMENT OF FINANCIAL CONDITION

DECEMBER 31, 2004

ASSETS	
Cash	\$ 9,761
Receivables:	
Accounts receivable, trade	16,602
Prepaid expenses	<u>3,053</u>
Total current assets	<u>29,416</u>
Property and equipment:	
Office equipment	6,529
Automobile	<u>29,480</u>
	36,009
Less accumulated depreciation	<u>(13,408)</u>
	<u>22,601</u>
Stock (NASD)	<u>32,288</u>
	<u>\$ 84,305</u>

LIABILITIES AND SHAREHOLDER'S EQUITY

Liabilities:	
Loan payable – shareholder	\$ 1,964
Retirement plan payable	<u>15,000</u>
Total current liabilities	<u>16,964</u>
Shareholder's equity:	
Common stock, \$6 par value; authorized, 10,000 shares; issued and outstanding, 1,000 shares	6,000
Additional paid in capital	67,210
Accumulated other comprehensive income (loss)	(12,612)
Accumulated earnings	<u>6,743</u>
	<u>67,341</u>
	<u>\$ 84,305</u>

The accompanying notes are an integral part of this financial statement.

POTOMAC INVESTMENT COMPANY

STATEMENT OF INCOME

YEAR ENDED DECEMBER 31, 2004

Fee income	\$ 205,624
Direct costs	<u>(28,982)</u>
	<u>176,642</u>
Operating expenses:	
Charitable contributions	8,925
Depreciation	5,896
Filing and licenses	1,283
Insurance	10,592
Office	1,962
Payroll and other taxes	6,170
Professional fees	5,640
Rent/management	12,595
Retirement plan	15,000
Salaries	74,228
Subcontractor	8,941
Telephone	1,967
Travel and transportation	15,042
Utilities	<u>892</u>
	<u>169,133</u>
Net income before other income	7,509
Other income	<u>34</u>
Net income	<u>\$ 7,543</u>

The accompanying notes are an integral part of this financial statement.

POTOMAC INVESTMENT COMPANY
STATEMENT OF CHANGES IN SHAREHOLDER'S EQUITY

YEAR ENDED DECEMBER 31, 2004

	Total	Comprehensive Income	Accumulated Earnings	Accumulated Other Comprehensive Income (loss)	Common Shares	Stock Amount	Additional Paid- in Capital
Balance, beginning of year	\$ 73,230		\$ 15,000	\$(14,980)	1000	\$6,000	\$67,210
Comprehensive income (loss):							
Net income	7,543	\$7,543	7,543				
Other comprehensive income (loss):							
Unrealized holding losses during period	2,368	2,368		2,368			
Total comprehensive income	(15,800)	\$9,911					
Distribution from capital			(15,800)				
Balance, end of year	<u>\$ 67,341</u>		<u>\$ 6,743</u>	<u>\$(12,612)</u>	<u>1000</u>	<u>\$6,000</u>	<u>\$67,210</u>

The accompanying notes are an integral part of this financial statement.

POTOMAC INVESTMENT COMPANY

STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31, 2004

Cash flows from operating activities:	
Cash received from investment services	\$ 210,860
Cash paid for investment services and expenses	(196,082)
Interest received	<u>34</u>
Net cash provided by operating activities	<u>14,812</u>
Cash flows from financing activities:	
Capital distributed to shareholder	(15,800)
Loan from shareholder	<u>1,800</u>
Net cash used in financing activities	<u>(14,000)</u>
Net increase in cash and cash equivalents	812
Cash and cash equivalents, beginning of year	<u>8,949</u>
Cash and cash equivalents, end of year	<u>\$ 9,761</u>
Reconciliation of net income to net cash provided by operating activities:	
Net income	\$ 7,543
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	5,896
Changes in assets and liabilities:	
Decrease in accounts receivable	5,236
Decrease in prepaid expenses	1,193
Decrease in accrued expenses and payroll taxes withheld	(56)
Decrease in retirement plan payable	<u>(5,000)</u>
Net cash provided by operating activities	<u>\$ 14,812</u>

The accompanying notes are an integral part of this financial statement.

POTOMAC INVESTMENT COMPANY

NOTES TO FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 2004

1. Organization and summary of significant accounting policies:

Organization:

Potomac Investment Company (the "Company") was incorporated under the laws of the District of Columbia on October 19, 1983 to provide investment services in the Washington metropolitan area. The Company, which is regulated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934, is an "introducing" broker-dealer as defined in Rule 15c3-1(a)(2).

Accounts receivable:

Accounts receivable are recorded net of allowance for expected losses. The allowance, estimated at zero for 2004, is estimated based on historical performances.

Depreciation:

The Company's equipment is depreciated using the straight line method over three to five years.

Income taxes:

Beginning with the taxable year ended December 31, 1983, the Company's shareholders elected to be treated as an S Corporation for Federal income tax purposes. Under this election, income, losses and credits are included in the individual tax returns of the shareholder. Therefore, no provision has been made for Federal income taxes in the accompanying financial statements.

Statement of cash flows:

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Use of estimates:

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

POTOMAC INVESTMENT COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED DECEMBER 31, 2004

2. Related party:

The Company leases operating space from the sole shareholder. The monthly payment represents a percentage of space used and is determined on a month to month basis.

3. Investment in NASD stock:

The Company purchased 3,200 shares of NASD stock for \$44,900. The fair market value of this security was \$32,288 at December 31, 2004. There are no intentions of selling this security and thus, it is recorded as noncurrent at December 31, 2004.

4. Net capital requirements:

The Company is required to comply with the net capital rule of the Securities and Exchange Commission. This rule prohibits the Company from engaging in any security transactions should its "aggregate indebtedness" exceed 15 times its "net capital," as those terms are defined in the rule. The rule may also limit the circumstances under which the Company may declare dividends. The minimum net capital requirement under the rule is the greater of \$6,000 or 6.67% of aggregate indebtedness. In computing net capital, items not readily convertible into cash are excluded.

The Company's aggregate indebtedness is \$16,964 and its net capital of \$9,399 exceeded the minimum required by the net capital rule by \$3,399 at December 31, 2004.

5. Retirement plan:

The Company maintains a Simplified Employer Plan (SEP) for employees. The Company provides a discretionary contribution to the SEP on an annual basis and the contribution is accrued as a liability in the year to which it applies. For 2004, the Company elected to make a contribution of \$15,000.

6. Computation for determination of reserve requirements pursuant to SEC Rule 15c3-3:

The Company is exempt from the provisions of the reserve requirements of the Securities and Exchange Commission under Section (k)(2)(i)(i) since the Company does not carry security accounts for customers or perform custodial functions relating to customer securities.

SUPPLEMENTARY INFORMATION

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER Potomac Investment Company	as of December 31, 2004
COMPUTATION OF NET CAPITAL	

1. Total ownership equity from Statement of Financial Condition	\$ 67,341	3480
2. Deduct ownership equity not allowable for Net Capital		3490
3. Total ownership equity qualified for Net Capital	\$ 67,341	3500
4. Add:		
A. Liabilities subordinated to claims of general creditors allowable in computation of net capital		3520
B. Other (deductions) or allowable credits (List)		3525
5. Total capital and allowable subordinated liabilities	\$ 67,341	3530
6. Deductions and/or changes:		
A. Total nonallowable assets from Statement of Financial Condition (Notes B and C)	\$57,942	
B. Secured demand note delinquency		
C. Commodity futures contracts and spot commodities - proprietary capital changes		
D. Other deductions and /or changes		3620
7. Other additions and/or allowable credits (List)		3630
8. Net capital before haircuts on securities positions	\$(57,942)	3640
9. Haircuts on securities (computed, where applicable, pursuant to 15c3-1(f))		
A. Contractual securities commitments		
B. Subordinated securities borrowings		
C. Trading and investment securities:		
1. Exempted securities		
2. Debt securities		
3. Options		
4. Other securities		
D. Undue Concentration		
E. Other (List)		3740
10. Net Capital	\$ 9,399	3750

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER Potomac Investment Company	as of December 31, 2004
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COMPUTATION OF NET CAPITAL REQUIREMENT

Part A

11. Minimum net capital required (6 2/3% of line 19)	\$ 1,131	3750
12. Minimum dollar net capital requirement of reporting broker or dealer and minimum net capital requirement of subsidiaries computed in accordance with Note (A)	\$ 6,000	3750
13. Net capital requirement (greater of line 11 or 12)	\$ 6,000	3760
14. Excess net capital (line 10 less 13)	\$ 3,399	3770
15. Excess net capital at 1000% (line 10 less 10% of line 19)	\$ 7,703	3780

COMPUTATION OF AGGREGATE INDEBTEDNESS

16. Total A.I. liabilities from Statement of Financial Condition	\$ 16,964	3790
17. Add:		
A. Drafts for immediate credit	\$	3830
B. Market value of securities borrowed for which no equivalent value is paid or credited	\$	
C. Other unrecorded amounts (List)	\$	3830
19. Total aggregate indebtedness	\$ 16,964	3840
20. Percentage of aggregate indebtedness to net capital (line 19 ÷ line 10)	180.49%	3850
21. Percentage of debt to debt equity total computed in accordance with Rule 15c3-1(d)		3860

COMPUTATION OF ALTERNATE NET CAPITAL REQUIREMENT

Part B

22. 2% of combined aggregate debit items as shown in Formula for Reserve Requirements pursuant to Rule 15c3-3 prepared as of the date of the net capital computation including both brokers or dealers and consolidated subsidiaries' debits	\$ N/A	3870
23. Minimum dollar net capital requirement of reporting broker or dealer and minimum net capital requirement of subsidiaries computed in accordance with Note (A)	\$	3880
24. Net capital requirement (greater of line 22 or 23)	\$	3760
25. Excess capital (line 10 less 24)	\$	3910
26. Net capital in excess of the greater of:		
A. 5% of combined aggregate debit items of \$120,000	\$	3920

NOTES:

- (A) The minimum net capital requirement should be computed by adding the minimum dollar net capital requirement of the reporting broker dealer and, for each subsidiary to be consolidated, the greater of:
1. Minimum dollar net capital requirement, or
 2. 6 2/3% of aggregate indebtedness or 4% of aggregate debits if alternative method is used.
- (B) Do not deduct the value of securities borrowed under subordination agreements or secured demand note covered by subordination agreements not in satisfactory form and the market values of memberships in exchanges contributed for use of company (contra item 1740) and partners' securities which were included in non-allowable assets.
- (C) For reports filed pursuant to paragraph (d) of Rule 17a-5, respondent should provide a list of material non-allowable assets.

POTOMAC INVESTMENT COMPANY**SUPPLEMENTARY INFORMATION****NON-ALLOWABLE ASSETS FOR
NET CAPITAL COMPUTATION****YEAR ENDED DECEMBER 31, 2004**

NASD stock	\$32,288
Prepaid expenses	3,053
Net value of fixed assets	<u>22,601</u>
Total non-allowable assets	<u>\$57,942</u>

POTOMAC INVESTMENT COMPANY

SUPPLEMENTARY INFORMATION

SCHEDULE OF DIFFERENCES BETWEEN THE COMPUTATION OF NET CAPITAL AND AGGREGATE INDEBTEDNESS AT DECEMBER 31, 2003

Focus Reference Line	Description	Unaudited as Previously Reported Computation	Adjustment Increase (Decrease)	Audited Computation
3480-1	Total ownership equity	\$79,924	12,583	\$67,341
3500-3	Total ownership equity qualified for net capital	79,924	12,583	67,341
3530-5	Total capital and allowable subordinated liabilities	79,924	12,583	67,341
3540-6A	Total non-allowable assets	70,525	12,583	57,942
3640-8	Net capital before haircuts	9,399	-	9,399
3750-10	Net capital	9,399	-	9,399
3756-11	Minimum net capital required	-	1,131	1,131
3760-13	Net capital requirement	6,000	-	6,000
3770-14	Excess net capital	3,399	-	3,399
3780-15	Excess net capital at 1000 percentum	9,399	1,696	7,703
3840-19	Total aggregate indebtedness	-	16,964	16,964
3850-20	Percentage of aggregate indebtedness to net capital	-	180.47%	180.47%

There were no material differences between the audited Computation of Net Capital and Potomac Investment Company's corresponding unaudited part II A.

Independent Auditors' Report on Internal Control Structure
and Compliance

Board of Directors
Potomac Investment Company
Washington, D.C.

In planning and performing our audit of the financial statements and supplementary schedules of Potomac Investment Company for the year ended December 31, 2004, we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications and comparisons
2. Recordation of differences required by rule 17a-13
3. Complying with the requirements for prompt payment of securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control or the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including control activities for safeguarding securities, that we consider to be material weaknesses as defined above.

However, we noted the following matters involving the control environment and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of Potomac Investment Company for the year ended December 31, 2004, and this report does not affect our report thereon dated January 14, 2005.

The size of the Company and its limited personnel provide for minimal segregation of duties; i.e., the handling, recording and reconciliation of Company assets. The condition was considered in determining the nature, timing and extent of the audit tests to be applied in our examination of the 2004 financial statements, and this report does not affect our report on those financial statements dated January 14, 2005.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Securities and Exchange Commission to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding, and on our study, we believe that the Company's practices and procedures were adequate at December 31, 2004, to meet the SEC's objectives.

This report is intended solely for the information and use of the Board of Directors, management and the Securities and Exchange Commission, and other regulatory agencies that rely on rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Friedman, Motzke & Horn, P.A.

January 14, 2005