

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2010

**OR**

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

Commission File Number 0-14773

**NATIONAL BANCSHARES CORPORATION**

exact name of registrant as specified in its charter

Ohio

State of incorporation

34-1518564

IRS Employer

Identification No.

112 West Market Street, Orrville, Ohio 44667

Address of principal executive offices

Registrant's telephone number: (330) 682-1010

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No \_\_\_\_\_

Indicate by check mark whether the registrant 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.)

Yes X No \_\_\_\_\_

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]

Non-accelerated filer [ ]

Accelerated filer [ ]

Smaller reporting company [X]

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

Yes \_\_\_\_\_ No X

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of November 2, 2010.

Common Stock, Without Par Value: 2,205,973 Shares Outstanding

# NATIONAL BANCSHARES CORPORATION

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**Item 1. Financial Statements****NATIONAL BANCSHARES CORPORATION  
CONSOLIDATED BALANCE SHEETS (Unaudited)***(dollars in thousands)*

	Sept. 30, 2010	Dec. 31, 2009
<b>ASSETS</b>		
Cash and due from banks	\$ 21,805	\$ 8,124
Time deposits with other financial institutions	9,187	13,580
Securities available for sale	131,799	130,241
Restricted equity securities	3,219	3,218
Loans held for sale	338	316
Loans, net of allowance for loan losses:		
September 30, 2010 - \$2,748; December 31, 2009 - \$2,906	195,004	194,071
Premises and equipment, net	11,972	9,033
Goodwill	4,723	4,723
Identified intangible assets	130	197
Accrued interest receivable	1,494	1,334
Cash surrender value of life insurance	2,843	2,771
Other assets	2,594	2,620
Total assets	<u>\$ 385,108</u>	<u>\$ 370,228</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest bearing	\$ 59,003	\$ 54,290
Interest bearing	250,293	237,083
Total deposits	309,296	291,373
Repurchase agreements	6,551	6,105
Federal funds purchased	-	3,300
Federal Reserve Bank note account	154	315
Federal Home Loan Bank advances	25,000	27,000
Accrued interest payable	331	408
Accrued expenses and other liabilities	3,191	2,824
Total liabilities	344,523	331,325
<b>SHAREHOLDERS' EQUITY</b>		
Common stock, no par value; 6,000,000 shares authorized; 2,289,528 shares issued	11,447	11,447
Additional paid-in capital	4,764	4,752
Retained earnings	22,643	21,856
Treasury stock, at cost (83,555 shares)	(1,639)	(1,639)
Accumulated other comprehensive income	3,370	2,487
Total shareholders' equity	40,585	38,903
Total liabilities and shareholders' equity	<u>\$ 385,108</u>	<u>\$ 370,228</u>

See accompanying notes to consolidated financial statements.

NATIONAL BANCSHARES CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (Unaudited)

(dollars in thousands, except per share data)

	Three months ended		Nine months ended	
	Sept. 30, 2010	Sept. 30, 2009	Sept. 30, 2010	Sept. 30, 2009
Interest and dividend income				
Loans, including fees	\$ 2,689	\$ 2,472	\$ 7,929	\$ 7,621
Securities:				
Taxable	864	1,330	2,831	4,203
Nontaxable	313	222	877	555
Federal funds sold and other	<u>53</u>	<u>2</u>	<u>160</u>	<u>7</u>
Total interest and dividend income	3,919	4,026	11,797	12,386
Interest expense				
Deposits	536	681	1,665	2,479
Short-term borrowings	11	10	37	33
Federal Home Loan Bank advances	<u>252</u>	<u>263</u>	<u>762</u>	<u>793</u>
Total interest expense	<u>799</u>	<u>954</u>	<u>2,464</u>	<u>3,305</u>
Net interest income	3,120	3,072	9,333	9,081
Provision for loan losses	<u>228</u>	<u>576</u>	<u>1,350</u>	<u>927</u>
Net interest income after provision for loan losses	2,892	2,496	7,983	8,154
Noninterest income				
Checking account fees	288	282	822	788
Visa check card interchange fees	113	95	323	256
Deposit and miscellaneous service fees	88	71	251	203
Mortgage banking activities	91	71	192	213
Securities gains, net	540	79	616	387
Loss on sale of other real estate owned	(13)	(80)	(24)	(88)
Other	<u>102</u>	<u>77</u>	<u>266</u>	<u>226</u>
Total noninterest income	1,209	595	2,446	1,985
Noninterest expense				
Salaries and employee benefits	1,380	1,329	4,115	4,003
Data processing	261	224	758	670
Net occupancy	319	262	917	789
FDIC Assessment	132	116	398	512
Professional and consulting fees	178	171	570	402
Franchise tax	86	81	263	246
Maintenance and repairs	44	49	157	149
Amortization of intangibles	22	57	67	170
Telephone	60	60	176	160
Marketing	61	48	192	144
Director fees and pension	67	57	207	167
Software expense	60	46	153	145
Postage and supplies	65	62	220	207
Other	<u>212</u>	<u>244</u>	<u>685</u>	<u>722</u>
Total noninterest expense	<u>2,947</u>	<u>2,806</u>	<u>8,878</u>	<u>8,486</u>
Income before income tax expense	1,154	285	1,551	1,653
Income tax expense	<u>288</u>	<u>18</u>	<u>234</u>	<u>367</u>
Net income	866	267	1,317	1,286

(Continued)

NATIONAL BANCSHARES CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (Unaudited)

<i>(Continued)</i>	Three months ended		Nine months ended	
	<u>Sept. 30, 2010</u>	<u>Sept. 30, 2009</u>	<u>Sept. 30, 2010</u>	<u>Sept. 30, 2009</u>
Other comprehensive income (loss):				
Unrealized appreciation (depreciation) in fair value of securities available for sale, net of taxes of \$(140), \$(771), \$(665) and \$(1,021)	272	1,497	1,290	1,983
Reclassification adjustment for realized gains included in earnings, net of taxes of \$184, \$27, \$209 and \$132	<u>(356)</u>	<u>(52)</u>	<u>(407)</u>	<u>(255)</u>
Total other comprehensive income (loss), net of taxes	<u>(84)</u>	<u>1,445</u>	<u>883</u>	<u>1,728</u>
Comprehensive income	<u>\$ 782</u>	<u>\$ 1,712</u>	<u>\$ 2,200</u>	<u>\$ 3,014</u>
Weighted average basic and diluted common shares outstanding	<u>2,205,973</u>	<u>2,202,368</u>	<u>2,205,973</u>	<u>2,202,368</u>
Basic and diluted earnings per common share	<u>\$ 0.39</u>	<u>\$ 0.12</u>	<u>\$ 0.60</u>	<u>\$ 0.58</u>
Dividends declared per common share	<u>\$ 0.08</u>	<u>\$ 0.08</u>	<u>\$ 0.24</u>	<u>\$ 0.24</u>

See accompanying notes to consolidated financial statements.

NATIONAL BANCSHARES CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

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*(dollars in thousands, except per share data)*

	Nine months ended,	
	Sept. 30, 2010	Sept. 30, 2009
Balance at beginning of period	\$ 38,903	\$ 36,881
Comprehensive income		
Net income	1,317	1,286
Other comprehensive income	<u>883</u>	<u>1,728</u>
Total comprehensive income	2,200	3,014
Stock-based compensation	12	29
Cash dividends declared (\$0.24 per share in 2010 and 2009)	<u>(530)</u>	<u>(529)</u>
Balance at end of period	<u>\$ 40,585</u>	<u>\$ 39,395</u>

See accompanying notes to consolidated financial statements.

NATIONAL BANCSHARES CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands, except per share data)

	Nine months ended	
	Sept. 30, 2010	Sept. 30, 2009
Net cash from operating activities	\$ 2,932	\$ 1,576
Cash flows from investing activities		
Purchases of time deposits with other financial institutions	(984)	-
Proceeds from time deposits with other financial institutions	5,377	-
Securities available for sale		
Proceeds from maturities and repayments	26,742	27,228
Proceeds from sales	15,179	13,787
Purchases	(42,131)	(45,755)
Purchases of property and equipment	(3,479)	(2,512)
Proceeds from the sale of other real estate owned	63	122
Proceeds from the sale of an impaired loan	930	-
Purchase of loans	(1,184)	(1,151)
Net change in loans	(2,142)	(3,521)
Net cash from investing activities	(1,629)	(11,802)
Cash flows from financing activities		
Net change in deposits	17,923	15,833
Net change in short-term borrowings	(3,015)	(6,347)
Proceeds from Federal Home Loan Bank advances	-	7,000
Repayments of Federal Home Loan Bank advances	(2,000)	(1,000)
Dividends paid	(530)	(529)
Net cash from financing activities	12,378	14,957
Net change in cash and cash equivalents	13,681	4,731
Beginning cash and cash equivalents	8,124	11,001
Ending cash and cash equivalents	<u>\$ 21,805</u>	<u>\$ 15,732</u>
Supplemental Disclosures		
Cash paid for interest	\$ 2,541	\$ 3,545
Cash paid for income taxes	\$ 470	\$ 340
Supplemental noncash disclosures:		
Transfer from loans to other real estate owned	\$ 91	\$ 54

See accompanying notes to consolidated financial statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Quarters and Years ended September 30, 2010 and 2009**

**Note 1 – Basis of Presentation**

*(dollars in thousands)*

*Company Organization and Financial Presentation*

The accompanying consolidated financial statements include the accounts of National Bancshares Corporation (the “Company”) and its wholly owned subsidiaries, First National Bank, Orrville, Ohio (the “Bank”) and NBOH Properties, LLC. The Bank has a minority interest in First Kropf Title, LLC. The Bank’s investment in First Kropf Title, LLC is immaterial to the consolidated financial statements. All significant intercompany transactions and balances have been eliminated.

The Company provides a broad range of financial services to individuals and companies in Medina, Stark, Summit and Wayne Counties, Ohio. While the Company’s chief decision makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all the Company’s banking operations are considered by management to be aggregated in one reportable operating segment.

The consolidated balance sheet as of September 30, 2010, the consolidated statements of income and comprehensive income for the three and nine month periods ended September 30, 2010 and 2009, and the condensed consolidated statements of changes in shareholders’ equity and the condensed consolidated statements of cash flows for the nine month periods ended September 30, 2010 and 2009, have been prepared by the Company without audit. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

The consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q, but do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These statements should be read in conjunction with the consolidated financial statements and footnotes in the Company’s annual report on Form 10-K for the year ended December 31, 2009. Operating results for the nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The Company believes that the disclosures are adequate to make the information presented not misleading; however, the results of operations and other data presented for the periods presented are not necessarily indicative of results to be expected for the entire fiscal year.

*Use of Estimates*

To prepare financial statements in conformity with U.S. generally accepted accounting principles, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ. The allowance for loan losses, fair values of financial instruments and carrying value of intangible assets are particularly subject to change.

*Cash Flows*

Cash and cash equivalents include cash, deposits with other banks with original maturities under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, repurchase agreements and other short-term borrowings.

*Earnings Per Common Share*

Earnings per common share is net income divided by the weighted average number of shares outstanding during the period. Diluted earnings per share includes the dilutive effect of additional potential common shares issuable under stock options. 46,000 and 53,000 stock options were not considered in computing diluted earnings per common share for the periods ending September 30, 2010 and 2009, respectively, because they were antidilutive.

**Note 2 – Securities**  
(dollars in thousands)

Securities consist of the following at September 30, 2010 and December 31, 2009:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<u>September 30, 2010</u>				
U.S. Government and federal agency	\$ 6,725	\$ 87	\$ (1)	\$ 6,811
State and municipal	37,622	1,886	(12)	39,496
Corporate bonds and notes	2,476	45	-	2,521
Mortgage-backed: residential	79,847	3,134	(16)	82,965
Equity securities	23	-	(17)	6
Total	<u>\$ 126,693</u>	<u>\$ 5,152</u>	<u>\$ (46)</u>	<u>\$ 131,799</u>
<u>December 31, 2009</u>				
U.S. Government and federal agency	\$ 819	\$ -	\$ -	\$ 819
State and municipal	28,019	763	(99)	28,683
Corporate bonds and notes	7,640	137	-	7,777
Mortgage-backed: residential	89,972	3,058	(87)	92,943
Equity securities	23	-	(4)	19
Total	<u>\$ 126,473</u>	<u>\$ 3,958</u>	<u>\$ (190)</u>	<u>\$ 130,241</u>

	<u>For the nine months ended</u>	
	<u>Sept. 30,</u>	<u>Sept. 30,</u>
	<u>2010</u>	<u>2009</u>
Sales of available for sale securities were as follows:		
Proceeds	\$ 15,179	\$ 13,787
Gross gains	642	566
Gross losses	(26)	(179)

	<u>For the three months ended</u>	
	<u>Sept. 30,</u>	<u>Sept. 30,</u>
	<u>2010</u>	<u>2009</u>
Sales of available for sale securities were as follows:		
Proceeds	\$ 13,192	\$ 8,172
Gross gains	566	258
Gross losses	(26)	(179)

The tax provision related to these net realized gains and losses was \$209 and \$132, respectively for the nine months ended September 30, 2010 and 2009.

The fair value of securities at September 30, 2010 by contractual maturity were as follows. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 5,253	\$ 5,277
Due from one to five years	7,938	8,178
Due from five to ten years	16,876	17,738
Due after ten years	16,756	17,635
Mortgage-backed: residential	79,847	82,965
Equity securities	23	6
Total	<u>\$ 126,693</u>	<u>\$ 131,799</u>

Securities pledged at September 30, 2010 and December 31, 2009 had a carrying amount of \$61,020 and \$45,882 and were pledged to secure public deposits and repurchase agreements.

At September 30, 2010 and December 31, 2009, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

Securities with unrealized losses at September 30, 2010 and December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>September 30, 2010</u>						
U.S. Government and federal agency	\$ 2,396	\$ (1)	\$ -	\$ -	\$ 2,396	\$ (1)
State and municipal	4,647	(12)	-	-	4,647	(12)
Mortgage-backed: residential	4,498	(16)	-	-	4,498	(16)
Equity securities	<u>23</u>	<u>(17)</u>	<u>-</u>	<u>-</u>	<u>23</u>	<u>(17)</u>
Total temporarily impaired	<u>\$ 11,564</u>	<u>\$ (46)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,564</u>	<u>\$ (46)</u>

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>December 31, 2009</u>						
State and municipal	\$ 4,375	\$ (60)	\$ 455	\$ (39)	\$ 4,830	\$ (99)
Mortgage-backed: residential	11,761	(87)	-	-	11,761	(87)
Equity securities	<u>19</u>	<u>(4)</u>	<u>-</u>	<u>-</u>	<u>19</u>	<u>(4)</u>
Total temporarily impaired	<u>\$ 16,155</u>	<u>\$ (151)</u>	<u>\$ 455</u>	<u>\$ (39)</u>	<u>\$ 16,610</u>	<u>\$ (190)</u>

Management believes the unrealized losses of securities as of September 30, 2010 are the result of fluctuations in interest rates and do not reflect deterioration in the credit quality of the securities. Accordingly management considers these unrealized losses to be temporary in nature. The Company does not have the intent to sell and does not believe it is more likely than not the Company will be required to sell these securities before their recovery. The fair value of debt securities is expected to recover as the securities approach their maturity date.

### **Note 3 – Allowance for Loan Losses**

(dollars in thousands)

The activity in the allowance for loan losses for the periods indicated was as follows:

	For the nine months ended	
	Sept. 30, 2010	Sept. 30, 2009
Beginning balance	\$ 2,906	\$ 1,718
Provision for loan losses	1,350	927
Loans charged-off	(1,531)	(535)
Recoveries	<u>23</u>	<u>15</u>
Ending balance	<u>\$ 2,748</u>	<u>\$ 2,125</u>
	For the three months ended	
	Sept. 30, 2010	Sept. 30, 2009
Beginning balance	\$ 2,560	\$ 1,992
Provision for loan losses	228	576
Loans charged-off	(49)	(455)
Recoveries	<u>9</u>	<u>12</u>
Ending balance	<u>\$ 2,748</u>	<u>\$ 2,125</u>

Individually impaired loans were as follows:

	Sept. 30, 2010	Dec. 31, 2009
Loans with no allocated allowance for loan losses	\$ 325	\$ 2,069
Loans with allocated allowance for loan losses	2,324	3,692
Amount of the allowance for loan losses allocated	515	916

The impact on interest income of impaired loans was not significant to the consolidated statements of income.

Impaired loans are generally measured for impairment using the fair value of the collateral supporting the loan. Evaluating impaired loan collateral is based on level 3 inputs utilizing outside appraisals adjusted by management for sales costs and other assumptions regarding market conditions to arrive at fair value.

Nonaccrual loans and loans past due 90 days still on accrual were as follows:

	Sept. 30, 2010	Dec. 31, 2009
Loans past due over 90 days still on accrual	\$ 475	\$ 458
Nonaccrual loans	3,088	4,716

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

#### **Note 4 – Interest-Rate Swaps**

*(dollars in thousands)*

The Company utilizes interest-rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position, not for speculation. The notional amount of the interest-rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest-rate swap agreements.

The Company implemented a program in 2009 whereby it lends to its borrowers at a fixed rate with the loan agreement containing a two-way yield maintenance provision. The program has one participant as of September 30, 2010. If the borrower prepays the loan, the yield maintenance provision will result in a prepayment penalty or benefit depending on the interest rate environment at the time of the prepayment. This provision represents an embedded derivative which is required to be bifurcated from the host loan contract. As a result of bifurcating the embedded derivative, the Company records the transaction with the borrower as a floating rate loan and a pay floating / receive fixed interest-rate swap. To offset the risk of the interest-rate swap with the borrower, the Company enters into an interest-rate swap with an outside counterparty that mirrors the terms of the interest-rate swap between the Company and the borrower. Both interest-rate swaps are carried as freestanding derivatives with their changes in fair value reported in current earnings. The interest-rate swaps are not designated as hedges. The change in the fair value of the interest-rate swap between the Company and its borrower was an increase of \$63 for the nine months ended September 30, 2010, which was offset by an equal decrease in value during the nine months ended September 30, 2010 on the interest-rate swap with an outside counterparty, with the result that there was no impact on income as of September 30, 2010.

Summary information about the interest-rate swaps not designated as hedges between the Company and its borrower as of September 30, 2010 is as follows:

Notional amount	\$ 1,500
Weighted average receive rate	5.33%
Weighted average pay rate	3.36%
Weighted average maturity (years)	3.3
Fair value of interest-rate swaps	\$ 67

Summary information about the interest-rate swaps between the Company and outside parties as of September 30, 2010 is as follows:

Notional amount	\$ 1,500
Weighted average pay rate	5.33%
Weighted average receive rate	3.36%
Weighted average maturity (years)	3.3
Fair value of interest-rate swaps	\$ (67)

The fair value of the interest-rate swaps at September 30, 2010 is reflected in other assets and other liabilities with a corresponding offset to noninterest income.

#### **Note 5 – Stock-Based Compensation**

*(dollars in thousands, except per share information)*

The Corporation's 2008 Equity Incentive Plan ("the Plan"), which is shareholder-approved, permits the grant of stock options or restricted stock awards, to its officers, employees, consultants and non-employee directors for up to 223,448 shares of common stock.

Option awards are granted with an exercise price equal to the fair value of the Corporation's common stock at the date of grant; those option awards have vesting periods determined by the Corporation's compensation committee and have terms that shall not exceed 10 years.

On May 20, 2008, the Corporation granted options to purchase 58,000 shares of stock to directors and certain key officers. The exercise price of the options is \$18.03 per share. The options vest in five equal installments over a five-year period and have a term of 10 years. 7,000 and 5,000 options were forfeited during 2010 and 2009, leaving 46,000 outstanding at September 30, 2010. All remaining options are expected to vest.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. (Employee and management options are tracked separately.) The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferrable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of options granted of \$1.83 per option was determined using the following weighted-average assumptions as of grant date.

Risk-free interest rate	3.19%
Expected term (years)	6.5
Expected stock price volatility	13.76%
Dividend yield	3.60%

The total compensation cost that has been charged against income for the plan was \$3 and \$6 for the quarters ended September 30, 2010 and 2009 and \$12 and \$29 for the nine month periods ended September 30, 2010 and 2009. The total income tax benefit was \$1 and \$2 for the quarters ended September 30, 2010 and 2009 and \$4 and \$10 for the nine month periods ended September 30, 2010 and 2009. As of September 30, 2010, there was \$20 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 2.7 years. At September 30, 2010, 20,800 options are vested and the outstanding options have no intrinsic value. The weighted average remaining contractual term is 7.7 years.

#### **Note 6 – Fair Value**

*(dollars in thousands)*

ASC 820-10 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as 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.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Discounted cash flows are calculated using estimates of current market rates for each type of security. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

The fair value of derivatives is based on valuation models using observable market data as of the measurement date (Level 2 inputs).

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less cost to sell. Fair Values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors.

#### Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are summarized below:

Fair Value Measurements at September 30, 2010 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:			
Available for sale securities:			
U.S. Government and federal agency	\$ -	\$ 6,040	\$ 771
State and municipal	-	39,196	300
Corporate bonds and notes	-	2,521	-
Mortgage-backed securities - residential	-	82,945	20
Equity securities	6	-	-
Interest rate swaps	-	67	-

Fair Value Measurements at September 30, 2010 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:			
Interest rate swaps	\$ -	\$ 67	\$ -

Fair Value Measurements at December 31, 2009 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:			
Available for sale securities:			
U.S. Government and federal agency	\$ -	\$ 819	\$ -
State and municipal	-	28,683	-
Corporate bonds and notes	-	7,777	-
Mortgage-backed securities - residential	-	92,943	-
Equity securities	19	-	-
Interest rate swaps	-	4	-

Fair Value Measurements at December 31, 2009 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:			
Interest rate swaps	\$ -	\$ 4	\$ -

#### Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

Fair Value Measurements at September 30, 2010 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:			
Impaired loans	\$ -	\$ -	\$ 1,809
Other real estate owned	-	-	108

Fair Value Measurements at December 31, 2009 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:			
Impaired loans	\$ -	\$ -	\$ 3,626
Other real estate owned	-	-	58

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal amount of \$2,324, with a valuation allowance of \$515, resulting in an additional provision of \$1,057 for loan loss in the nine months ended September 30, 2010. Impaired loans had a principal amount of \$4,542, with a valuation allowance of \$916, resulting in an additional provision of \$1,091 for loan loss in the year ended December 31, 2009.

Other real estate owned measured at fair value less costs to sell, had a net carrying amount of \$108, which is made up of the outstanding balance of \$183, net of a valuation allowance of \$75 at September 30, 2010. There were no write-downs of other real estate owned for the periods ending September 30, 2010. Other real estate owned measured at fair value less costs to sell,

had a net carrying amount of \$58, which is made up of the outstanding balance of \$133, net of a valuation allowance of \$75 at December 31, 2009, resulting in a write-down of \$75 for the year ending December 31, 2009.

Carrying amount and estimated fair values of financial instruments at September 30, 2010 were as follows:

	For the nine months ended			
	Sept. 30, <u>2010</u>		Dec. 31, <u>2009</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Financial assets				
Cash and cash equivalents	\$ 21,805	\$ 21,805	\$ 8,124	\$ 8,124
Time deposits with other financial institutions	9,187	9,187	13,580	13,580
Securities available for sale	131,799	131,799	130,241	130,241
Restricted equity securities	3,219	na	3,218	na
Loans held for sale	338	338	316	316
Loans, net	195,004	196,859	194,071	194,103
Accrued interest receivable	1,494	1,494	1,334	1,334
Interest rate swaps	67	67	4	4
Financial liabilities				
Deposits	\$ 309,296	\$ 310,535	\$ 291,373	\$ 292,045
Short-term borrowings	6,705	6,705	9,720	9,720
Federal Home Loan Bank advances	25,000	25,641	27,000	27,779
Accrued interest payable	331	331	408	408
Interest rate swaps	67	67	4	4

The methods and assumptions used to estimate fair value are described as follows:

Carrying amount is the estimated fair value for cash and cash equivalents, time deposits with other financial institutions, interest bearing deposits, accrued interest receivable and payable, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. Security fair values are determined as previously described. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of restricted equity securities due to restrictions placed on its transferability. The fair value of off-balance-sheet items is not considered material.

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

### **FORWARD-LOOKING INFORMATION**

This Form 10-Q contains forward-looking statements as referenced in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to many risks and uncertainties. When used herein, the terms “anticipates,” “plans,” “expects,” “believes,” and similar expressions as they relate to the Company or its management are intended to identify such forward looking statements. Actual results could differ materially from those indicated by the forward-looking statements. Risks and uncertainties that could cause or contribute to differences include, changes in the regulatory environment, changes in business conditions and inflation, risks associated with credit quality and other factors discussed in the Company's filings with the U.S. Securities and Exchange Commission, including its Annual Report on Form 10-K for the year ended December 31, 2009. The Company assumes no obligation to update any forward-looking statement.

### **GENERAL**

The Company's results of operations are dependent primarily on net interest income, provision for loan losses, noninterest income and its ability to control costs. Net interest income is the difference (“spread”) between the interest income earned on loans and securities and the cost of funds, consisting of interest paid on deposits, Federal Home Loan Bank advances and short-term funds. The interest rate spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand and deposit flows. The provision for loan losses is significantly affected by the relative strength or weakness of the local economy. The Company's net income is also affected by, among other things, loan fee income, service charges, gains on securities and loans, operating expenses, FDIC assessment expense and franchise and income taxes. The Company's operating expenses principally consist of employee compensation and benefits, occupancy and other general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory

authorities. Additionally, future changes in applicable laws, regulations or government policies may also materially impact the Company.

## OVERVIEW

Total assets increased to \$385.1 million as of September 30, 2010, from \$370.2 million at December 31, 2009.

Net income for the first nine months of 2010 was \$1,317 thousand compared to \$1,286 thousand for the same period of 2009 or \$0.60 and \$0.58 basic and diluted per share, respectively. Net income was positively impacted by an increase in net interest income and noninterest income and negatively impacted by an increase in the provision for loan losses and noninterest expense.

Net interest income for the nine month period ended September 30, 2010 increased 2.8% compared to the same period in 2009 despite a declining interest rate environment. The improvement in net interest margin was driven by a 9.4% increase in average earning assets and growth in lower cost core deposits. The provision for loan losses increased to \$1.4 million for the nine months ended September 30, 2010 compared to \$927 thousand for the same period in 2009. The increase in the provision was primarily related to the specific loss allocation, attributable to the deterioration during 2010 of two adversely classified loans. Noninterest income for the first nine months of 2010 increased \$461 thousand compared to the same period in 2009, primarily related to the increase in net gains recorded on the sale of securities from \$387 thousand in 2009 to \$616 thousand in 2010.

Noninterest expense for the first nine months of 2010 increased \$392 thousand compared to the same period in 2009 due primarily to an increase in professional and consulting fees, occupancy expense and salaries and employee benefits. The increase in professional and consulting fees was due to an increase in legal fees related to loan collection efforts and a document imaging project completed in August, 2010. Income tax expense was \$234 thousand for the nine months ended September 30, 2010 compared to \$367 thousand for the same period in 2009.

Office of the Controller of the Currency (“OCC”) regulations requires banks to maintain certain minimum levels of regulatory capital. Additionally, the regulations establish a framework for the classification of banks into five categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Generally, an institution is considered well-capitalized if it has a core (Tier 1) capital ratio of at least 5.0% (based on adjusted total assets); a core (Tier 1) risk-based capital ratio of at least 6.0%; and a total risk-based capital ratio of at least 10.0%. The Bank had capital ratios above the minimum to be well-capitalized at September 30, 2010 and December 31, 2009.

The Company is not aware of any market or institutional trends, events or uncertainties that are expected to have a material effect on liquidity, capital resources or operations or any current recommendations by its regulators which would have a material effect if implemented. The Company has not engaged in sub-prime lending activities and does not plan to engage in those activities in the future.

## FINANCIAL CONDITION – SEPTEMBER 30, 2010, COMPARED TO DECEMBER 31, 2009

### Balance Sheet

Cash and due from banks increased \$13.7 million to \$21.8 million at September 30, 2010.

Securities available for sale increased \$1.6 million due to the purchase of \$42.1 million of securities, offset by maturities and repayments of \$26.7 million and \$15.2 million in sales. The net unrealized gains on securities increased to \$5.1 million as of September 30, 2010 compared to \$3.8 million net unrealized gains on securities as of December 31, 2009.

Gross loans increased \$751 thousand during the first nine months of 2010. Average loans have increased from \$180.6 million for the nine month period ended September 30, 2009 to \$193.3 million for the same period in 2010. The loan demand in the Bank’s primary market remains soft. However, the Bank continues to focus on enhancing its ability to originate commercial loans and improving demand for commercial loan products. The Bank is also concentrating on the expansion of our agricultural business and lending services. Commercial and commercial real estate loans have increased \$17.9 million over the last twelve month period. The Bank began offering Small Business Administration (SBA) guaranteed loan services in 2009. \$1.9 million of SBA guaranteed loans were originated during the nine months ending September, 30, 2010.

Loans at September 30, 2010 and December 31, 2009 were as follows:  
(dollars in thousands)

	Sept. 30, 2010	Dec. 31, 2009
Collateralized by real estate:		
Commercial	\$ 71,300	\$ 65,139
Residential	45,312	50,390
Home Equity	27,728	26,526
Construction and land development	<u>11,900</u>	<u>12,395</u>
	156,240	154,450
Other:		
Consumer	10,730	12,343
Commercial	27,958	26,792
Other	<u>3,238</u>	<u>3,830</u>
	198,166	197,415
Unearned and deferred income	(414)	(438)
Allowance for loan losses	<u>(2,748)</u>	<u>(2,906)</u>
Total	<u>\$ 195,004</u>	<u>\$ 194,071</u>

Allowance for loan losses is a valuation allowance for probable incurred credit losses. This account is increased by the provision for loan losses and decreased by charge-offs less recoveries. The allowance balance required is established using the following methodology:

- All problem loans, impaired loans, past due loans and non-performing loans are closely monitored and analyzed by management on an ongoing basis. A classification rating is assigned to problem loans based on information about specific borrower situations and estimated collateral values. These loans are classified as either special mention, substandard, doubtful or loss.
- Specific problem loans, past due loans or non-performing loans are identified and analyzed individually in an effort to determine the expected probable incurred loss on these specifically identified loans.
- For problem loans that are not analyzed individually, a provision is established based on a historical migration analysis. The historical migration analysis identifies the percentage of problem loans that have been ultimately charged-off historically and over what time periods such loans have been charged off. Historical migration percentages are reviewed and adjusted by management to reflect various factors such as the growth and change in mix of the loan portfolio and by Comptroller of the Currency regulatory guidance. Non-individually analyzed loans are pooled and evaluated by loan type. The probable incurred loss on these pooled past due loans is estimated using historical loan loss experience.
- National and local economic conditions and other factors are also considered in determining the adequacy of the allowance for loan losses.
- A percentage of the allowance is allocated to specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.
- The allowance for loan losses is reviewed on a regular basis to determine the adequacy of the allowance.

The allowance for loan losses to total loans outstanding was 1.39% as of September 30, 2010, which is a decrease from 1.48% at December 31, 2009. The decrease in the allowance for loan losses was primarily related to a \$1.1 million partial charge-off of a commercial credit and a \$270 thousand charge-off of a commercial real estate loan sold in the second quarter. These loans were graded substandard and considered impaired as of December 31, 2009. Management allocated \$720 thousand of the allowance for loan losses to these two loans as of December 31, 2009. The provision for loan losses for the nine months ended September 30, 2010 was \$1.4 million, compared to \$927 thousand for the same period in 2009. Net charge-offs were \$1.5 million for the nine months ended September 30, 2010, compared to \$638 thousand for the same period in 2009.

The ratio of non-performing loans to total loans was 1.80% (\$3.6 million) for September 30, 2010 compared to 2.67% (\$5.2 million) for December 31, 2009. Non-performing loans consist of loans that have been placed on non-accrual status and loans past due over 90 days and still accruing interest. Loans past due 30 through 89 days and still accruing decreased from \$1.7 million as of December 31, 2009 to \$1.3 million as of September 30, 2010.

Adversely classified assets at September 30, 2010 and December 31, 2009 were as follows:

(dollars in thousands)

	Sept. 30, 2010		Dec. 31, 2009	
	<u>Amount</u>	<u>Percent of total loans</u>	<u>Amount</u>	<u>Percent of total loans</u>
Classified loans:				
Special mention	\$ 953	0.5%	\$ 2,841	1.4%
Substandard	9,086	4.6%	11,783	6.0%
Doubtful	-	0.0%	-	0.0%
Loss	-	0.0%	-	0.0%
Total classified loans	10,039	5.1%	14,624	7.4%
Other real estate owned	108	0.1%	104	0.1%
Total classified assets	<u>\$ 10,147</u>	<u>5.2%</u>	<u>\$ 14,728</u>	<u>7.5%</u>

Total classified loans decreased from \$14.6 million at December 31, 2009 to \$10.0 million at September 30, 2010. The Bank's classification ratio was 29.54% and 39.5% as of September 30, 2010 and December 31, 2009. The classification ratio is calculated using total adversely classified assets (excluding special mention loans) divided by Tier 1 capital plus allowance for loan losses. Management believes the allowance for loan losses is adequate as of September 30, 2010.

Total deposits increased \$17.9 million as of September 30, 2010 compared to December 31, 2009. Interest bearing demand deposits have increased \$7.4 million due primarily to an increase in local governmental deposit accounts. Historically noninterest-bearing demand accounts have fluctuated based upon the liquidity needs of our customers.

Deposits at September 30, 2010 and December 31, 2009 were as follows:

(dollars in thousands)

	<u>Sept. 30, 2010</u>	<u>Dec. 31, 2009</u>
Demand, noninterest-bearing	\$ 59,003	\$ 54,290
Demand, interest-bearing	125,256	117,862
Savings	49,414	46,371
Time, \$100,000 and over	20,924	15,712
Time, other	54,699	57,138
	<u>\$ 309,296</u>	<u>\$ 291,373</u>

#### Shareholders' Equity

Total shareholders' equity increased \$1.7 million to \$40.6 million as of September 30, 2010 from \$38.9 million as of December 31, 2009. Net income for the nine months ended September 30, 2010 was \$1.3 million, while dividends declared were \$530 thousand. Accumulated other comprehensive income increased from \$2.5 million on December 31, 2009 to \$3.4 million as of September 30, 2010.

The Bank is subject to regulatory capital requirements. The following is a summary of the actual and required regulatory capital amounts and ratios. Management believes the capital position of the Bank remains strong.

(dollars in thousands)

September 30, 2010	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets	\$ 31,122	13.19%	\$ 18,872	8.00%	\$ 23,590	10.00%
Tier 1 capital to risk-weighted assets	28,374	12.03%	9,436	4.00%	14,154	6.00%
Tier 1 capital to average assets	28,374	7.41%	15,322	4.00%	19,153	5.00%

  

December 31, 2009	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets	\$ 29,842	12.46%	\$ 19,161	8.00%	\$ 23,952	10.00%
Tier 1 capital to risk-weighted assets	26,936	11.25%	9,581	4.00%	14,371	6.00%
Tier 1 capital to average assets	26,936	7.40%	14,562	4.00%	18,202	5.00%

## **Statements of Cash Flows**

Net cash from operating activities for the first nine months of 2010 was \$2.9 million compared to \$1.6 million for the same period of 2009. Net cash from investing activities for the first nine months of 2010 was \$(1.6) million, compared to \$(11.8) million for the first nine months of 2009. Net cash from financing activities was \$12.4 million for the first nine months of 2010 compared to \$15.0 million for the first nine months of 2009. The increase in cash and cash equivalents was \$13.7 million during the first nine months of 2010, primarily related to an increase in local governmental deposit accounts. Total cash and cash equivalents was \$21.8 million as of September 30, 2010 compared to \$8.1 million at December 31, 2009. The Company intends to use the excess liquidity to reduce the Company's outstanding borrowings.

**COMPARISON OF RESULTS OF OPERATIONS FOR THE NINE MONTH PERIODS ENDED  
September 30, 2010 and 2009**

Net income for the first nine months of 2010 was \$1,317 thousand or \$0.60 per basic and diluted earnings per share compared to \$1,286 thousand or \$0.58 per basic and diluted earnings per share for the same period in 2009. The increase was due primarily to an increase in net interest income and noninterest income, partially offset by an increase in the provision for loan losses and an increase in noninterest expense.

Annualized return on average equity ("ROAE") and average assets ("ROAA") for the first nine months of 2010 were 4.41% and 0.46%, respectively, compared with 4.51% and 0.49% for the first nine months of 2009.

Nine months ended September 30,						
<u>2010</u>			<u>2009</u>			
(dollars in thousands)	<u>Daily Average Balance</u>	<u>Interest</u>	<u>Average yield/cost (1)</u>	<u>Daily Average Balance</u>	<u>Interest</u>	<u>Average yield/cost (1)</u>
Assets						
Interest earning assets:						
Securities:						
Taxable	\$ 99,871	\$ 2,831	3.93%	\$ 114,565	\$4,203	5.01%
Nontaxable	33,006	1,327	5.55%	18,728	841	6.12%
(tax equivalent basis) (2)						
Federal funds sold	-	-	0.00%	8,106	6	0.10%
Interest bearing deposits	26,772	160	0.80%	513	1	0.26%
Net loans (including nonaccrual loans)	<u>193,298</u>	<u>7,929</u>	<u>5.47%</u>	<u>180,603</u>	<u>7,621</u>	<u>5.63%</u>
Total interest-earning assets	352,947	<u>12,047</u>	<u>4.63%</u>	322,515	<u>12,672</u>	<u>5.21%</u>
All other assets	<u>25,623</u>			<u>24,542</u>		
Total assets	<u>\$ 378,570</u>			<u>\$ 347,057</u>		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing checking	\$ 121,376	501	0.55%	\$ 107,043	847	1.06%
Savings	48,438	49	0.13%	48,747	103	0.28%
Time, \$100,000 and over	18,819	260	1.84%	13,236	254	2.56%
Time, other	56,617	855	2.01%	59,129	1,275	2.88%
Federal Home Loan Bank advances	25,319	762	4.01%	24,458	793	4.32%
Other funds purchased	<u>9,421</u>	<u>37</u>	<u>0.52%</u>	<u>9,383</u>	<u>33</u>	<u>0.47%</u>
Total interest-bearing liabilities	<u>279,990</u>	<u>2,464</u>	<u>1.17%</u>	<u>261,996</u>	<u>3,305</u>	<u>1.68%</u>
Demand deposits	55,460			43,757		
Other liabilities	3,337			3,308		
Shareholders' equity	<u>39,783</u>			<u>37,996</u>		
Total liabilities and shareholders' equity	<u>\$ 378,570</u>			<u>\$ 347,057</u>		
Net interest income						
(tax equivalent basis) (2)		<u>\$ 9,583</u>			<u>\$9,367</u>	
Interest rate spread (3)			3.45%			3.53%
Net yield on interest-earning assets (4)			3.70%			3.84%
Ratio of average interest-earning assets to average interest-bearing liabilities			126.06%			123.10%

(1) Average yields are computed using annualized interest income and expense for the periods.

(2) Tax equivalence based on highest statutory rate of 34%.

(3) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(4) Net yield on interest-earning assets represents net interest income as a percentage of average interest-earning assets.

Interest and dividend income totaled \$11.8 million, a decrease of \$589 thousand for the nine months ended September 30, 2010 compared to the same period in 2009. Adjusted on a fully tax-equivalent ("FTE") basis the yield on earning assets in the first nine months of 2010 was 4.63% compared to 5.21% in the first nine months of 2009.

Interest expense totaled \$2.5 million, a decrease of \$841 thousand or 25.4% for the nine months ended September 30, 2010 as compared to the same period in 2009. The average cost for interest bearing liabilities was 1.17% compared to 1.68% for the first nine months of 2009.

The decrease of 51 basis points from the first nine months of 2010 is the result of change in the average volume in the mix of interest bearing liabilities and declining interest rates. Most of the growth in interest-bearing liabilities has occurred in interest-bearing demand accounts. The cost of interest-bearing demand deposits is relatively low compared to other interest-bearing liabilities.

\$15 million of Federal Home Loan Bank advances will mature from November 8, 2010 to April 11, 2011. The weighted average rate of these advances is 5.16%. The Bank does not intend to replace the advances with new advances as they mature. These advances account for approximately \$579 thousand or 23.5% of interest expense for the nine months ended September 30, 2010.

Net interest income increased \$252 thousand, or 2.8% for the nine month period ended September 30, 2010 as compared to September 30, 2009. During the first nine months of 2010, the interest rate spread on a FTE basis decreased by 8 basis points when compared to the first nine months of 2009.

Provision for loan losses totaled \$1.4 million for the first nine months of 2010 compared to \$927 thousand for the same period in 2009. The increase in the provision for loan losses is primarily related to the deterioration in 2010 of two loan relationships mentioned earlier in the allowance for loan loss section.

Non-performing loans were \$3.6 million as of September 30, 2010, compared to \$5.2 million as of December 31, 2009. Adversely classified loans decreased to \$10.0 million at September 30, 2010 compared to \$14.6 million as of December 31, 2009. Adversely classified loans are credits that Bank management has graded special mention, doubtful and substandard. Loans past due 30 through 89 days and still accruing decreased from \$1.7 million as of December 31, 2009 to \$1.3 million as of September 30, 2010.

Each quarter, management reviews the adequacy of the allowance for loan losses by reviewing the overall quality and risk profile of the Company's loan portfolio, by reviewing specific problem credits and assessing the potential for losses based on expected cash flows or collateral values, by reviewing trends in problem loan levels, by updating loss history for the Company's loans, by analyzing the growth and change in mix of the portfolio, and by analyzing economic trends that are believed to impact the Company's borrowers. Management reviewed all of these factors and determined the allowance for loan losses was adequate as of September 30, 2010.

Noninterest income for the nine months ended September 30, 2010 increased to \$2.4 million or 23.2%, from \$2.0 million for the same period in 2009. The change is primarily related to the increase in net gains recorded on the sale of securities from \$387 thousand in 2009 to \$616 thousand in 2010.

Noninterest expense for the nine months ended September 30, 2010 was \$8.9 million, an increase of 4.6% from \$8.5 million for the same period in 2009. The increase in professional and consulting fees was due to an increase in legal fees related to loan collection expenses and the costs associated with a project to convert all loan and deposit documents to digital images. The conversion of the loan and deposit documents to digital images was completed in August of 2010.

Income tax expense was \$234 thousand for the nine months ended September 30, 2010 which represents a decrease of \$133 thousand compared to the same period in 2009. Lower pre-tax income and an increase in interest income from tax-exempt securities for the nine months ended September 30, 2010, compared to the same period in 2009, are the primary factors causing the decrease in income tax expense.

Quarters ended September 30, 2010 and September 30, 2009 income statement highlights:

- Net interest income increased \$48 thousand, compared to the same period in 2009. The change was driven by an increase in average earning assets and growth in lower cost core deposit funding.
- Interest income decreased \$107 thousand or 2.7%, primarily related to a decrease in interest income from taxable securities, partially offset by an increase in interest income from loans and nontaxable securities.
- Interest expense decreased \$155 thousand or 16.2%, primarily related to a decrease in deposit interest expense.
- The provision for loan losses was \$228 thousand in the quarter ended September 30, 2010 compared to \$576 for the same period in 2009. The provision for loan losses in 2009 was higher due to the \$400 thousand partial charge-off of a \$1.6 million commercial real estate loan and an increase in specific allocations for classified loans during the period.
- Mortgage banking income increased to \$91 thousand for the three months ended September 30, 2010 from \$71 thousand for the same period in 2009. The change was due to an increase in the volume of loans sold in 2010 compared to 2009.

- Securities gains, net was \$540 thousand in 2010 compared to \$79 thousand in 2009. Management sold \$13.2 million of securities in the third quarter of 2010 and \$8.2 million of securities in the third quarter of 2009.
- Occupancy expense increased \$57 thousand, compared to the same period in 2009. The change was the result of improvement made to existing Bank facilities in late 2009 and 2010 and the purchase of a building in Fairlawn, Ohio. A portion of this building will be utilized for a full-service banking office. The new full-service office in Fairlawn will open for business in November of 2010.
- Income tax expense was \$288 thousand for the three months ended September 30, 2010, an increase of \$270 thousand compared to the same period in 2009. Higher pre-tax income in 2010, compared to the same period in 2009, is the primary causes of the increase.

### ***Item 3. Quantitative and Qualitative Disclosures About Market Risk***

#### **Economic Value of Equity**

The economic value of equity, (EVE), is the difference between the net present value of the assets and the net present value of liabilities. EVE can be thought of as the liquidation value of the Bank on the date the calculation is made. Calculating EVE involves using a discount rate to calculate the net present value of assets and liabilities after making assumptions about the duration of assets and liabilities. As interest rates change, the discount rate changes and the change in interest rates effects the duration of assets and liabilities. If interest rates fall, for example, the duration of loans shortens since borrowers tend to prepay. Conversely the duration of loans increases if interest rates rise since borrowers are inclined to hold on to the favorable rate they were able to obtain in the lower interest rate environment.

The Board of Directors has established revised limits on a decline in the economic value of equity (EVE) and earnings at risk (EAR) given changes in interest rates. These limits are that EVE shall not decline by more than 10%, 20% and 30% given a 1%, 2% and 3% increase or decrease in interest rates respectively and that EAR shall not be greater than 8%, 16% or 24% given a 1%, 2% or 3% increase or decrease in interest rates respectively. The following illustrates our equity at risk in the economic value of equity model.

#### **September 30, 2010**

Basis Point Change in Rates	<u>+300 bp</u>	<u>+200 bp</u>	<u>+100 bp</u>	<u>-100 bp</u>	<u>-200 bp</u>	<u>-300 bp</u>
Increase (decrease) in EVE	(8.1)%	(3.5)%	(0.1)%	(7.0)%	<i>nm</i>	<i>nm</i>

#### **December 31, 2009**

Basis Point Change in Rates	<u>+300 bp</u>	<u>+200 bp</u>	<u>+100 bp</u>	<u>-100 bp</u>	<u>-200 bp</u>	<u>-300 bp</u>
Increase (decrease) in EVE	(13.4)%	(7.4)%	(2.3)%	(4.4)%	<i>nm</i>	<i>nm</i>

*nm* – not meaningful

The Bank is in compliance with the interest rate risk policy limits related to EVE as of September 30, 2010 and December 31, 2009.

#### **Earnings at Risk**

Earnings at risk, is the amount by which net interest income will be affected given a change in interest rates. The interest income and interest expense for each category of earning assets and interest bearing liabilities is recalculated after making up and down assumptions about the change in interest rates. Changes in prepayment speeds and repricing speeds are also taken into account when computing earnings at risk given a change in interest rates.

The following illustrates the effect on earnings or EAR given rate increases of 100 to 300 basis points and decreases in interest rates of 100 to 300 basis points.

#### **September 30, 2010**

Basis Point Change in Rates	<u>+300 bp</u>	<u>+200 bp</u>	<u>+100 bp</u>	<u>-100 bp</u>	<u>-200 bp</u>	<u>-300 bp</u>
Increase (decrease) in Earnings	(0.6)%	(0.6)%	(0.7)%	(1.7)%	<i>nm</i>	<i>nm</i>

#### **December 31, 2009**

Basis Point Change in Rates	<u>+300 bp</u>	<u>+200 bp</u>	<u>+100 bp</u>	<u>-100 bp</u>	<u>-200 bp</u>	<u>-300 bp</u>
Increase (decrease) in Earnings	(1.6)%	(1.1)%	(0.3)%	(0.1)%	<i>nm</i>	<i>nm</i>

*nm* – not meaningful

The Bank is in compliance with the interest rate risk policy limits related to EAR as of September 30, 2010 and December 31, 2009.

***Item 4T. Controls and Procedures***

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2010, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were, to the best of their knowledge, effective as of September 30, 2010, in timely alerting them to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic SEC filings.

There were no changes in the Company's internal controls over financial reporting during the nine months ended September 30, 2010 that materially affected or are reasonably likely to materially affect the Company's internal controls over financial reporting.

## PART II. OTHER INFORMATION

Item 1.	Legal Proceedings - None
Item 1A.	Risk Factors - There have been no significant changes in the Company's risk factors as outlined in the Company's Form 10-K for the period ending December 31, 2009.
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds - None
Item 3.	Defaults Upon Senior Securities - None
Item 4.	Removed and Reserved
Item 5.	Other Information - None
Item 6.	Exhibits

Exhibit No. Under Reg. <u>S-K, Item 601</u>	<u>Description of Exhibits</u>	If incorporated by Reference, Documents with Which Exhibit Was Previously Filed with SEC
(3.1)	Amended Articles of Incorporation	Annual Report 10-K filed 3/26/04 File No. 000-14773
(3.2)	Code of Regulations	Annual Report 10-K filed 3/26/04 File No. 000-14773
(10.1)	Directors Defined Benefit Plan Agreement	Annual Report 10-K filed 3/29/01 File No. 000-14773
(10.2)	Employment Agreement entered into by David C. Vernon and National Bancshares and First National Bank	Special Report 8-K filed 12/7/06
(10.3)	Special Separation Agreement of James R. VanSickle	Quarterly Report 10-Q filed 8/14/07 File No. 000-14473
(10.4)	Special Separation Agreement of Thomas R. Poe	Quarterly Report 10-Q filed 11/14/09 File No. 000-14473
(10.5)	Special Separation Agreement of Myron Filarski	Quarterly Report 10-Q filed 10/29/10 File No. 000-14473
(11)	Computation of Earnings per Share	See Consolidated Statements of Income and Comprehensive Income Page 4
(31.1)	Certification	
(31.2)	Certification	
(32)	Certification	

No other exhibits are required to be filed herewith pursuant to Item 601 of Regulation S-K.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

National Bancshares Corporation

Date: November 2, 2010

/s/David C. Vernon  
David C. Vernon, President and  
Chief Executive Officer

Date: November 2, 2010

/s/James R. VanSickle  
James R. VanSickle, Chief Financial Officer

**SPECIAL SEPARATION AGREEMENT**

This **SPECIAL SEPARATION AGREEMENT** ("Agreement") is entered into as of this 12th day of October, 2010, by and between First National Bank (the "Company") and Myron Filarski (the "Executive") and is guaranteed by National Bancshares Corp. (the "Parent Company").

**WHEREAS**, the Executive will be employed by the Company as Senior Vice President and Senior Loan Officer of the Company; and

**WHEREAS**, the Company has determined that it is desirable to obtain from the Executive certain protections with respect to non-disclosure, non-interference and non-competition; and

**WHEREAS**, the Company has determined that it is desirable to agree at this time to provide the Executive with severance benefits under certain circumstances after a Change in Control has occurred in order that the Executive may more fully focus his current efforts on expanding the Company's business and profits without concern for his personal security in the event of a Change in Control;

**WHEREAS**, the Company and the Executive desire to set forth in a written agreement the terms and provisions of these protections; and

**WHEREAS**, the Parent Company desires to guarantee the benefits payable under this Agreement;

**NOW THEREFORE**, in consideration of the foregoing, the mutual covenants and agreements set forth in this Agreement, the Company and the Executive agree as follows:

**Section 1. Definitions**

**1.1 Affiliate.** The term "Affiliate" shall mean any entity controlling, controlled by or under common control with the Company, including, but not limited to, divisions and subsidiaries of the Company.

**1.2 Cause.** The term "Cause" shall include:

- a. a breach of the Executive's obligations under Section 5 hereof; or
- b. the indictment of the Executive for, conviction of the Executive for, or written confession of the Executive to a misdemeanor or felony against the Company or any of its Affiliates, employees or customers, including but not limited to

embezzlement or embezzlement of customer account assets, but excluding any such misdemeanor or felony related to an automobile accident.

**1.3 Change in Control.** The term "Change in Control" shall include:

- a. the first purchase of shares pursuant to a tender offer or exchange (other than a tender offer or exchange by the Parent Company) for twenty-five percent (25%) or more of the Parent Company's common stock of any class and any securities convertible into such common stock;
- b. the receipt by the Parent Company of a Schedule 13D or other advice after the date of execution of this Agreement indicating that a person is the "beneficial owner" (as that term is defined in Rule 13d-3 under the Securities Exchange Act of 1934) of twenty-five percent (25%) or more of the Parent Company's common stock of any class or any securities convertible in such common stock calculated as provided in paragraph (d) of said Rule 13d-3;
- c. the date of approval by stockholders of the Parent Company of an agreement providing for any consolidation or merger of the Parent Company in which the Parent Company will not be the continuing or surviving corporation or pursuant to which shares of capital stock, of any class or any securities convertible into such capital stock, of the Parent Company would be converted into cash, securities, or other property, other than a merger of the Parent Company in which the holders of common Stock of all classes of the Parent Company immediately prior to the merger would own in excess of fifty percent (50%) of the common stock of the surviving corporation immediately after the merger;
- d. the date of the approval by stockholders of the Parent Company of any sale, lease, exchange, or other transfer (in one transaction or a series of related transactions) of all or substantially all the assets of the Parent Company or the Company;
- e. the adoption of any plan or proposal for the liquidation (but not a partial liquidation) or dissolution of the Company or the Parent Company; any transaction whereby the Company ceases to be a wholly owned subsidiary of the Parent Company;

- f. any sequence of events whereby the individuals who constitute the Board of Directors of the Parent Company as of the date of this Agreement ("Incumbent Directors") together with individuals whose election or nomination for election by the Parent Company's shareholders was approved by a majority of the Incumbent Directors do not constitute at least seventy-five percent (75%) of the then current Board of Directors of the Parent Company; or
- g. such other event as the Outside Committee Members shall, in their sole and absolute discretion, deem to be a "Change in Control."

**1.4 Company.** The term "Company" shall mean First National Bank or any successor corporation or business organization which shall assume the obligations of the Company under Agreement.

**1.5 Confidential Information.** The term "Confidential Information" shall mean any and all information (excluding information in the public domain) which relates to the business of the Company and its Affiliates, including without limitation all information relating to the identity and/or location of all past, present and prospective customers of the Company and its Affiliates, strategic plans, financial plans, financial information, computer programs, information concerning pricing and pricing policies, marketing techniques, and methods and manner of operations.

**1.6 Good Reason.** The term "Good Reason" shall include:

- a. any reduction in either the current base salary or the annual bonus of the Executive;
- b. any material reduction in the employee benefits and fringe benefits of the Executive;
- c. any material reduction in the position, office or title of the Executive;
- d. the Executive ceases to have the powers, perquisites, responsibilities or duties commensurate with being the Senior Vice President and Senior Loan Officer of a bank of comparable size to the Company;
- e. the Executive ceases to report to the President and Chief Executive Officer of the Bank; or

- f. the principal place of employment of the Executive is relocated to any location which is outside of a twenty (20) mile radius of the current main office of the Company in Orrville, Ohio.

**1.7 Outside Committee Members.** The term "Outside Committee Members" shall mean members of the Executive Committee of the Board of Directors of the Company who are not employees of the Company or an Affiliate; provided, however, that in the event of a Change in Control, "Outside Committee Members" shall mean those same individuals who were Outside Committee Members immediately prior to such Change in Control.

**1.8 Parent Company.** The term "Parent Company" shall mean National Bancshares Corp. or any successor corporation or business organization which shall assume the obligations of the Parent Company under Agreement.

**1.9 Protection Period.** The term "Protection Period" shall mean the twenty four (24) month period after a Change in Control occurs.

**1.10 Successor.** The term "successor" will include any person, firm, corporation or business entity which acquires all or substantially all of the assets or succeeds to the business of the Company.

## **Section 2. Employment Terminations Which Qualify For Severance Benefits**

**2.1 Termination by the Company Other Than For Cause.** In the event the Company terminates the Executive's employment within the Protection Period other than for Cause, the Executive will be entitled to receive the Severance Benefits set forth in Section 4 hereof.

**2.2 Voluntary Termination by the Executive With Good Reason.** In the event the Executive terminates his employment within the Protection Period with Good Reason, the Executive will be entitled to receive the Severance Benefits set forth in Section 4 hereof. In order to terminate employment in accordance with this Section 2.2, an Executive must give sixty (60) days advance written notice of his impending termination of employment to the Company, specify the reason for such termination in such notice and provide the Company with an opportunity to correct the situation which he feels necessitates his termination of employment with Good Reason under this Section 2.2.

## **Section 3. Employment Terminations Which Do Not Qualify For Severance Benefits**

**3.1 Termination by the Company Outside the Protection Period.** In the event the Company terminates the Executive's employment outside the Protection Period, the Executive will

not be entitled to receive the Severance Benefits set forth in Section 4 hereof. The Executive shall, however, comply with the provisions of Section 5 hereof. The Company may, in its sole discretion, provide some form or amount of severance benefits to the Executive in such circumstances as the Company shall, in its sole discretion, determine.

**3.2 Voluntary Termination by the Executive Outside the Protection Period.** In the event the Executive terminates his employment outside the Protection Period, the Executive will not be entitled to receive the Severance Benefits set forth in Section 4 hereof. The Executive shall, however, comply with the provisions of Section 5 hereof.

**3.3 Termination by the Company For Cause.** In the event the Company terminates the Executive's employment for Cause (whether before or after a Change in Control), the Executive will not be entitled to receive the Severance Benefits set forth in Section 4 hereof. The Executive shall, however, comply with the provisions of Section 5 hereof. Cause will be determined by the Outside Committee Members in the exercise of good faith and reasonable judgment.

**3.4 Voluntary Termination by the Executive Other Than For Good Reason.** In the event the Executive terminates his employment other than for Good Reason (whether before or after a Change in Control), the Executive will not be entitled to receive the Severance Benefits set forth in Section 4 hereof. The Executive shall, however, comply with the provisions of Section 5 hereof.

#### **Section 4. Severance Benefits**

In the event that the Company shall terminate the employment of the Executive as described in Section 2.1 hereof, or in the event the Executive terminates his employment as described in Section 2.2 hereof, the Company will, in lieu of any other severance which may otherwise be payable:

- a. Continue to pay to the Executive, for the twenty four (24) months following his termination of employment, his monthly base salary at the rate in effect as of the date of such termination in accordance with the Company's normal payroll practices.
- b. Throughout the twenty four (12) months following his termination of employment, continue the normal fringe benefits and perquisites being provided to the Executive immediately prior to his termination of employment, including but not limited to life insurance and health care benefits coverage, in the same

amounts and at the same cost to the Executive as was applicable prior to the Change in Control; provided, however, that in the event the Executive begins to receive comparable fringe benefits and perquisites (determined at the sole discretion of the Outside Committee Members) from a subsequent employer during such period, the Company may immediately terminate such fringe benefits and perquisites. Coverage under the Company's health care benefits plan will be in lieu of health care continuation under the Consolidated Omnibus Budget Reconciliation Act ("COBRA"); for periods such coverage is in effect under this Agreement.

- c. Pay to the Executive in cash an amount equal to the matching and discretionary contributions which would have been made by the Company under any qualified and nonqualified 401(k), profit sharing, savings or retirement plan of the Company or an Affiliate during the period described in paragraph a of this Section 4 if the Executive made 401(k) contributions and the Company made matching and discretionary contributions during such period at the same rate as the Executive and the Company made such contributions during the twelve (12) month period immediately prior to the Change of Control. Such amounts shall be paid to the Executive on the same days that the salary is payable to him under paragraph a. above.
- d. Pay for the costs of outplacement services actually used by the Executive; provided, however, that the total fee paid for such services will be limited to an amount equal to ten percent (10%) of the Executive's annual base salary rate as of the effective date of his termination of employment.
- e. Continue to be obligated to pay when due all other benefits to which the Executive has a vested right according to the provisions of any applicable retirement or other benefit plan or program.

## **Section 5. Covenants**

**5.1 Disclosure or Use of Information.** The Executive will at all times during and after the period of his employment by the Company keep and maintain the confidentiality of all Confidential Information and will not at any time either directly or indirectly use such Confidential Information for his own benefit or otherwise divulge, disclose or communicate such

Confidential Information to any person or entity in any manner whatsoever other than employees or agents of the Company or its Affiliates who have a need to know such Confidential Information and then only to the extent necessary to perform their responsibilities on behalf of the Company or its Affiliates.

**5.2 Co-operation.** During the term of his employment and for a period of two (2) years following his termination of employment, the Executive will not attempt to induce any employee of the Company or an Affiliate to terminate his or her employment with the Company or an Affiliate nor will he take any action with respect to any of the customers of the Company and its Affiliates which would have or might be likely to have an adverse effect upon the business of the Company and its Affiliates. Executive hereby agrees not to make any statement or take any action, directly or indirectly, that will disparage or discredit the Company and its Affiliates, their Officers, Directors of the Company, their employees or any of their products or services, or in any way damage their reputation or ability to do business or conduct their affairs. Executive agrees that subsequent to his termination of employment he will, in conjunction with a Company request, reasonably co-operate with the Company in connection with transition matters, disputes and litigation matters upon reasonable notice, at reasonable times, and will be paid or reimbursed for reasonable expenses incurred by the Executive relating to such matters.

**5.3 Non-Competition.** The Executive agrees that, in the event his employment with the Company terminates prior to a Change in Control for any reason, he will not for one year after his date of termination of employment, directly or indirectly, work or otherwise perform services for a financial institution or any affiliate of a financial institution which has a branch or location within a twenty (20) mile radius of the main office of the Company located at 112 West Market St. Orrville, Ohio 44667; except that the Executive may work or perform services for such a financial institution provided that his place of employment is outside of a twenty (20) mile radius of the Company and provided further that the Executive does not have any direct or indirect control, oversight, supervision or involvement with the operations which are conducted by any of the branches or locations which are within a twenty (20) mile radius of the main office of the Company and does not have any customer contact or solicit customers, potential customers or business located within a twenty (20) mile radius of the main office of the Company. This provision will have no force or effect if the employment of the Executive terminates subsequent to a Change in Control.

The Executive understands that the foregoing restrictions of this Section 5.3 may limit his ability to engage in certain business pursuits, but acknowledges that the protections of this Agreement for the Executive justify such restrictions. The Executive acknowledges that he understands the effect of the provisions of this Section 5.3, that he has had reasonable time to consider the effect of these provisions, and that he was encouraged to and had an opportunity to consult an attorney with respect to these provisions. The Company and the Executive consider the restrictions contained in this Section 5.3 to be reasonable and necessary. Nevertheless, if any aspect of these restrictions is found to be unreasonable or otherwise unenforceable by a Court of competent jurisdiction, the parties intend for such restrictions to be modified by such Court so as to be reasonable and enforceable and, as so modified by the Court, to be fully enforced.

**5.4 Injunctive Relief.** In the event of a breach or threatened breach of any of the provisions of this Section 5 by the Executive, the Executive and the Company agree that the Company will be entitled to preliminary and permanent injunctive relief, without bond or security, sufficient to enforce the provisions thereof. In addition, the Company will be entitled to pursue such other remedies at law or in equity as it deems appropriate.

## **Section 6. Miscellaneous**

**6.1 Successors.** This Agreement is personal to the Executive and will not be assignable by him without the prior written consent of the Outside Committee Members. This Agreement will be assigned or transferred to and will be binding upon and inure to the benefit of any Successor of the Company.

**6.2 Entire Agreement.** This Agreement supersedes any prior agreements or understandings, oral or written, between the Executive and the Company with respect to the subject matter hereof and constitutes the entire agreement of the parties with respect thereto.

**6.3 Administration.** The provisions of this Agreement shall be administered by the Outside Committee Members. The Outside Committee Members shall have the sole discretion to make all determinations which may be necessary or advisable for the administration of this Agreement. Any action expressed from time to time by a vote at a meeting, or expressed in writing, after notice to all Outside Committee Members, may be done by a majority of the Outside Committee Members; and such action shall have the same effect for all purposes as if assented to by all the Outside Committee Members.

**6.4 Appeals Procedure.** Any disputes arising under this Agreement with regard to any determination made by the Company or the Outside Committee Members under this Agreement, including but not limited to any dispute with regard to the denial of Severance Benefits to the Executive, may be appealed to the Outside Committee Members by the Executive. The Executive, or any authorized representative of the Executive, may upon written notice to the Outside Committee Members within sixty (60) days after any such determination or denial request a review by the Outside Committee Members of any such determination or denial. Such review may be made by written briefs submitted by the Executive and the Outside Committee Members or at a hearing, or by both, as shall be deemed necessary by the Outside Committee Members. Any hearing shall be held in the Corporate Headquarters of the Company, unless the Outside Committee Members shall specify otherwise. The date and time of any such hearing shall be designated by the Outside Committee Members upon not less than seven (7) days' notice to the Executive unless the Executive accepts shorter notice. The Outside Committee Members shall make every effort to schedule the hearing on a day and at a time which is convenient to the Executive. The Outside Committee Members may, in their sole discretion, establish such rules of procedure as it may deem necessary or advisable for the conduct of any such review or of any such hearing. After the review has been completed, the Outside Committee Members shall render a decision in writing, a copy of which shall be sent to the Executive. In rendering their decision, the Outside Committee Members shall have full power and discretion to interpret this Agreement, to resolve ambiguities, inconsistencies and omissions, to determine any question of fact, to determine the right to Severance Benefits, and the amount of Severance Benefits, if any, payable to, the Executive in accordance with the provisions of this Agreement. Such decision shall set forth the specific reason or reasons for the decision and the specific provisions of this Agreement upon which the decision is based. There shall be no further appeal from a decision rendered by a quorum of the Outside Committee Members. Any determination made by the Outside Committee Members as a result of an appeal shall be final and binding in all respects upon the Company, the Parent Company and the Executive.

**6.5 Modification.** This Agreement will not be varied, altered, modified, canceled, changed, or in any way amended except by mutual agreement in a written instrument executed by either two (2) officers of the Company on behalf of the Board of Directors of the Company or, in

the event a Change in Control has occurred, by the Outside Committee Members, and by the Executive, or by their legal representatives.

**6.6 Tax Withholding.** The Company may withhold from any benefits payable under this Agreement all federal, state, city, or other taxes as may be required pursuant to any law or governmental regulation or ruling.

**6.7 Governing Law.** To the extent not preempted by federal law, the provisions of this Agreement will be construed and enforced in accordance with the laws of the State of Ohio.

**6.8 Section 280(G) Limit.** Notwithstanding anything contained in this Agreement to the contrary, in the event the Company experiences a change described in Section 280G(bX2)(A)(i) of the Internal Revenue Code, the amounts payable to the Executive under this Agreement which are contingent on such change shall not exceed an amount which, when added to the present value of all other amounts which are payable to him under other plans and programs of the Company, shall cause the total present value of all such amounts to equal one dollar (\$1.00) less than three (3) times the base amount (as described in Section 280G(bX3) of the Internal Revenue Code.)

If the Internal Revenue Service subsequently asserts that the amounts payable to the Executive under this Agreement give rise to an excise tax under Section 4999 of the Internal Revenue Code and the Executive co-operates with the Company in appealing the determination of the Internal Revenue Service through whatever level of administrative or judicial appeals is deemed appropriate by the Company, the Company shall indemnify the Executive for all costs of challenging the determination that the excise tax applies to payments hereunder including any administrative costs, court costs, attorney fees, and accounting fees, whether incurred by the Company or incurred by the Executive.

**6.9 Reimbursement of Legal Fees.** In the event that the Executive brings an action in a court of law to enforce any provision of this Agreement and prevails in such action in any respect, the Company shall reimburse the Executive for his attorney fees and expenses and any other fees and expenses incurred by the Executive in connection with such cause of action or in connection with the enforcement of this Agreement against the Company.

**IN WITNESS WHEREOF,** the Executive and the Company have executed this Agreement as of the day and year first above written.

**First National Bank**

By: /s/David C. Vernon,  
President and Chief Executive Officer

And: /s/Myron Filarski, Executive

The Parent Company hereby guarantees the benefits payable under this Agreement as of the day and year first above written.

**National Bancshares Corp.**

By: /s/David C. Vernon, President and Chief Executive Officer

And: /s/Myron Filarski, Executive

## CERTIFICATIONS

I, David C. Vernon, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bancshares Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2010

/s/ David C. Vernon  
David C. Vernon, President and  
Chief Executive Officer

## CERTIFICATIONS

I, James R. VanSickle, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bancshares Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2010

/s/James R. VanSickle  
James R. VanSickle, Chief Financial Officer

SECTION 1350 CERTIFICATION OF QUARTERLY REPORT ON FORM 10-Q  
OF  
NATIONAL BANCSHARES CORPORATION  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2010

The undersigned are the President and Chief Financial Officer of National Bancshares Corporation (the “Registrant”). This Certification is made pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This Certification accompanies the Quarterly Report on Form 10-Q of the Registrant for the quarterly period ended September 30, 2010.

We certify that such Quarterly Report on Form 10-Q fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in such 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

This Certification is executed as of November 2, 2010

/s/ David C. Vernon  
David C. Vernon, President and  
Chief Executive Officer

/s/ James R. VanSickle  
James R. VanSickle, Chief Financial Officer