LCNB CORP
Form 10-Q
August 06, 2014

UNITED STATES
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 June 30, 2014

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

For the transition period from to

Commission File Number 000-26121

LCNB Corp.
(Exact name of registrant as specified in its charter)

Ohio	31-1626393
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2 North Broadway, Lebanon, Ohio 45036
(Address of principal executive offices, including Zip Code)

(513) 932-1414
(Registrant's telephone number, including area code)

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.
x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
x Yes ¨ 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. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the issuer's common stock, without par value, as of August 4, 2014 was 9,298,829 shares.

LCNB CORP. AND SUBSIDIARIES

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

	June 30, 2014 (Unaudited)	December 31, 2013
ASSETS:		
Cash and due from banks	$18,771	10,410
Interest-bearing demand deposits	110	4,278
Total cash and cash equivalents	18,881	14,688
Investment securities:		
Available-for-sale, at fair value	327,740	258,241
Held-to-maturity, at cost	23,843	16,323
Federal Reserve Bank stock, at cost	2,346	1,603
Federal Home Loan Bank stock, at cost	3,638	2,854
Loans, net	688,325	570,766
Premises and equipment, net	21,230	19,897
Goodwill	27,638	14,186
Bank owned life insurance	21,607	21,280
Other assets	15,861	12,500
TOTAL ASSETS	$1,151,109	932,338
LIABILITIES:		
Deposits:		
Noninterest-bearing	$201,928	164,912
Interest-bearing	784,896	620,849
Total deposits	986,824	785,761
Short-term borrowings	23,523	8,655
Long-term debt	11,506	12,102
Accrued interest and other liabilities	6,672	6,947
TOTAL LIABILITIES	1,028,525	813,465
SHAREHOLDERS' EQUITY:		
Preferred shares – no par value, authorized 1,000,000 shares, none outstanding	—	—
Common shares – no par value, authorized 12,000,000 shares, issued 10,051,897 and 10,041,163 shares at June 30, 2014 and December 31, 2013, respectively	66,974	66,785
Retained earnings	66,437	65,475
Treasury shares at cost, 753,627 shares at June 30, 2014 and December 31, 2013	(11,665)	(11,665)
Accumulated other comprehensive income (loss), net of taxes	838	(1,722)
TOTAL SHAREHOLDERS' EQUITY	122,584	118,873
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,151,109	932,338

The accompanying notes to consolidated financial statements are an integral part of these statements.

The consolidated balance sheet as of December 31, 2013 has been derived from the audited consolidated balance sheet as of that day.

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LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans	$8,144	6,816	15,840	13,396
Interest on investment securities:				
Taxable	1,026	860	1,917	1,694
Non-taxable	657	655	1,303	1,278
Other investments	99	74	144	113
TOTAL INTEREST INCOME	9,926	8,405	19,204	16,481
INTEREST EXPENSE:				
Interest on deposits	814	931	1,623	1,914
Interest on short-term borrowings	5	4	8	7
Interest on long-term debt	101	110	204	222
TOTAL INTEREST EXPENSE	920	1,045	1,835	2,143
NET INTEREST INCOME	9,006	7,360	17,369	14,338
PROVISION FOR LOAN LOSSES	255	42	336	191
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	8,751	7,318	17,033	14,147
NON-INTEREST INCOME:				
Trust income	728	609	1,383	1,184
Service charges and fees on deposit accounts	1,252	1,073	2,374	2,052
Net gain (loss) on sales of securities	—	108	(4)	695
Bank owned life insurance income	170	172	342	344
Gains from sales of mortgage loans	53	119	68	248
Other operating income	98	97	215	162
TOTAL NON-INTEREST INCOME	2,301	2,178	4,378	4,685
NON-INTEREST EXPENSE:				
Salaries and employee benefits	3,956	3,242	7,874	6,536
Equipment expenses	345	298	639	590
Occupancy expense, net	514	518	1,165	1,024
State franchise tax	239	211	483	427
Marketing	197	157	329	301
FDIC insurance premiums	160	119	309	247
Merger-related expenses	70	271	1,362	1,326
Other non-interest expense	2,119	1,508	4,111	2,964
TOTAL NON-INTEREST EXPENSE	7,600	6,324	16,272	13,415
INCOME BEFORE INCOME TAXES	3,452	3,172	5,139	5,417
PROVISION FOR INCOME TAXES	841	824	1,205	1,341
NET INCOME	$2,611	2,348	3,934	4,076
Dividends declared per common share	$0.16	0.16	0.32	0.32
Earnings per common share:				
Basic	$0.28	0.31	0.42	0.54

Diluted	0.28	0.30	0.42	0.53
Weighted average common shares outstanding:				
Basic	9,293,382	7,627,900	9,290,905	7,570,817
Diluted	9,402,343	7,759,438	9,407,964	7,686,890

The accompanying notes to consolidated financial statements are an integral part of these statements.

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LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$2,611	2,348	3,934	4,076
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities (net of taxes of $822 and $2,667 for the three months ended June 30, 2014 and 2013, respectively, and $1,315 and $2,843 for the six months ended June 30, 2014 and 2013, respectively)	1,598	(5,176)	2,554	(5,518)
Reclassification adjustment for net realized (gain) loss on sale of available-for-sale securities included in net income (net of taxes of $- and $36 for the three months ended June 30, 2014 and 2013, respectively, and $1 and $236 for the six months ended June 30, 2014 and 2013, respectively)	—	(72)	3	(459)
Change in nonqualified pension plan unrecognized net loss and unrecognized prior service cost (net of taxes of $- and $4 for the three months ended June 30, 2014 and 2013, respectively, and $1 and $9 for the six months ended June 30, 2014 and 2013)	1	10	3	18
TOTAL COMPREHENSIVE INCOME (LOSS)	$4,210	(2,890)	6,494	(1,883)

The accompanying notes to consolidated financial statements are an integral part of these statements.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Dollars in thousands, except per share amounts)
(Unaudited)

	Common Shares Outstanding	Common Stock	Retained Earnings	Treasury Shares	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2012	6,731,900	$27,107	61,843	(11,665)	4,721	82,006
Net income			4,076			4,076
Other comprehensive loss, net of taxes					(5,959)	(5,959)
Dividend Reinvestment and Stock Purchase Plan	9,568	163				163
Exercise of stock options	3,400	43				43
Acquisition of First Capital Bancshares, Inc.	888,811	12,321				12,321
Compensation expense relating to stock options		19				19
Common stock dividends, $0.32 per share			(2,440)			(2,440)
Balance at June 30, 2013	7,633,679	$39,653	63,479	(11,665)	(1,238)	90,229
Balance at December 31, 2013	9,287,536	$66,785	65,475	(11,665)	(1,722)	118,873
Net income			3,934			3,934
Other comprehensive income, net of taxes					2,560	2,560
Dividend Reinvestment and Stock Purchase Plan	10,734	176				176
Compensation expense relating to stock options		13				13
Common stock dividends, $0.32 per share			(2,972)			(2,972)
Balance at June 30, 2014	9,298,270	$66,974	66,437	(11,665)	838	122,584

The accompanying notes to consolidated financial statements are an integral part of these statements.

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LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$3,934	4,076
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization, and accretion	1,482	1,390
Provision for loan losses	336	191
Increase in cash surrender value of bank owned life insurance	(342)	(344)
Realized (gain) loss from sales of securities available-for-sale	4	(695)
Realized (gain) loss from sales of premises and equipment	(7)	—
Realized (gain) loss from sales and write-downs of other real estate owned and repossessed assets	68	(196)
Origination of mortgage loans for sale	(3,480)	(14,397)
Realized gains from sales of mortgage loans	(68)	(248)
Proceeds from sales of mortgage loans	3,514	14,504
Compensation expense related to stock options	13	19
Changes in:		
Accrued income receivable	56	(184)
Other assets	(532)	1,110
Other liabilities	(534)	(1,601)
TOTAL ADJUSTMENTS	510	(451)
NET CASH FLOWS FROM OPERATING ACTIVITIES	4,444	3,625
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sales of investment securities available-for-sale	26,071	38,005
Proceeds from maturities and calls of investment securities:		
Available-for-sale	19,863	11,170
Held-to-maturity	3,006	3,680
Purchases of investment securities:		
Available-for-sale	(76,330)	(57,099)
Held-to-maturity	(10,526)	(9,435)
Purchase of Federal Reserve Bank stock	(743)	(497)
Proceeds from redemption of Federal Reserve Bank stock	41	—
Net (increase) decrease in loans	(2,252)	(3,614)
Proceeds from redemption of bank owned life insurance	3,633	—
Proceeds from sale of other real estate owned and repossessed assets	203	988
Additions to other real estate owned	(17)	—
Purchases of premises and equipment	(770)	(362)
Proceeds from sale of premises and equipment	38	—
Net cash acquired from (paid for) acquisition	(9,115)	9,771
NET CASH FLOWS FROM INVESTING ACTIVITIES	(46,898)	(7,393)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	35,822	(7,374)

Net increase (decrease) in short-term borrowings	14,217	22,516
Principal payments on long-term debt	(596)	(2,709)
Proceeds from issuance of common stock	24	20
Proceeds from exercise of stock options	—	43
Cash dividends paid on common stock	(2,820)	(2,297)
NET CASH FLOWS FROM FINANCING ACTIVITIES	46,647	10,199
NET CHANGE IN CASH AND CASH EQUIVALENTS	4,193	6,431
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	14,688	13,475
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$18,881	19,906
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$1,710	2,140
Income taxes paid	1,700	1,745
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:		
Transfer from loans to other real estate owned and repossessed assets	435	6

The accompanying notes to consolidated financial statements are an integral part of these statements.

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - Basis of Presentation

Substantially all of the assets, liabilities and operations of LCNB Corp. ("LCNB" or the "Company") are attributable to its wholly-owned subsidiary, LCNB National Bank (the "Bank"). The accompanying unaudited consolidated financial statements include the accounts of LCNB and the Bank.

The unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, the unaudited interim consolidated financial statements include all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation of financial position, results of operations, and cash flows for the interim periods, as required by Regulation S-X, Rule 10-01.

The consolidated balance sheet as of December 31, 2013 has been derived from the audited consolidated balance sheet as of that day.

Certain prior period data presented in the financial statements have been reclassified to conform with the current year presentation.

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

Results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results to be expected for the full year ending December 31, 2014. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements, accounting policies, and financial notes thereto included in LCNB's 2013 Annual Report on Form 10-K filed with the SEC.

Note 2 – Acquisitions

On October 9, 2012, LCNB and First Capital Bancshares, Inc. ("First Capital") entered into an Agreement and Plan of Merger ("Merger Agreement") pursuant to which First Capital was merged into LCNB on January 11, 2013 in a stock and cash transaction valued at approximately $20.2 million. Immediately following the merger of First Capital into LCNB, Citizens National Bank of Chillicothe ("Citizens"), a wholly-owned subsidiary of First Capital, was merged into LCNB National Bank. Citizens operated six full–service branches with a main office and two other facilities in Chillicothe, Ohio and one branch in each of Frankfort, Ohio, Clarksburg, Ohio, and Washington Court House, Ohio. These offices became branches of the Bank after the merger.

On October 28, 2013, LCNB and Colonial Banc Corp. (“Colonial”) entered into a Stock Purchase Agreement (“Purchase Agreement”) pursuant to which LCNB purchased from Colonial on January 24, 2014 all of the issued and outstanding shares of Eaton National Bank & Trust Co. ("ENB") in a cash transaction valued at $24.75 million. Immediately following the acquisition, ENB was merged into the Bank. ENB operated five full–service branches with a main office and another facility in Eaton, Ohio and branch offices in each of West Alexandria, Ohio, New Paris, Ohio, and Lewisburg, Ohio. These offices became branches of the Bank after the merger.

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)
Note 2 – Acquisitions (continued)

The merger with ENB was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration paid were recorded at their estimated fair values as of the merger date, as summarized in the following table (in thousands):

Consideration Paid:	
Cash paid to shareholder	$24,750
Identifiable Assets Acquired:	
Cash and cash equivalents	15,635
Investment securities:	
Available-for-sale	35,859
Federal Reserve Bank stock	41
Federal Home Loan Bank stock	784
Loans	115,944
Premises and equipment	1,314
Bank owned life insurance	3,618
Core deposit intangible	2,466
Other real estate owned	262
Other assets	1,624
Total identifiable assets acquired	177,547
Liabilities Assumed:	
Deposits	165,335
Short-term borrowings	651
Other liabilities	263
Total liabilities assumed	166,249
Total Identifiable Net Assets Acquired	11,298
Goodwill resulting from merger	$13,452

The amount of goodwill recorded reflects LCNB's entrance into a new market and related synergies that are expected to result from the acquisition and represents the excess purchase price over the estimated fair value of the net assets acquired. The goodwill will not be amortizable on LCNB's financial records, but is deductible for tax purposes. The core deposit intangible will be amortized over eight years using the straight-line method.

Prior to the end of the one-year measurement period for finalizing the purchase allocation, if information becomes available which would indicate adjustments to the purchase price allocation, such adjustments will be included in the purchase price retrospectively.

The following table details the changes in fair value of net assets acquired and liabilities assumed from the amounts reported in the Form 10-Q for the period ending March 31, 2014 (in thousands):

Goodwill at March 31, 2014	$13,238

Effect of adjustments to:	
Loans	189
Other assets	21
Other liabilities	4
Goodwill at June 30, 2014	$13,452

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)
Note 2 – Acquisitions (continued)

Direct costs related to the acquisition were expensed as incurred and are recorded in merger-related expense in the consolidated statements of income.

The results of operations are included in the consolidated statement of income from the date of the merger. The estimated amount of ENB revenue (net interest income plus non-interest income) and net income, excluding merger and data conversion costs, included in LCNB's consolidated statement of income for the six months ended June 30, 2014 were as follows (in thousands):

Total revenue	$2,639
Net income	984

The following table presents unaudited pro forma information as if the merger with ENB had occurred on January 1, 2013 (in thousands). This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments, amortization of the core deposit intangible, and related income tax effects. It does not include merger and data conversion costs. The pro forma information does not necessarily reflect the results of operations that would have occurred had the merger with ENB occurred in 2013. In particular, expected operational cost savings are not reflected in the pro forma amounts.

	Six Months Ended June 30,	
	2014	2013
Total revenue	$22,205	23,537
Net income	4,963	5,175
Basic earnings per common share	0.53	0.56
Diluted earnings per common share	0.53	0.55

LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)

Note 3 - Investment Securities

The amortized cost and estimated fair value of available-for-sale investment securities at June 30, 2014 and December 31, 2013 are summarized as follows (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2014				
Available-for-Sale:				
U.S. Treasury notes	$60,677	206	162	60,721
U.S. Agency notes	118,416	431	1,525	117,322
U.S. Agency mortgage-backed securities	41,979	540	369	42,150
Certificates of deposit	3,078	15	—	3,093
Municipal securities:				
Non-taxable	83,067	2,044	374	84,737
Taxable	15,177	406	126	15,457
Mutual funds	2,436	—	17	2,419
Trust preferred securities	50	—	1	49
Equity securities	1,474	343	25	1,792
	$326,354	3,985	2,599	327,740
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	23,443	119	215	23,347
Taxable	400	1	—	401
	$23,843	120	215	23,748
December 31, 2013				
Available-for-Sale:				
U.S. Treasury notes	$13,184	—	290	12,894
U.S. Agency notes	110,248	141	3,714	106,675
U.S. Agency mortgage-backed securities	40,602	555	848	40,309
Certificates of deposit	1,492	9	—	1,501
Municipal securities:				
Non-taxable	74,185	2,116	968	75,333
Taxable	17,020	503	214	17,309
Mutual funds	2,419	—	39	2,380
Trust preferred securities	149	4	6	147
Equity securities	1,429	329	65	1,693
	$260,728	3,657	6,144	258,241
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	15,923	159	285	15,797
Taxable	400	—	1	399

	$16,323	159	286	16,196

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)
Note 3 - Investment Securities (continued)

Information concerning available-for-sale investment securities with gross unrealized losses at June 30, 2014 and December 31, 2013, aggregated by length of time that individual securities have been in a continuous loss position, is as follows (dollars in thousands):

	Less than Twelve Months		Twelve Months or Greater	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2014				
Investment Securities Available-for-Sale:				
U.S. Treasury notes	$9,185	1	$8,743	161
U.S. Agency notes	—	—	73,891	1,525
U.S. Agency mortgage-backed securities	12	—	12,076	369
Municipal securities:				
Non-taxable	6,771	35	16,805	339
Taxable	2,162	17	4,301	109
Mutual funds	—	—	1,160	17
Trust preferred securities	49	1	—	—
Equity securities	155	11	217	14
	$18,334	65	$117,193	2,534
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	$5,022	215	—	—
Taxable	—	—	—	—
	$5,022	215	$—	—
December 31, 2013				
Investment Securities Available-for-Sale:				
U.S. Treasury notes	$12,894	290	$—	—
U.S. Agency notes	89,080	2,880	9,636	834
U.S. Agency mortgage-backed securities	17,557	575	5,130	273
Municipal securities:				
Non-taxable	15,641	398	10,751	570
Taxable	4,903	202	1,252	12
Mutual funds	1,380	39	—	—
Trust preferred securities	—	—	93	6
Equity securities	300	44	93	21
	$141,755	4,428	$26,955	1,716
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	$4,890	285	$—	—
Taxable	399	1	—	—

$5,289	286	$—	—

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)
Note 3 - Investment Securities (continued)

Management has determined that the unrealized losses at June 30, 2014 are primarily due to fluctuations in market interest rates and do not reflect credit quality deterioration of the securities. Because LCNB does not have the intent to sell the investments and it is more likely than not that LCNB will not be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, LCNB does not consider these investments to be other-than-temporarily impaired.

Contractual maturities of investment securities at June 30, 2014 were as follows (in thousands). Actual maturities may differ from contractual maturities when issuers have the right to call or prepay obligations.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	$13,154	13,238	2,086	2,097
Due from one to five years	146,077	147,276	4,130	4,131
Due from five to ten years	111,848	111,583	5,117	4,939
Due after ten years	9,336	9,233	12,510	12,581
	280,415	281,330	23,843	23,748
U.S. Agency mortgage-backed securities	41,979	42,150	—	—
Mutual funds	2,436	2,419	—	—
Trust preferred securities	50	49	—	—
Equity securities	1,474	1,792	—	—
	$326,354	327,740	23,843	23,748

Investment securities with a market value of $202,316,000 and $157,956,000 at June 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

Certain information concerning the sale of investment securities available-for-sale for the three and six months ended June 30, 2014 and 2013 was as follows (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Proceeds from sales	$—	14,611	26,071	38,005
Gross realized gains	—	109	2	701
Gross realized losses	—	1	6	6

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Continued)

Note 4 - Loans

Major classifications of loans at June 30, 2014 and December 31, 2013 are as follows (in thousands):

	June 30, 2014	December 31, 2013
Commercial and industrial	38,919	29,337
Commercial, secured by real estate	377,806	314,252
Residential real estate	243,966	215,587
Consumer	20,015	12,643
Agricultural	8,466	2,472
Other loans, including deposit overdrafts	2,594	91
	691,766	574,382
Deferred net origination costs (fees)	(47)	(28)
	691,719	574,354
Less allowance for loan losses	3,394	3,588
Loans, net	688,325	570,766

All advances from the FHLB are secured by a blanket pledge of LCNB's 1-4 family first lien mortgage loans in the amount of approximately $203 million and $183 million at June 30, 2014 and December 31, 2013, respectively. Additionally, LCNB is required to hold minimum levels of FHLB stock, based on the outstanding borrowings.

Loans acquired from the mergers with First Capital and ENB are recorded at fair value with no carryover of the acquired entity's previously established allowance for loan losses. The excess of expected cash flows over the estimated fair value of acquired loans is recognized as interest income over the remaining contractual lives of the loans using the level yield method.
Subsequent decreases in expected cash flows will require additions to the allowance for loan losses. Subsequent improvements in expected cash flows result in the recognition of additional interest income over the then-remaining contractual lives of the loans.

Impaired loans acquired are accounted for under FASB ASC 310-30. Factors considered in evaluating whether an acquired loan was impaired include delinquency status and history, updated borrower credit status, collateral information, and updated loan-to-value information. The difference between contractually required payments at the time of acquisition and the cash flows expected to be collected is referred to as the nonaccretable difference. The interest component of the cash flows expected to be collected is referred to as the accretable yield and is recognized as interest income over the remaining contractual life of the loan using the level yield method. Subsequent decreases in expected cash flows will require additions to the allowance for loan losses. Subsequent improvements in expected cash flows will result in a reclassification from the nonaccretable difference to the accretable yield.

The following table provides certain information at the acquisition date on loans acquired from ENB, not including loans considered to be impaired (in thousands):

Contractually required principal at acquisition	$102,483
Less fair value adjustment	1,347
Fair value of acquired loans	$101,136

Contractual cash flows not expected to be collected	$1,702

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Note 4 – Loans (continued)

The following table provides details on acquired credit impaired loans obtained through the merger with ENB that are accounted for in accordance with FASB ASC 310-30 (in thousands):

Contractually required principal at acquisition	$23,414
Contractual cash flows not expected to be collected (nonaccretable difference)	(6,088)
Expected cash flows at acquisition	17,326
Interest component of expected cash flows (accretable discount)	(2,163)
Fair value of acquired impaired loans	$15,163

Non-accrual, past-due, and accruing restructured loans as of June 30, 2014 and December 31, 2013 are as follows (in thousands):

	June 30, 2014	December 31, 2013
Non-accrual loans:		
Commercial and industrial	262	144
Commercial, secured by real estate	4,596	1,418
Agricultural	67	—
Residential real estate	1,318	1,399
Total non-accrual loans	6,243	2,961
Past-due 90 days or more and still accruing	130	250
Total non-accrual and past-due 90 days or more and still accruing	6,373	3,211
Accruing restructured loans	14,512	15,151
Total	20,885	18,362

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Note 4 – Loans (continued)

The allowance for loan losses and recorded investment in loans for the six months ended June 30, 2014 and 2013 are as follows (in thousands):

	Commercial & Industrial	Commercial, Secured by Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
June 30, 2014							
Allowance for loan losses:							
Balance, beginning of year	$ 175	2,520	826	66	—	1	3,588
Provision charged to expenses	146	(81)	239	14	8	10	336
Losses charged off	—	(371)	(175)	(61)	—	(33)	(640)
Recoveries	10	—	26	50	—	24	110
Balance, end of period	$ 331	2,068	916	69	8	2	3,394
Individually evaluated for impairment	$ 1	437	136	—	—	—	574
Collectively evaluated for impairment	66	1,516	744	69	8	2	2,405
Acquired credit impaired loans	264	115	36	—	—	—	415
Balance, end of period	$ 331	2,068	916	69	8	2	3,394
Loans:							
Individually evaluated for impairment	$ 324	13,707	1,833	18	—	—	15,882
Collectively evaluated for impairment	36,057	350,271	238,484	19,858	8,351	2,056	655,077
Acquired credit impaired loans	2,501	13,461	3,930	215	115	538	20,760
Balance, end of period	$ 38,882	377,439	244,247	20,091	8,466	2,594	691,719
June 30, 2013							
Allowance for loan losses:							
Balance, beginning of year	$ 320	2,296	712	108	—	1	3,437
Provision charged to expenses	(32)	100	118	(6)	—	11	191
Losses charged off	(119)	(34)	(39)	(85)	—	(33)	(310)
Recoveries	—	11	13	61	—	23	108
Balance, end of period	$ 169	2,373	804	78	—	2	3,426
Individually evaluated for impairment	$ 1	684	269	—	—	—	954
Collectively evaluated for impairment	168	1,689	535	78	—	2	2,472
Acquired credit impaired loans	—	—	—	—	—	—	—
Balance, end of period	$ 169	2,373	804	78	—	2	3,426

Loans:							
Individually evaluated for impairment	$ 166	13,858	1,742	34	—	—	15,800
Collectively evaluated for impairment	32,755	276,741	206,817	13,402	2,838	400	532,953
Acquired credit impaired loans	356	5,614	1,591	—	—	—	7,561
Balance, end of period	$ 33,277	296,213	210,150	13,436	2,838	400	556,314

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Note 4 – Loans (continued)

The risk characteristics of LCNB's material loan portfolio segments are as follows:

Commercial and Industrial Loans. LCNB’s commercial and industrial loan portfolio consists of loans for various purposes, including loans to fund working capital requirements (such as inventory and receivables financing) and purchases of machinery and equipment. LCNB offers a variety of commercial and industrial loan arrangements, including term loans, balloon loans, and line of credit. Most commercial and industrial loans have a variable rate, with adjustments occurring monthly, annually, every three years, or every five years. Adjustments are generally based on a publicly available index rate plus a margin. The margin varies based on the terms and collateral securing the loan. Commercial and industrial loans are offered to businesses and professionals for short and medium terms on both a collateralized and uncollateralized basis. Commercial and industrial loans typically are underwritten on the basis of the borrower’s ability to make repayment from the cash flow of the business. Collateral, when obtained, may include liens on furniture, fixtures, equipment, inventory, receivables, or other assets. As a result, such loans involve complexities, variables, and risks that require thorough underwriting and more robust servicing than other types of loans.

Commercial, Secured by Real Estate Loans. Commercial real estate loans include loans secured by a variety of commercial, retail, and office buildings, religious facilities, multifamily (more than two-family) residential properties, construction and land development loans, and other land loans. Commercial real estate loan products generally amortize over five to twenty-five years and are payable in monthly principal and interest installments. Some have balloon payments due within one to ten years after the origination date. Many have adjustable interest rates with adjustment periods ranging from one to ten years, some of which are subject to established “floor” interest rates.

Commercial real estate loans are underwritten based on the ability of the property, in the case of income producing property, or the borrower’s business to generate sufficient cash flow to amortize the debt. Secondary emphasis is placed upon global debt service, collateral value, financial strength of any guarantors, and other factors. Commercial real estate loans are generally originated with a 75 percent maximum loan to appraised value ratio.

Residential Real Estate Loans. Residential real estate loans include loans secured by first or second mortgage liens on one-to-two family residential property. Home equity lines of credit and mortgage loans secured by owner-occupied agricultural property are included in this category. First and second mortgage loans are generally amortized over five to thirty years with monthly principal and interest payments. Home equity lines of credit generally have a five year draw period with interest only payments followed by a repayment period with monthly payments based on the amount outstanding. LCNB offers both fixed and adjustable rate mortgage loans. Adjustable rate loans are available with adjustment periods ranging between one to ten years and adjust according to an established index plus a margin, subject to certain floor and ceiling rates. Home equity lines of credit have a variable rate based on the Wall Street Journal prime rate plus a margin.

LCNB does not originate reverse mortgage loans or residential real estate loans generally considered to be “subprime.”

Residential real estate loans are underwritten primarily based on the borrower’s ability to repay, prior credit history, and the value of the collateral. LCNB requires private mortgage insurance for first mortgage loans that have a loan to appraised value ratio of greater than 80%.

Consumer Loans. LCNB's portfolio of consumer loans generally includes secured and unsecured loans to individuals for household, family and other personal expenditures. Secured loans include loans to fund the purchase of automobiles, recreational vehicles, boats, and similar acquisitions. Consumer loans made by LCNB generally have fixed rates and terms ranging up to 72 months, depending upon the nature of the collateral, size of the loan, and other relevant factors.

Consumer loans generally have higher interest rates, but pose additional risks of collectability and loss when compared to certain other types of loans. Collateral, if present, is generally subject to damage, wear, and depreciation. The borrower's ability to repay is of primary importance in the underwriting of consumer loans.

Agricultural Loans. LCNB's portfolio of agricultural loans includes loans for financing agricultural production or for financing the purchase of equipment used in the production of agricultural products. LCNB's agricultural loans are generally secured by farm machinery, livestock, crops, vehicles, or other agri-related collateral.

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Note 4 – Loans (continued)

LCNB uses a risk-rating system to quantify loan quality. A loan is assigned to a risk category based on relevant information about the ability of the borrower to service the debt including, but not limited to, current financial information, historical payment experience, credit documentation, public information, and current economic trends. The categories used are:

- Pass – loans categorized in this category are higher quality loans that do not fit any of the other categories described below.
- Other Assets Especially Mentioned (OAEM) - loans in this category are currently protected but are potentially weak. These loans constitute a risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an undue risk in light of the circumstances surrounding a specific asset.
- Substandard – loans in this category are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the possibility that LCNB will sustain some loss if the deficiencies are not corrected.
- Doubtful – loans classified in this category have all the weaknesses inherent in loans classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

A breakdown of the loan portfolio by credit quality indicators at June 30, 2014 and December 31, 2013 is as follows (in thousands):

	Pass	OAEM	Substandard	Doubtful	Total
June 30, 2014					
Commercial & industrial	$37,151	20	1,711	—	38,882
Commercial, secured by real estate	349,487	2,916	25,036	—	377,439
Residential real estate	235,402	127	8,718	—	244,247
Consumer	19,874	—	217	—	20,091
Agricultural	8,351	—	115	—	8,466
Other	2,056	—	538	—	2,594
Total	$652,321	3,063	36,335	—	691,719
December 31, 2013					
Commercial & industrial	$27,563	44	1,699	—	29,306
Commercial, secured by real estate	295,189	3,967	14,757	—	313,913
Residential real estate	208,881	1,136	5,825	—	215,842
Consumer	12,681	—	49	—	12,730
Agricultural	2,472	—	—	—	2,472
Other	91	—	—	—	91
Total	$546,877	5,147	22,330	—	574,354

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Note 4 – Loans (continued)

A loan portfolio aging analysis at June 30, 2014 and December 31, 2013 is as follows (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans Receivable	Total Loans Greater Than 90 Days and Accruing
June 30, 2014							
Commercial & industrial	$963	—	261	1,224	37,658	38,882	—
Commercial, secured by real estate	878	377	3,055	4,310	373,129	377,439	69
Residential real estate	1,141	184	974	2,299	241,948	244,247	45
Consumer	52	47	16	115	19,976	20,091	16
Agricultural	—	—	67	67	8,399	8,466	—
Other	57	—	—	57	2,537	2,594	—
Total	$3,091	608	4,373	8,072	683,647	691,719	130
December 31, 2013							
Commercial & industrial	$277	—	144	421	28,885	29,306	—
Commercial, secured by real estate	951	582	1,174	2,707	311,206	313,913	—
Residential real estate	1,131	299	1,604	3,034	212,808	215,842	236
Consumer	38	35	13	86	12,644	12,730	14
Agricultural	—	—	—	—	2,472	2,472	—
Other	91	—	—	91	—	91	—
Total	$2,488	916	2,935	6,339	568,015	574,354	250

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Note 4 – Loans (continued)

Impaired loans, including acquired credit impaired loans, at June 30, 2014 and December 31, 2013 are as follows (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance
June 30, 2014			
With no related allowance recorded:			
Commercial & industrial	$2,240	3,627	—
Commercial, secured by real estate	22,810	28,337	—
Residential real estate	4,394	6,535	—
Consumer	233	393	—
Agricultural	115	639	—
Other	538	774	—
Total	$30,330	40,305	—
With an allowance recorded:			
Commercial & industrial	$585	647	265
Commercial, secured by real estate	4,358	4,723	552
Residential real estate	1,369	1,476	172
Total	$6,312	6,846	989
Total:			
Commercial & industrial	$2,825	4,274	265
Commercial, secured by real estate	27,168	33,060	552
Residential real estate	5,763	8,011	172
Consumer	233	393	—
Agricultural	115	639	—
Other	538	774	—
Total	$36,642	47,151	989
December 31, 2013			
With no related allowance recorded:			
Commercial & industrial	$332	531	—
Commercial, secured by real estate	10,883	12,317	—
Residential real estate	2,096	2,967	—
Consumer	—	—	—
Total	$13,311	15,815	—
With an allowance recorded:			
Commercial & industrial	$165	270	2
Commercial, secured by real estate	7,725	7,725	760
Residential real estate	1,645	1,663	270
Consumer	27	27	—

Total	$9,562	9,685	1,032
Total:			
Commercial & industrial	$497	801	2
Commercial, secured by real estate	18,608	20,042	760
Residential real estate	3,741	4,630	270
Consumer	27	27	—
Total	$22,873	25,500	1,032

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Note 4 – Loans (continued)

The following presents information related to the average recorded investment and interest income recognized on impaired loans, including acquired credit impaired loans, for the three and six months ended June 30, 2014 and 2013 (in thousands):

	2014		2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three Months Ended June 30,				
With no related allowance recorded:				
Commercial & industrial	$2,057	38	774	9
Commercial, secured by real estate	23,282	327	11,965	155
Residential real estate	4,528	101	1,986	42
Consumer	234	2	—	—
Agricultural	118	7	16	6
Other	560	10	—	—
Total	$30,779	485	14,741	212
With an allowance recorded:				
Commercial & industrial	$494	2	185	—
Commercial, secured by real estate	4,344	—	7,581	60
Residential real estate	1,352	11	1,255	8
Consumer	—	—	22	1
Agricultural	—	—	—	—
Other	—	—	—	—
Total	$6,190	13	9,043	69
Total:				
Commercial & industrial	$2,551	40	959	9
Commercial, secured by real estate	27,626	327	19,546	215
Residential real estate	5,880	112	3,241	50
Consumer	234	2	22	1
Agricultural	118	7	16	6
Other	560	10	—	—
Total	$36,969	498	23,784	281
Six Months Ended June 30,				
With no related allowance recorded:				
Commercial & industrial	$2,088	70	943	24
Commercial, secured by real estate	23,839	616	12,001	300
Residential real estate	4,682	177	2,085	86
Consumer	246	9	—	—
Agricultural	129	9	21	6
Other	564	17	—	—

Total	$31,548	898	15,050	416
With an allowance recorded:				
Commercial & industrial	$291	13	204	1
Commercial, secured by real estate	4,228	50	7,485	123
Residential real estate	1,296	23	1,185	15
Consumer	—	—	18	1
Agricultural	—	—	—	—
Other	—	—	—	—
Total	$5,815	86	8,892	140
Total:				
Commercial & industrial	$2,379	83	1,147	25
Commercial, secured by real estate	28,067	666	19,486	423
Residential real estate	5,978	200	3,270	101
Consumer	246	9	18	1
Agricultural	129	9	21	6
Other	564	17	—	—
Total	$37,363	984	23,942	556

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Note 4 – Loans (continued)

Loan modifications that were classified as troubled debt restructurings during the three and six months ended June 30, 2014 and 2013 are as follows (dollars in thousands):

	2014 Number of Loans	2014 Balance at Modification	2013 Number of Loans	2013 Balance at Modification
Three Months Ended June 30,				
Commercial and industrial	6	$ 628	1	$ 22
Commercial, secured by real estate	1	818	—	—
Residential real estate	1	78	2	335
Consumer	—	—	2	27
Total	8	$ 1,524	5	$ 384
Six Months Ended June 30,				
Commercial and industrial	7	$ 638	1	$ 22
Commercial, secured by real estate	1	818	—	—
Residential real estate	1	78	2	335
Consumer	1	2	2	27
Total	10	$ 1,536	5	$ 384

Each restructured loan is separately negotiated with the borrower and includes terms and conditions that reflect the borrower's ability to pay the debt as modified. Modifications may include interest only payments for a period of time, temporary or permanent reduction of the loan's interest rate, capitalization of delinquent interest, or extensions of the maturity date.

LCNB is not committed to lend additional funds to borrowers whose loan terms were modified in a troubled debt restructuring.

A restructured automobile loan with a balance of $13,000 was charged off during the first quarter 2013, which was within twelve months of the loan's modification date. There were no other troubled debt restructurings that subsequently defaulted within twelve months of the restructuring date for the six months ended June 30, 2014 and 2013.

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Note 5 - Acquired Credit Impaired Loans

The following table provides the major classifications of loans acquired during 2014 and 2013 that are accounted for in accordance with FASB ASC 310-30 (in thousands):

	June 30, 2014	December 31, 2013
Commercial and industrial	$2,501	332
Commercial, secured by real estate	13,461	4,363
Residential real estate	3,930	1,332
Consumer	215	—
Agricultural	115	—
Other loans, including deposit overdrafts	538	—
	20,760	6,027
Less allowance for loan losses	415	—
Loans, net	20,345	6,027

The following table provides the outstanding balance and related carrying amount for acquired credit impaired loans at the dates indicated (in thousands):

	June 30, 2014	December 31, 2013
Outstanding balance	$30,644	8,220
Carrying amount	20,760	6,027

Activity during 2014 for the accretable discount related to acquired credit impaired loans is as follows (in thousands):

Accretable discount at December 31, 2013	$1,107
Accretable discount acquired during period	2,163
Reclass from nonaccretable discount to accretable discount	28
Less transferred to other real estate owned	(61)
Less accretion	(175)
Accretable discount at June 30, 2014	$3,062

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Note 6 – Other Real Estate Owned

Other real estate owned includes property acquired through foreclosure or deed-in-lieu of foreclosure and also includes property deemed to be in-substance foreclosed and are included in "other assets" in the consolidated balance sheets. Changes in other real estate owned are as follows (in thousands):

	Six Months Ended June 30,	
	2014	2013
Balance, beginning of year	$1,463	2,189
Additions	452	—
Additions due to merger	262	127
Reductions due to sales	(266)	(748)
Reductions due to valuation write downs	(5)	(38)
Balance, end of period	$1,906	1,530

Other real estate owned at June 30, 2014 and December 31, 2013 consisted of (dollars in thousands):

	June 30, 2014	December 31, 2013
Commercial real estate	$1,700	$1,415
Residential real estate	206	48
	$1,906	$1,463

Note 7 – Income Taxes

A reconciliation between the statutory income tax and LCNB's effective tax rate on income from continuing operations follows:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Statutory tax rate	34.0 %	34.0 %	34.0 %	34.0 %
Increase (decrease) resulting from:				
Tax exempt interest	(6.2)%	(6.8)%	(8.3)%	(7.7)%
Tax exempt income on bank owned life insurance	(1.7)%	(1.8)%	(2.3)%	(2.2)%
Other, net	(1.7)%	0.6 %	— %	0.7 %
Effective tax rate	24.4 %	26.0 %	23.4 %	24.8 %

Note 8 - Commitments and Contingent Liabilities

LCNB is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. Exposure to credit loss in the event of nonperformance by the other parties to financial instruments for commitments to extend credit is represented by the contract amount of those instruments.

LCNB offers the Bounce Protection product, a customer deposit overdraft program, which is offered as a service and does not constitute a contract between the customer and LCNB.

LCNB uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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Note 8 – Commitments and Contingent Liabilities (continued)

Financial instruments whose contract amounts represent off-balance-sheet credit risk at June 30, 2014 and December 31, 2013 are as follows (in thousands):

	June 30, 2014	December 31, 2013
Commitments to extend credit:		
Commercial loans	$2,429	9,316
Other loans		
Fixed rate	2,465	852
Adjustable rate	1,839	1,653
Unused lines of credit:		
Fixed rate	8,876	3,404
Adjustable rate	69,582	60,236
Unused overdraft protection amounts on demand and NOW accounts	10,530	9,494
Standby letters of credit	590	365
	$96,311	85,320

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Unused lines of credit include amounts not drawn on line of credit loans. Commitments to extend credit and unused lines of credit generally have fixed expiration dates or other termination clauses.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These guarantees generally are fully secured and have varying maturities.

LCNB evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable; inventory; property, plant and equipment; residential realty; and income-producing commercial properties.

Capital expenditures include the construction or acquisition of new office buildings, improvements to LCNB's offices, purchases of furniture and equipment, and additions or improvements to LCNB's information technology system. Commitments outstanding for capital expenditures as of June 30, 2014 were not material.

Management believes that LCNB has sufficient liquidity to fund its lending and capital expenditure commitments.

LCNB and its subsidiary are parties to various claims and proceedings arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such proceedings and claims will not be material to the consolidated financial position or results of operations.

Note 9 – Regulatory Capital

The Bank and LCNB are required by regulators to meet certain minimum levels of capital adequacy. These are expressed in the form of certain ratios. Capital is separated into Tier 1 capital (essentially shareholders' equity less goodwill and other intangibles) and Tier 2 capital (essentially the allowance for loan losses limited to 1.25% of risk-weighted assets). The first two ratios, which are based on the degree of credit risk in LCNB's assets, provide for weighting assets based on assigned risk factors and include off-balance sheet items such as loan commitments and stand-by letters of credit. The leverage ratio supplements the risk-based capital guidelines.

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Note 9 – Regulatory Capital (continued)

For various regulatory purposes, financial institutions are classified into categories based upon capital adequacy.

	Minimum Requirement		To Be Considered Well-Capitalized	
Ratio of tier 1 capital to risk-weighted assets	4.0	%	6.0	%
Ratio of total capital (tier 1 capital plus tier 2 capital) to risk-weighted assets	8.0	%	10.0	%
Leverage ratio (tier 1 capital to adjusted quarterly average total assets)	3.0	%	5.0	%

As of the most recent notification from their regulators, the Bank and LCNB were categorized as "well-capitalized" under the regulatory framework for prompt corrective action. Management believes that no conditions or events have occurred since the last notification that would change the Bank's or LCNB's category.

A summary of the regulatory capital and capital ratios of LCNB follows (dollars in thousands):

	June 30, 2014		December 31, 2013	
Regulatory Capital:				
Shareholders' equity	$122,584		118,873	
Goodwill and other intangibles	(32,192	)	(16,532	)
Accumulated other comprehensive (income) loss	(838	)	1,722	
Tier 1 risk-based capital	89,554		104,063	
Eligible allowance for loan losses	3,394		3,588	
Total risk-based capital	$92,948		107,651	
Capital ratios:				
Tier 1 capital to risk-weighted assets	13.27	%	18.03	%
Total capital to risk-weighted assets	13.77	%	18.65	%
Leverage	8.05	%	11.10	%

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Note 10 – Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income for the six months ended June 30, 2014 and 2013 are as follows (in thousands):

	Unrealized Gains and Losses on Available-for-Sale Securities	Changes in Pension Plan Assets and Benefit Obligations	Total
June 30, 2014			
Balance at beginning of period	$ (1,641)	(81)	(1,722)
Before reclassifications	2,554	3	2,557
Reclassifications	3	—	3
Balance at end of period	$ 916	(78)	838
June 30, 2013			
Balance at beginning of period	$ 4,875	(154)	4,721
Before reclassifications	(5,518)	18	(5,500)
Reclassifications	(459)	—	(459)
Balance at end of period	$ (1,102)	(136)	(1,238)

Reclassifications out of accumulated other comprehensive income during the three and six months ended June 30, 2014 and 2013 and the affected line items in the consolidated statements of income are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,		Affected Line Item in the Consolidated Statements of Income
	2014	2013	2014	2013	
Realized gain (loss) on sale of securities	$—	108	(4)	695	Net gain (loss) on sale of securities
Less provision for income taxes	—	36	(1)	236	Provision for income taxes
Reclassification adjustment, net of taxes	$—	72	(3)	459	

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Note 11 – Retirement Plans

LCNB participates in a noncontributory defined benefit retirement multi-employer plan that covers substantially all regular full-time employees hired before January 1, 2009.

Employees of LCNB also participate in a defined contribution retirement plan. Employees hired on or after January 1, 2009 receive a 50% employer match on their contributions into the 401(k) plan, up to a maximum LCNB contribution of 3% of each individual employee's annual compensation. Employees hired before January 1, 2009 who received a benefit reduction under certain amendments to the defined benefit retirement plan receive an automatic contribution of 5% or 7% of annual compensation, depending on the sum of an employee's age and vesting service, into the 401(k) plan, regardless of the contributions made by the employees. This contribution is made annually and these employees do not receive any employer matches to their 401(k) contributions.

Funding and administrative costs of the qualified noncontributory defined benefit retirement plan and 401(k) plan charged to pension and other employee benefits in the consolidated statements of income for the three and six-month periods ended June 30, 2014 and 2013 are as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Qualified noncontributory defined benefit retirement plan	$209	31	416	62
401(k) plan	83	75	161	154

Certain highly compensated employees participate in a nonqualified defined benefit retirement plan. The nonqualified plan ensures that participants receive the full amount of benefits to which they would have been entitled under the noncontributory defined benefit retirement plan in the absence of limits on benefit levels imposed by certain sections of the Internal Revenue Code.

The components of net periodic pension cost of the nonqualified defined benefit retirement plan for the three and six months ended June 30, 2014 and 2013 are summarized as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Service cost	$17	18	34	36
Interest cost	15	12	30	23
Amortization of unrecognized net loss	—	6	—	12
Amortization of unrecognized prior service cost	4	7	8	14
Net periodic pension cost	$36	43	72	85

Amounts recognized in accumulated other comprehensive income, net of tax, at June 30, 2014 and December 31, 2013 for the nonqualified defined benefit retirement plan consists of (in thousands):

	June 30, 2014	December 31, 2013
Net actuarial loss	$70	70
Past service cost	6	10

	$76	80

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Note 12 - Stock Based Compensation

LCNB established an Ownership Incentive Plan (the "Plan") during 2002 that allowed for stock-based awards to eligible employees, as determined by the Board of Directors. The awards were made in the form of stock options, share awards, and/or appreciation rights. The Plan provided for the issuance of up to 200,000 shares. The plan expired on April 16, 2012. Any outstanding unexercized options, however, continue to be exercisable in accordance with their terms.

Options granted to date vest ratably over a five-year period and expire ten years after the date of grant. Stock options outstanding at June 30, 2014 are as follows:

	Outstanding Stock Options			Exercisable Stock Options		
Exercise Price Range	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
\$9.00 - \$10.99	23,494	\$9.00	4.6	23,494	\$9.00	4.6
\$11.00 - \$12.99	63,354	12.05	6.0	42,249	12.02	5.7
\$17.00 - \$18.99	12,962	18.41	2.1	12,962	18.41	2.1
	99,810	12.16	5.2	78,705	12.17	4.8

The following table summarizes stock option activity for the periods indicated:

	2014		2013	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding, January 1	104,966	\$12.43	110,586	\$12.42
Granted	—	—	—	—
Exercised	—	—	(3,400)	12.66
Expired	(5,156)	17.66	—	—
Outstanding, June 30	99,810	12.16	107,186	12.41
Exercisable, June 30	78,705	12.17	70,119	12.83

The aggregate intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) for options outstanding at June 30, 2014 that were "in the money" (market price greater than exercise price) was \$429,000. The aggregate intrinsic value at that date for only the options that were exercisable was \$343,000. The aggregate intrinsic value for options outstanding at June 30, 2013 that were in the money was \$1,066,000 and the aggregate intrinsic value at that date for only the options that were exercisable was \$668,000. The intrinsic value changes based upon fluctuations in the market value of LCNB's stock.

Total expense related to options included in salaries and employee benefits in the consolidated statements of income for the three and six months ended June 30, 2014 was \$6,000 and \$13,000, respectively, and \$10,000 and \$19,000 for the three and six months ended June 30, 2013, respectively.

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Note 13 - Earnings per Common Share

Basic earnings per common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is adjusted for the dilutive effects of stock options, warrants, and restricted stock. The diluted average number of common shares outstanding has been increased for the assumed exercise of stock options and warrants with proceeds used to purchase treasury shares at the average market price for the period. The computations are as follows for the three and six months ended June 30, 2014 and 2013 (dollars in thousands, except share and per share data):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$2,611	2,348	3,934	4,076
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	9,293,382	7,627,900	9,290,905	7,570,817
Add dilutive effect of:				
Stock options	18,349	23,889	20,099	19,125
Stock warrants	90,612	107,649	96,960	96,948
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share	9,402,343	7,759,438	9,407,964	7,686,890
Earnings per common share:				
Basic	$0.28	0.31	0.42	0.54
Diluted	0.28	0.30	0.42	0.53

Options to purchase 18,118 and 18,046 shares of common stock at a weighted average price of $18.19 and $18.19 per share were outstanding at June 30, 2014 and 2013, respectively, but were not included in the computation of diluted earnings per common share because the exercise prices of the options were greater than the average market price of the common shares.

Note 14 - Fair Value Measurements

LCNB measures certain assets at fair value using various valuation techniques and assumptions, depending on the nature of the asset. Fair value is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

The inputs to valuation techniques used to measure fair value are assigned to one of three broad levels:

- Level 1 – quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the reporting date.
- Level 2 – inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly. Level 2 inputs may include quoted prices for similar assets in active markets, quoted prices for identical assets or liabilities in markets that are not active, inputs other than quoted prices (such as interest rates or yield curves) that are observable for the asset or liability, and inputs that are derived from or corroborated by observable market data.
- Level 3 - inputs that are unobservable for the asset or liability.

The majority of LCNB's financial debt securities are classified as available-for-sale. The securities are reported at fair value with unrealized holding gains and losses reported net of income taxes in accumulated other comprehensive income.

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Note 14 - Fair Value Measurements (continued)

LCNB utilizes a pricing service for determining the fair values of most of its investment securities. Fair value for U.S. Treasury notes and corporate securities are determined based on market quotations (level 1). Fair value for most of the other investment securities is calculated using the discounted cash flow method for each security. The discount rates for these cash flows are estimated by the pricing service using rates observed in the market (level 2). Cash flow streams are dependent on estimated prepayment speeds and the overall structure of the securities given existing market conditions. In addition, LCNB has invested in two mutual funds that invest in debt securities or loans that qualify for credit under the Community Reinvestment Act. The investment in one of the mutual funds is considered to have level 1 inputs because it is publicly traded in an active market and it publishes a daily net asset value. The investment in the other mutual fund is considered to have level 2 inputs because, although its shares are not traded in an active market, an investor can have its interest in the fund redeemed for the balance of its capital account at any quarter-end assuming the fund is given a 60 day notice. The investment in this fund is carried at fair value, which approximates cost. Additionally, LCNB owns trust preferred securities in various financial institutions, equity securities in various financial and non-financial companies, and a mutual fund that invests primarily in floating rate loans. Market quotations (level 1) are used to determine fair values for these investments. The investment in the mutual fund is considered to have level 1 inputs because it is publicly traded in an active market and it publishes a daily net asset value.

Assets that may be recorded at fair value on a nonrecurring basis include impaired loans, other real estate owned, and other repossessed assets. A loan is considered impaired when management believes it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate or the fair value of collateral if the loan is collateral dependent, if this value is less than the loan balance. When the fair value of the collateral is based on an observable market price or current appraised value, the inputs are considered to be level 2. When an appraised value is not available and there is not an observable market price, the inputs are considered to be level 3.

Other real estate owned is adjusted to fair value upon transfer of the loan to foreclosed assets, usually based on an appraisal of the property. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. The inputs for a valuation based on current appraised value are considered to be level 2.

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Note 14 - Fair Value Measurements (continued)

The following table summarizes the valuation of LCNB's assets recorded at fair value by input levels as of June 30, 2014 and December 31, 2013 (in thousands):

		Fair Value Measurements at the End of the Reporting Period Using		
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2014				
Recurring fair value measurements:				
Investment securities available-for-sale:				
U.S. Treasury notes	$60,721	60,721	—	—
U.S. Agency notes	117,322	—	117,322	—
U.S. Agency mortgage-backed securities	42,150	—	42,150	—
Certificates of deposit with other banks	3,093	—	3,093	—
Municipal securities:				
Non-taxable	84,737	—	84,737	—
Taxable	15,457	—	15,457	—
Mutual funds	2,419	1,419	1,000	—
Trust preferred securities	49	49	—	—
Equity securities	1,792	1,792	—	—
Total recurring fair value measurements	$327,740	63,981	263,759	—
Nonrecurring fair value measurements:				