

LCNB CORP  
Form 10-Q  
November 06, 2012

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

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

(State or other jurisdiction of incorporation or organization)

31-1626393

(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.

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).

Yes       No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer,

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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 <input type="radio"/>   | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="radio"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="radio"/>       |

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

The number of shares outstanding of the issuer's common stock, without par value, as of November 5, 2012 was 6,726,719 shares.

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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)

|   | September 30,<br>2012<br>(Unaudited) | December 31,<br>2011 |
|---|--------------------------------------|----------------------|
| <b>ASSETS:</b>  |                                      |                      |
| Cash and due from banks   | \$ 15,166                            | 12,449               |
| Interest-bearing demand deposits  | 17,908                               | 7,086                |
| Total cash and cash equivalents   | 33,074                               | 19,535               |
| <b>Investment securities:</b>   |                                      |                      |
| Available-for-sale, at fair value   | 265,737                              | 254,006              |
| Held-to-maturity, at cost   | 12,503                               | 10,734               |
| Federal Reserve Bank stock, at cost   | 949                                  | 940                  |
| Federal Home Loan Bank stock, at cost   | 2,091                                | 2,091                |
| Loans, net  | 454,541                              | 458,331              |
| Premises and equipment, net   | 16,820                               | 17,346               |
| Goodwill  | 5,915                                | 5,915                |
| Bank owned life insurance   | 16,770                               | 14,837               |
| Other assets  | 8,792                                | 7,835                |
| <b>TOTAL ASSETS</b>   | <b>\$ 817,192</b>                    | <b>791,570</b>       |
| <b>LIABILITIES:</b>   |                                      |                      |
| <b>Deposits:</b>  |                                      |                      |
| Noninterest-bearing   | \$ 116,489                           | 106,793              |
| Interest-bearing  | 584,591                              | 556,769              |
| Total deposits  | 701,080                              | 663,562              |
| Short-term borrowings   | 12,076                               | 21,596               |
| Long-term debt  | 14,049                               | 21,373               |
| Accrued interest and other liabilities  | 7,856                                | 7,079                |
| <b>TOTAL LIABILITIES</b>  | <b>735,061</b>                       | <b>713,610</b>       |
| <b>SHAREHOLDERS' EQUITY:</b>  |                                      |                      |
| Preferred shares – no par value, authorized 1,000,000 shares, none outstanding  | -                                    | -                    |
| Common shares – no par value, authorized 12,000,000 shares, issued 7,480,134 and 7,460,494 shares at September 30, 2012 and December 31, 2011, respectively | 27,040                               | 26,753               |
| Retained earnings   | 60,760                               | 57,877               |
| Treasury shares at cost, 753,627 and 755,771 shares at September 30, 2012 and December 31, 2011, respectively   | (11,665 )                            | (11,698 )            |
| Accumulated other comprehensive income, net of taxes  | 5,996                                | 5,028                |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>82,131</b>                        | <b>77,960</b>        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$ 817,192</b>                    | <b>791,570</b>       |

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 INCOME  
(Dollars in thousands, except per share data)  
(Unaudited)

|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|--------------|------------------------------------|---------------|
|  | 2012                                | 2011         | 2012                               | 2011          |
| <b>INTEREST INCOME:</b>  |                                     |              |                                    |               |
| Interest and fees on loans                                     | \$5,822                             | 6,294        | 17,950                             | 19,289        |
| Interest on investment securities –                            |                                     |              |                                    |               |
| Taxable  | 941                                 | 1,036        | 2,810                              | 2,826         |
| Non-taxable  | 615                                 | 619          | 1,831                              | 1,966         |
| Other short-term investments                                   | 26                                  | 27           | 115                                | 124           |
| <b>TOTAL INTEREST INCOME</b>                                   | <b>7,404</b>                        | <b>7,976</b> | <b>22,706</b>                      | <b>24,205</b> |
| <b>INTEREST EXPENSE:</b>                                       |                                     |              |                                    |               |
| Interest on deposits   | 1,050                               | 1,371        | 3,332                              | 4,454         |
| Interest on short-term borrowings                              | 4                                   | 6            | 12                                 | 23            |
| Interest on long-term debt                                     | 136                                 | 160          | 440                                | 499           |
| <b>TOTAL INTEREST EXPENSE</b>                                  | <b>1,190</b>                        | <b>1,537</b> | <b>3,784</b>                       | <b>4,976</b>  |
| <b>NET INTEREST INCOME</b>                                     | <b>6,214</b>                        | <b>6,439</b> | <b>18,922</b>                      | <b>19,229</b> |
| <b>PROVISION FOR LOAN LOSSES</b>                               | <b>436</b>                          | <b>588</b>   | <b>742</b>                         | <b>1,476</b>  |
| <b>NET INTEREST INCOME AFTER PROVISION FOR<br/>LOAN LOSSES</b> | <b>5,778</b>                        | <b>5,851</b> | <b>18,180</b>                      | <b>17,753</b> |
| <b>NON-INTEREST INCOME:</b>                                    |                                     |              |                                    |               |
| Trust income   | 530                                 | 553          | 1,769                              | 1,572         |
| Service charges and fees on deposit accounts                   | 911                                 | 957          | 2,698                              | 2,810         |
| Net gain on sales of securities                                | 427                                 | 273          | 886                                | 692           |
| Bank owned life insurance income                               | 145                                 | 153          | 432                                | 447           |
| Gains from sales of mortgage loans                             | 151                                 | 35           | 360                                | 92            |
| Other operating income   | 41                                  | 62           | 151                                | 170           |
| <b>TOTAL NON-INTEREST INCOME</b>                               | <b>2,205</b>                        | <b>2,033</b> | <b>6,296</b>                       | <b>5,783</b>  |
| <b>NON-INTEREST EXPENSE:</b>                                   |                                     |              |                                    |               |
| Salaries and employee benefits                                 | 3,059                               | 2,983        | 9,004                              | 8,990         |
| Equipment expenses   | 263                                 | 288          | 789                                | 745           |
| Occupancy expense, net   | 445                                 | 443          | 1,242                              | 1,305         |
| State franchise tax  | 193                                 | 190          | 595                                | 582           |
| Marketing  | 129                                 | 145          | 409                                | 370           |
| FDIC insurance premiums  | 83                                  | 95           | 298                                | 563           |
| Other non-interest expense                                     | 1,392                               | 1,292        | 4,005                              | 3,973         |
| <b>TOTAL NON-INTEREST EXPENSE</b>                              | <b>5,564</b>                        | <b>5,436</b> | <b>16,342</b>                      | <b>16,528</b> |
| <b>INCOME BEFORE INCOME TAXES</b>                              | <b>2,419</b>                        | <b>2,448</b> | <b>8,134</b>                       | <b>7,008</b>  |
| <b>PROVISION FOR INCOME TAXES</b>                              | <b>572</b>                          | <b>581</b>   | <b>2,023</b>                       | <b>1,640</b>  |
| <b>INCOME FROM CONTINUING OPERATIONS</b>                       | <b>1,847</b>                        | <b>1,867</b> | <b>6,111</b>                       | <b>5,368</b>  |
|  | -                                   | -            | -                                  | 793           |

| INCOME FROM DISCONTINUED OPERATIONS, NET OF TAX |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| NET INCOME                                      | \$1,847   | 1,867     | 6,111     | 6,161     |
| Dividends declared per common share             | \$0.16    | 0.16      | 0.48      | 0.48      |
| Basic earnings per common share:                |           |           |           |           |
| Continuing operations                           | \$0.27    | 0.28      | 0.91      | 0.80      |
| Discontinued operations                         | -         | -         | -         | 0.12      |
| Diluted earnings per common share:              |           |           |           |           |
| Continuing operations                           | \$0.27    | 0.28      | 0.90      | 0.80      |
| Discontinued operations                         | -         | -         | -         | 0.12      |
| Weighted average common shares outstanding:     |           |           |           |           |
| Basic   | 6,721,699 | 6,690,963 | 6,713,959 | 6,690,157 |
| Diluted   | 6,797,675 | 6,750,807 | 6,787,000 | 6,746,568 |

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 |              | Nine Months Ended |              |
|--|--------------------|--------------|-------------------|--------------|
|  | September 30,      |              | September 30,     |              |
|  | 2012               | 2011         | 2012              | 2011         |
| Net Income   | \$1,847            | 1,867        | 6,111             | 6,161        |
| Other comprehensive income:  |                    |              |                   |              |
| Net unrealized gain on available-for-sale securities (net of taxes of \$556 and \$1,348 for the three months ended September 30, 2012 and 2011, respectively, and \$787 and \$2,054 for the nine months ended September 30, 2012 and 2011, respectively)   | 1,080              | 2,618        | 1,529             | 3,969        |
| Reclassification adjustment for net realized gain on sale of available-for-sale securities included in net income (net of taxes of \$145 and \$92 for the three months ended September 30, 2012 and 2011, respectively, and \$300 and \$235 for the nine months ended September 30, 2012 and 2011, respectively) | (282 )             | (181 )       | (586 )            | (457 )       |
| Change in nonqualified pension plan unrecognized net loss and unrecognized prior service cost (net of taxes of \$4 and \$- for the three months ended September 30, 2012 and 2011, respectively, and \$12 and \$2 for the nine months ended September 30, 2012 and 2011, respectively)                           | 9                  | -            | 25                | 4            |
| Nonqualified pension plan curtailment (net of taxes of \$80)   | -                  | -            | -                 | 155          |
| <b>TOTAL COMPREHENSIVE INCOME</b>  | <b>\$2,654</b>     | <b>4,304</b> | <b>7,079</b>      | <b>9,832</b> |

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

|   | Common<br>Shares<br>Outstanding | Common<br>Stock | Retained<br>Earnings | Treasury<br>Shares | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders'<br>Equity |
|---|---------------------------------|-----------------|----------------------|--------------------|---|----------------------------------|
| Balance December 31, 2010   | 6,689,743                       | \$26,515        | 54,045               | (11,698 )          | 1,845   | 70,707                           |
| Net income  |                                 |                 | 6,161                |                    |   | 6,161                            |
| Net unrealized gain on<br>available-for-sale securities,<br>net of taxes  |                                 |                 |                      |                    | 3,969   | 3,969                            |
| Reclassification adjustment for<br>net realized gain on sale of<br>available-for-sale securities<br>included in net income, net of<br>taxes |                                 |                 |                      |                    | (457 )  | (457 )                           |
| Change in nonqualified<br>pension plan unrecognized net<br>loss and unrecognized prior<br>service cost, net of taxes                        |                                 |                 |                      |                    | 4   | 4                                |
| Nonqualified pension plan<br>curtailment entry, net of taxes  |                                 |                 |                      |                    | 155   | 155                              |
| Dividend Reinvestment and<br>Stock Purchase Plan  | 7,659                           | 97              |                      |                    |   | 97                               |
| Compensation expense<br>relating to stock options   |                                 | 35              |                      |                    |   | 35                               |
| Common stock dividends,<br>\$0.48 per share   |                                 |                 | (3,211 )             |                    |   | (3,211 )                         |
| Balance September 30, 2011  | 6,697,402                       | \$26,647        | 56,995               | (11,698 )          | 5,516   | 77,460                           |
| Balance December 31, 2011   | 6,704,723                       | \$26,753        | 57,877               | (11,698 )          | 5,028   | 77,960                           |
| Net income  |                                 |                 | 6,111                |                    |   | 6,111                            |
| Net unrealized gain on<br>available-for-sale securities,<br>net of taxes  |                                 |                 |                      |                    | 1,529   | 1,529                            |
| Reclassification adjustment for<br>net realized gain on sale of<br>available-for-sale securities<br>included in net income, net of<br>taxes |                                 |                 |                      |                    | (586 )  | (586 )                           |
| Change in nonqualified<br>pension plan unrecognized net<br>loss and unrecognized prior<br>service cost, net of taxes                        |                                 |                 |                      |                    | 25  | 25                               |
|   | 19,640                          | 257             |                      |                    |   | 257                              |

|   |           |          |        |         |    |        |
|---|-----------|----------|--------|---------|----|--------|
| Dividend Reinvestment and<br>Stock Purchase Plan  |           |          |        |         |    |        |
| Exercise of stock options                         | 2,144     |          | (5     | )       | 33 | 28     |
| Compensation expense<br>relating to stock options |           | 30       |        |         |    | 30     |
| Common stock dividends,<br>\$0.48 per share       |           |          | (3,223 | )       |    | (3,223 |
| Balance September 30, 2012                        | 6,726,507 | \$27,040 | 60,760 | (11,665 | )  | 5,996  |
|   |           |          |        |         |    | 82,131 |

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)

Nine Months Ended  
September 30,  
2012                      2011

## CASH FLOWS FROM OPERATING ACTIVITIES:

|   |              |              |
|---|--------------|--------------|
| Net income  | \$6,111      | 6,161        |
| Adjustments to reconcile net income to net cash flows from operating activities:                  |              |              |
| Depreciation, amortization, and accretion   | 2,339        | 2,137        |
| Provision for loan losses   | 742          | 1,476        |
| Curtailed charge for nonqualified defined benefit retirement plan                                 | -            | 191          |
| Increase in cash surrender value of bank owned life insurance                                     | (432 )       | (447 )       |
| Realized (gain) loss from sales of securities available-for-sale                                  | (886 )       | (692 )       |
| Realized (gain) loss from sales of premises and equipment   | (10 )        | (6 )         |
| Realized gain from sale of insurance agency   | -            | (1,503 )     |
| Realized (gain) loss from sales and write-downs of other real estate owned and repossessed assets | 80           | (48 )        |
| Origination of mortgage loans for sale  | (19,328 )    | (4,871 )     |
| Realized gains from sales of mortgage loans   | (360 )       | (92 )        |
| Proceeds from sales of mortgage loans   | 19,492       | 4,911        |
| Compensation expense related to stock options   | 30           | 35           |
| Changes in:   |              |              |
| Accrued income receivable   | (650 )       | (458 )       |
| Other assets  | 358          | 31           |
| Other liabilities   | 314          | (119 )       |
| <b>TOTAL ADJUSTMENTS</b>  | <b>1,689</b> | <b>545</b>   |
| <b>NET CASH FLOWS FROM OPERATING ACTIVITIES</b>   | <b>7,800</b> | <b>6,706</b> |

## CASH FLOWS FROM INVESTING ACTIVITIES:

|  |                  |                  |
|--|------------------|------------------|
| Proceeds from sales of investment securities available-for-sale      | 64,002           | 28,470           |
| Proceeds from maturities and calls of investment securities:         |                  |                  |
| Available-for-sale   | 22,759           | 43,123           |
| Held-to-maturity   | 1,563            | 3,658            |
| Purchases of investment securities:                                  |                  |                  |
| Available-for-sale   | (97,344 )        | (98,750 )        |
| Held-to-maturity   | (3,332 )         | (2,650 )         |
| Purchase of Federal Reserve Bank stock                               | (8 )             | (2 )             |
| Net (increase) decrease in loans                                     | 2,248            | 4,255            |
| Purchase of bank owned life insurance                                | (1,500 )         | -                |
| Proceeds from sale of other real estate owned and repossessed assets | 20               | 295              |
| Additions to other real estate owned                                 | (16 )            | -                |
| Purchases of premises and equipment                                  | (403 )           | (2,323 )         |
| Proceeds from sales of premises and equipment                        | 13               | 16               |
| Proceeds from sale of insurance agency, net of cash disposed         | -                | 1,523            |
| <b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>                      | <b>(11,998 )</b> | <b>(22,385 )</b> |

**CASH FLOWS FROM FINANCING ACTIVITIES:**

|   |                 |               |
|---|-----------------|---------------|
| Net increase (decrease) in deposits                     | 37,518          | 51,158        |
| Net increase (decrease) in short-term borrowings        | (9,520 )        | (9,305 )      |
| Proceeds from long-term debt                            | -               | 5,000         |
| Principal payments on long-term debt                    | (7,324 )        | (6,402 )      |
| Proceeds from issuance of common stock                  | 41              | 97            |
| Proceeds from exercise of stock options                 | 28              | -             |
| Cash dividends paid on common stock                     | (3,006 )        | (3,211 )      |
| <b>NET CASH FLOWS FROM FINANCING ACTIVITIES</b>         | <b>17,737</b>   | <b>37,337</b> |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>          | <b>13,539</b>   | <b>21,658</b> |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b> | <b>19,535</b>   | <b>10,999</b> |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>       | <b>\$33,074</b> | <b>32,657</b> |

**SUPPLEMENTAL CASH FLOW INFORMATION:**

|                   |         |       |
|-------------------|---------|-------|
| Interest paid     | \$3,857 | 5,096 |
| Income taxes paid | 1,735   | 2,844 |

**SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:**

|   |     |     |
|---|-----|-----|
| Transfer from loans to other real estate owned and repossessed assets | 755 | 229 |
|---|-----|-----|

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") 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. LCNB completed the sale of its subsidiary, Dakin Insurance Agency, Inc. ("Dakin") on March 23, 2011. The financial results of Dakin are included as income from discontinued operations, net of tax, in the accompanying unaudited consolidated financial statements through the date of sale.

The unaudited interim consolidated financial statements, which have been reviewed by J.D. Cloud & Co. L.L.P., LCNB's independent registered public accounting firm, in accordance with standards established by the Public Company Accounting Oversight Board, as indicated by their report included herein and which does not express an opinion on those 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.

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 nine months ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year ending December 31, 2012. 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 2011 Annual Report on Form 10-K filed with the SEC.

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

## Note 2 - Investment Securities

The amortized cost and estimated fair value of available-for-sale investment securities at September 30, 2012 and December 31, 2011 are summarized as follows (in thousands):

|  | September 30, 2012 |                  |                   | Fair Value     |
|--|--------------------|------------------|-------------------|----------------|
|  | Amortized Cost     | Unrealized Gains | Unrealized Losses |                |
| U.S. Treasury notes                    | \$18,512           | 294              | -                 | 18,806         |
| U.S. Agency notes                      | 91,148             | 2,004            | -                 | 93,152         |
| U.S. Agency mortgage-backed securities | 50,127             | 1,774            | -                 | 51,901         |
| Corporate securities                   | 3,036              | 45               | -                 | 3,081          |
| <b>Municipal securities:</b>           |                    |                  |                   |                |
| Non-taxable                            | 70,042             | 3,694            | 8                 | 73,728         |
| Taxable                                | 19,980             | 1,326            | -                 | 21,306         |
| Mutual funds                           | 2,125              | 44               | -                 | 2,169          |
| Trust preferred securities             | 299                | 8                | 3                 | 304            |
| Equity securities                      | 1,190              | 117              | 17                | 1,290          |
|  | <b>\$256,459</b>   | <b>9,306</b>     | <b>28</b>         | <b>265,737</b> |

|  | December 31, 2011 |                  |                   | Fair Value     |
|--|-------------------|------------------|-------------------|----------------|
|  | Amortized Cost    | Unrealized Gains | Unrealized Losses |                |
| U.S. Treasury notes                    | \$17,385          | 165              | -                 | 17,550         |
| U.S. Agency notes                      | 81,415            | 1,517            | 5                 | 82,927         |
| U.S. Agency mortgage-backed securities | 50,923            | 1,475            | 111               | 52,287         |
| Corporate securities                   | 6,334             | 47               | 16                | 6,365          |
| <b>Municipal securities:</b>           |                   |                  |                   |                |
| Non-taxable                            | 65,896            | 3,827            | 20                | 69,703         |
| Taxable                                | 21,027            | 894              | 14                | 21,907         |
| Mutual funds                           | 2,103             | 22               | -                 | 2,125          |
| Trust preferred securities             | 549               | 37               | 22                | 564            |
| Equity securities                      | 526               | 57               | 5                 | 578            |
|  | <b>\$246,158</b>  | <b>8,041</b>     | <b>193</b>        | <b>254,006</b> |

The fair value of held-to-maturity investment securities, consisting of taxable and non-taxable municipal securities, approximates amortized cost at September 30, 2012 and December 31, 2011.

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

## Note 2 - Investment Securities (continued)

Information concerning available-for-sale investment securities with gross unrealized losses at September 30, 2012, aggregated by length of time that individual securities have been in a continuous loss position, is as follows (in thousands):

|   | Less than Twelve Months<br>Fair<br>Value | Unrealized<br>Losses | Twelve Months or Greater<br>Fair<br>Value | Unrealized<br>Losses |
|---|--|----------------------|---|----------------------|
| U.S. Treasury notes                     | \$-                                      | -                    | -   | -                    |
| U.S. Agency notes                       | -  | -                    | -   | -                    |
| U.S. Agency mortgage- backed securities | -  | -                    | -   | -                    |
| Corporate securities                    | -  | -                    | -   | -                    |
| Municipal securities:                   |  |                      |   |                      |
| Non-taxable                             | 557                                      | 6                    | 459                                       | 2                    |
| Taxable                                 | -  | -                    | -   | -                    |
| Mutual funds                            | -  | -                    | -   | -                    |
| Trust preferred securities              | 147                                      | 3                    | 49  | -                    |
| Equity securities                       | 208                                      | 11                   | 58  | 6                    |
|   | \$912                                    | 20                   | 566                                       | 8                    |

Management has determined that the unrealized losses at September 30, 2012 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.



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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 3 - Loans

Major classifications of loans at September 30, 2012 and December 31, 2011 are as follows (in thousands):

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Commercial and industrial                 | \$ 25,749             | 30,990               |
| Commercial, secured by real estate        | 230,768               | 219,188              |
| Residential real estate                   | 184,256               | 186,904              |
| Consumer                                  | 11,478                | 14,562               |
| Agricultural                              | 2,061                 | 2,835                |
| Other loans, including deposit overdrafts | 2,993                 | 6,554                |
|   | 457,305               | 461,033              |
| Deferred net origination costs            | 102                   | 229                  |
|   | 457,407               | 461,262              |
| Less allowance for loan losses            | 2,866                 | 2,931                |
| Loans, net                                | \$ 454,541            | 458,331              |

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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 3 – Loans (continued)

Non-accrual, past-due, and accruing restructured loans as of September 30, 2012 and December 31, 2011 are as follows (in thousands):

|  | September 30,<br>2012 |   | December 31,<br>2011 |   |
|--|-----------------------|---|----------------------|---|
| Non-accrual loans:   |                       |   |                      |   |
| Commercial and industrial  | \$ 264                |   | 495                  |   |
| Commercial, secured by real estate   | 1,083                 |   | 1,950                |   |
| Residential real estate  | 1,430                 |   | 1,223                |   |
| Total non-accrual loans  | 2,777                 |   | 3,668                |   |
| Past-due 90 days or more and still accruing  | 22                    |   | 39                   |   |
| Total non-accrual and past-due 90 days or more and still accruing  | 2,799                 |   | 3,707                |   |
| Accruing restructured loans  | 13,356                |   | 14,739               |   |
| Total  | \$ 16,155             |   | 18,446               |   |
| Percentage of total non-accrual and past-due 90 days or more and still accruing to total loans                               | 0.61                  | % | 0.80                 | % |
| Percentage of total non-accrual, past-due 90 days or more and still accruing, and accruing restructured loans to total loans | 3.53                  | % | 4.00                 | % |

Loans sold to and serviced for the Federal Home Loan Mortgage Corporation and other investors are not included in the accompanying consolidated balance sheets. The unpaid principal balances of those loans at September 30, 2012 and December 31, 2011 are \$70,208,000 and \$67,410,000, respectively. Loans sold to the Federal Home Loan Mortgage Corporation during the three months ended September 30, 2012 and 2011 totaled \$7,934,000 and \$2,173,000, respectively, and \$19,328,000 and \$4,871,000 during the nine months ended September 30, 2012 and 2011, respectively.

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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 3 – Loans (continued)

The allowance for loan losses and recorded investment in loans for the nine months ended September 30 are as follows (in thousands):

|   | Commercial<br>& Industrial | Commercial<br>Real Estate | Residential<br>Real Estate | Consumer | Agricultural | Other | Total    |
|---|----------------------------|---------------------------|----------------------------|----------|--------------|-------|----------|
| 2012  |                            |                           |                            |          |              |       |          |
| Allowance for<br>loan losses:               |                            |                           |                            |          |              |       |          |
| Balance,<br>beginning of year               | \$ 162                     | 1,941                     | 656                        | 166      | -            | 6     | 2,931    |
| Change in<br>classification                 | 18                         | (18 )                     | -                          | -        | -            | -     | -        |
| Provision charged<br>to expenses            | 163                        | (24 )                     | 632                        | (49 )    | -            | 20    | 742      |
| Losses charged<br>off                       | (159 )                     | (234 )                    | (479 )                     | (84 )    | -            | (64 ) | (1,020 ) |
| Recoveries                                  | -                          | 71                        | 7                          | 95       | -            | 40    | 213      |
| Balance, end of<br>period                   | \$ 184                     | 1,736                     | 816                        | 128      | -            | 2     | 2,866    |
| Individually<br>evaluated for<br>impairment | \$ 21                      | 41                        | 227                        | -        | -            | -     | 289      |
| Collectively<br>evaluated for<br>impairment | 163                        | 1,695                     | 589                        | 128      | -            | 2     | 2,577    |
| Balance, end of<br>period                   | \$ 184                     | 1,736                     | 816                        | 128      | -            | 2     | 2,866    |
| Loans:                                      |                            |                           |                            |          |              |       |          |
| Individually<br>evaluated for<br>impairment | \$ 264                     | 9,942                     | 5,110                      | 13       | -            | -     | 15,329   |
| Collectively<br>evaluated for<br>impairment | 25,462                     | 220,622                   | 179,390                    | 11,550   | 2,061        | 2,993 | 442,078  |
| Balance, end of<br>period                   | \$ 25,726                  | 230,564                   | 184,500                    | 11,563   | 2,061        | 2,993 | 457,407  |

## 2011

Allowance for  
loan losses:

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|                               |        |        |        |        |   |        |          |
|-------------------------------|--------|--------|--------|--------|---|--------|----------|
| Balance, beginning of year    | \$ 305 | 1,625  | 459    | 246    | - | 6      | 2,641    |
| Provision charged to expenses | 499    | 409    | 501    | 36     | - | 31     | 1,476    |
| Losses charged off            | (251 ) | (203 ) | (371 ) | (183 ) | - | (100 ) | (1,108 ) |
| Recoveries                    | -      | 30     | 28     | 105    | - | 69     | 232      |
| Balance, end of period        | \$ 553 | 1,861  | 617    | 204    | - | 6      | 3,241    |

|                                       |        |       |     |     |   |   |       |
|---------------------------------------|--------|-------|-----|-----|---|---|-------|
| Individually evaluated for impairment | \$ 337 | 303   | 93  | -   | - | - | 733   |
| Collectively evaluated for impairment | 216    | 1,558 | 524 | 204 | - | 6 | 2,508 |
| Balance, end of period                | \$ 553 | 1,861 | 617 | 204 | - | 6 | 3,241 |

Loans:

|                                       |           |         |         |        |       |       |         |
|---------------------------------------|-----------|---------|---------|--------|-------|-------|---------|
| Individually evaluated for impairment | \$ 904    | 11,618  | 596     | 10     | -     | -     | 13,128  |
| Collectively evaluated for impairment | 31,236    | 192,453 | 183,532 | 16,183 | 3,245 | 9,759 | 436,408 |
| Balance, end of period                | \$ 32,140 | 204,071 | 184,128 | 16,193 | 3,245 | 9,759 | 449,536 |

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LCNB CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

Note 3 – 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.

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

## Note 3 – Loans (continued)

A breakdown of the loan portfolio by credit quality indicators at September 30, 2012 and December 31, 2011 is as follows (in thousands):

|                                    | Pass      | OAEM  | Substandard | Doubtful | Total   |
|------------------------------------|-----------|-------|-------------|----------|---------|
| September 30, 2012                 |           |       |             |          |         |
| Commercial & industrial            | \$22,452  | 2,646 | 447         | 181      | 25,726  |
| Commercial, secured by real estate | 218,963   | 2,412 | 9,189       | -        | 230,564 |
| Residential real estate            | 174,759   | 2,593 | 7,148       | -        | 184,500 |
| Consumer                           | 11,458    | -     | 100         | 5        | 11,563  |
| Agricultural                       | 2,057     | -     | 4           | -        | 2,061   |
| Other                              | 2,993     | -     | -           | -        | 2,993   |
| Total                              | \$432,682 | 7,651 | 16,888      | 186      | 457,407 |
| December 31, 2011                  |           |       |             |          |         |
| Commercial & industrial            | \$26,099  | 1,700 | 2,804       | 370      | 30,973  |
| Commercial, secured by real estate | 206,728   | 2,133 | 9,633       | 568      | 219,062 |
| Residential real estate            | 182,409   | 1,681 | 2,682       | 376      | 187,148 |
| Consumer                           | 14,601    | -     | 50          | 39       | 14,690  |
| Agricultural                       | 1,430     | -     | 1,405       | -        | 2,835   |
| Other                              | 6,554     | -     | -           | -        | 6,554   |
| Total                              | \$437,821 | 5,514 | 16,574      | 1,353    | 461,262 |

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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 3 – Loans (continued)

A loan portfolio aging analysis at September 30, 2012 and December 31, 2011 is as follows (in thousands):

|  | 30-59 Days<br>Past Due | 60-89<br>Days<br>Past Due | Greater<br>Than<br>90 Days | Total<br>Past Due | Current | Total Loans<br>Receivable | Total Loans<br>Greater<br>Than<br>90 Days and<br>Accruing |
|--|------------------------|---------------------------|----------------------------|-------------------|---------|---------------------------|---|
| September 30,<br>2012                    |                        |                           |                            |                   |         |                           |   |
| Commercial &<br>industrial               | \$-                    | -                         | 264                        | 264               | 25,462  | 25,726                    | -   |
| Commercial,<br>secured by real<br>estate | 172                    | 80                        | 1,083                      | 1,335             | 229,229 | 230,564                   | -   |
| Residential real<br>estate               | 900                    | 74                        | 1,346                      | 2,320             | 182,180 | 184,500                   | -   |
| Consumer                                 | 66                     | 44                        | 22                         | 132               | 11,431  | 11,563                    | 22  |
| Agricultural                             | -                      | -                         | -                          | -                 | 2,061   | 2,061                     | -   |
| Other                                    | 44                     | -                         | -                          | 44                | 2,949   | 2,993                     | -   |
| Total                                    | \$ 1,182               | 198                       | 2,715                      | 4,095             | 453,312 | 457,407                   | 22  |
| December 31,<br>2011                     |                        |                           |                            |                   |         |                           |   |
| Commercial &<br>industrial               | \$2                    | -                         | 495                        | 497               | 30,476  | 30,973                    | -   |
| Commercial,<br>secured by real<br>estate | -                      | 83                        | 1,769                      | 1,852             | 217,210 | 219,062                   | -   |
| Residential real<br>estate               | 1,132                  | 22                        | 1,202                      | 2,356             | 184,792 | 187,148                   | -   |
| Consumer                                 | 82                     | 37                        | 39                         | 158               | 14,532  | 14,690                    | 39  |
| Agricultural                             | -                      | -                         | -                          | -                 | 2,835   | 2,835                     | -   |
| Other                                    | 59                     | -                         | -                          | 59                | 6,495   | 6,554                     | -   |
| Total                                    | \$ 1,275               | 142                       | 3,505                      | 4,922             | 456,340 | 461,262                   | 39  |

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

Note 3 – Loans (continued)

Impaired loans at September 30, 2012 and December 31, 2011 are as follows (in thousands):

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| September 30, 2012                  |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial & industrial             | \$83                   | 572                            | -                    | 1,494                             | 43                               |
| Commercial real estate              | 12,827                 | 13,270                         | -                    | 12,486                            | 348                              |
| Residential real estate             | 474                    | 474                            | -                    | 389                               | 3                                |
| Consumer                            | 22                     | 22                             | -                    | 23                                | 1                                |
| Total                               | \$13,406               | 14,338                         | -                    | 14,392                            | 395                              |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial & industrial             | \$181                  | 250                            | 21                   | 181                               | -                                |
| Commercial real estate              | 1,168                  | 1,222                          | 98                   | 1,643                             | 43                               |
| Residential real estate             | 583                    | 777                            | 170                  | 728                               | -                                |
| Consumer                            | 5                      | 5                              | -                    | 4                                 | -                                |
| Total                               | \$1,937                | 2,254                          | 289                  | 2,556                             | 43                               |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial & industrial             | \$264                  | 822                            | 21                   | 1,675                             | 43                               |
| Commercial real estate              | 13,995                 | 14,492                         | 98                   | 14,129                            | 391                              |
| Residential real estate             | 1,057                  | 1,251                          | 170                  | 1,117                             | 3                                |
| Consumer                            | 27                     | 27                             | -                    | 27                                | 1                                |
| Total                               | \$15,343               | 16,592                         | 289                  | 16,948                            | 438                              |
| December 31, 2011                   |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial & industrial             | \$2,881                | 3,211                          | -                    | 3,015                             | 139                              |
| Commercial real estate              | 12,373                 | 12,587                         | -                    | 12,686                            | 529                              |
| Residential real estate             | 332                    | 332                            | -                    | 332                               | -                                |
| Consumer                            | 8                      | 8                              | -                    | 5                                 | 1                                |
| Total                               | \$15,594               | 16,138                         | -                    | 16,038                            | 669                              |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial & industrial             | \$177                  | 177                            | -                    | 330                               | 14                               |
| Commercial real estate              | 2,120                  | 3,136                          | 257                  | 2,514                             | 67                               |
| Residential real estate             | 264                    | 264                            | 142                  | 257                               | -                                |
| Consumer                            | 2                      | 2                              | -                    | 1                                 | -                                |
| Total                               | \$2,563                | 3,579                          | 399                  | 3,102                             | 81                               |
| Total:                              |                        |                                |                      |                                   |                                  |



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|                         |          |        |     |        |     |
|-------------------------|----------|--------|-----|--------|-----|
| Commercial & industrial | \$3,058  | 3,388  | -   | 3,345  | 153 |
| Commercial real estate  | 14,493   | 15,723 | 257 | 15,200 | 596 |
| Residential real estate | 596      | 596    | 142 | 589    | -   |
| Consumer                | 10       | 10     | -   | 6      | 1   |
| Total                   | \$18,157 | 19,717 | 399 | 19,140 | 750 |

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LCNB CORP. AND SUBSIDIARIES  
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## Note 3 – Loans (continued)

Loan modifications that were classified as troubled debt restructurings during the three and nine months ended September 30, 2012 and 2011 are as follows (dollars in thousands):

|                                    | Three Months Ended September 30,<br>2012 |                            | September 30,<br>2011 |                            | Nine Months Ended September 30,<br>2012 |                            | September 30,<br>2011 |                            |
|------------------------------------|--|----------------------------|-----------------------|----------------------------|---|----------------------------|-----------------------|----------------------------|
|                                    | Number<br>of<br>Loans                    | Balance at<br>Modification | Number<br>of<br>Loans | Balance at<br>Modification | Number<br>of<br>Loans                   | Balance at<br>Modification | Number<br>of<br>Loans | Balance at<br>Modification |
| Commercial and industrial          | -  | \$ -                       | -                     | \$ -                       | -                                       | \$ -                       | 1                     | \$ 204                     |
| Commercial, secured by real estate | -  | -                          | -                     | -                          | -                                       | -                          | 2                     | 625                        |
| Residential real estate            | 1  | 100                        | 5                     | 65                         | 3                                       | 273                        | 5                     | 65                         |
| Consumer                           | 2  | 20                         | -                     | -                          | 2                                       | 20                         | 3                     | 11                         |
| Total                              | 3  | \$ 120                     | 5                     | \$ 65                      | 5                                       | \$ 293                     | 11                    | \$ 905                     |

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.

There were no troubled debt restructurings that subsequently defaulted within twelve months of the restructuring date for the three or nine months ended September 30, 2012 and 2011.

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LCNB CORP. AND SUBSIDIARIES  
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## Note 4 – 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):

|   | Nine Months Ended<br>September 30, |       |
|---|------------------------------------|-------|
|   | 2012                               | 2011  |
| Balance, beginning of year              | \$ 1,619                           | 2,088 |
| Transfer from loans                     | 755                                | -     |
| Additions                               | 16                                 | -     |
| Reductions due to valuation write downs | (76 )                              | -     |
| Balance, end of period                  | \$ 2,314                           | 2,008 |

Other real estate owned at September 30, 2012 and December 31, 2011 consisted of (dollars in thousands):

|                         | September 30, 2012 |          | December 31, 2011 |          |
|-------------------------|--------------------|----------|-------------------|----------|
|                         | Number             | Balance  | Number            | Balance  |
| Commercial real estate  | 2                  | \$ 2,063 | 1                 | \$ 1,579 |
| Residential real estate | 8                  | 251      | 1                 | 40       |
|                         | 10                 | \$ 2,314 | 2                 | \$ 1,619 |

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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 5 – Borrowings

Funds borrowed from the Federal Home Loan Bank of Cincinnati at September 30, 2012 and December 31, 2011 are as follows (dollars in thousands):

|  | Interest<br>Rate |      | September 30,<br>2012 | December 31,<br>2011 |
|--|------------------|------|-----------------------|----------------------|
| Fixed Rate Advances, due at maturity:                              |                  |      |                       |                      |
| Advance due August 2012  | 1.99             | % \$ | -                     | 6,000                |
| Advance due January 2015   | 2.00             | %    | 5,000                 | 5,000                |
| Advance due March 2017   | 5.25             | %    | 5,000                 | 5,000                |
| Fixed Rate Advances, with monthly principal and interest payments: |                  |      |                       |                      |
| Advance due March 2014   | 2.45             | %    | 1,565                 | 2,326                |
| Advance due March 2019   | 2.82             | %    | 2,484                 | 3,047                |
|  |                  | \$   | 14,049                | 21,373               |

All advances from the Federal Home Loan Bank of Cincinnati are secured by a blanket pledge of LCNB's 1-4 family first lien mortgage loans in the amount of approximately \$143 million and \$147 million at September 30, 2012 and December 31, 2011, respectively. Additionally, LCNB is required to hold minimum levels of FHLB stock, based on the outstanding borrowings.

Short-term borrowings at September 30, 2012 and December 31, 2011 are as follows (dollars in thousands):

|                         | September 30, 2012 |      | December 31, 2011 |        |
|-------------------------|--------------------|------|-------------------|--------|
|                         | Amount             | Rate | Amount            | Rate   |
| FHLB short-term advance | \$ -               | -    | % 12,000          | 0.04 % |
| Repurchase agreements   | 12,076             | 0.10 | % 9,596           | 0.10 % |
|                         | \$ 12,076          | 0.10 | % 21,596          | 0.07 % |

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## LCNB CORP. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

## Note 6 – 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 |         | For the nine months ended |         |
|---|----------------------------|---------|---------------------------|---------|
|   | September 30,              |         | September 30,             |         |
|   | 2012                       | 2011    | 2012                      | 2011    |
| Statutory tax rate                                | 34.0 %                     | 34.0 %  | 34.0 %                    | 34.0 %  |
| Increase (decrease)<br>resulting from:            |                            |         |                           |         |
| Tax exempt interest                               | (8.3 )%                    | (8.2 )% | (7.3 )%                   | (9.0 )% |
| Tax exempt income on<br>bank owned life insurance | (2.0 )%                    | (2.1 )% | (1.8 )%                   | (2.2 )% |
| Other, net  | (0.1 )%                    | - %     | - %                       | 0.6 %   |
| Effective tax rate                                | 23.6 %                     | 23.7 %  | 24.9 %                    | 23.4 %  |

## Note 7 - 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 included 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.

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LCNB CORP. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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## Note 7 – Commitments and Contingent Liabilities (continued)

LCNB uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Financial instruments whose contract amounts represent off-balance-sheet credit risk at September 30, 2012 and December 31, 2011 are as follows (in thousands):

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Commitments to extend credit:                               |                       |                      |
| Commercial loans  | \$ 12,046             | 3,227                |
| Other loans   |                       |                      |
| Fixed rate  | 2,143                 | 1,391                |
| Adjustable rate   | 1,964                 | 2,099                |
| Unused lines of credit:                                     |                       |                      |
| Fixed rate  | 3,646                 | 3,883                |
| Adjustable rate   | 47,286                | 55,274               |
| Unused Bounce Protection amounts on demand and NOW accounts | 9,718                 | 9,810                |
| Standby letters of credit                                   | 5,575                 | 5,575                |
|   | \$ 82,378             | 81,259               |

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 in 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. At September 30, 2012 and December 31, 2011, outstanding guarantees of approximately \$546,000 were issued to developers and contractors. These guarantees generally are fully secured and have varying maturities. In addition, LCNB has a participation in four letters of credit securing payment of principal and interest on a bond issue. The participation amounts at September 30, 2012 and December 31, 2011 totaled approximately \$5.0 million. The letters of credit have a final maturity date of July 15, 2014, as extended.

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.

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## Note 7 – Commitments and Contingent Liabilities (continued)

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 8 – 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.

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

|   | Minimum<br>Requirement | To Be Considered<br>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.

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## Note 8 – Regulatory Capital (continued)

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

|   | At<br>September 30,<br>2012 |   | At<br>December 31,<br>2011 |   |
|---|-----------------------------|---|----------------------------|---|
| Regulatory Capital:                           |                             |   |                            |   |
| Shareholders' equity                          | \$ 82,131                   |   | 77,960                     |   |
| Goodwill and other intangibles                | (6,032 )                    |   | (6,071 )                   |   |
| Accumulated other comprehensive (income) loss | (5,996 )                    |   | (5,028 )                   |   |
| Tier 1 risk-based capital                     | 70,103                      |   | 66,861                     |   |
| Eligible allowance for loan losses            | 2,866                       |   | 2,931                      |   |
| Total risk-based capital                      | \$ 72,969                   |   | 69,792                     |   |
| Capital ratios:                               |                             |   |                            |   |
| Tier 1 risk-based                             | 14.71                       | % | 13.93                      | % |
| Total risk-based                              | 15.32                       | % | 14.54                      | % |
| Leverage                                      | 8.76                        | % | 8.51                       | % |

## Note 9 – Employee Benefits

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.



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## Note 9 – Employee Benefits (continued)

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 nine-month periods ended September 30, 2012 and 2011 are as follows (in thousands):

|   | For the Three Months<br>Ended September 30, |      | For the Nine Months<br>Ended September 30, |      |
|---|---|------|--|------|
|   | 2012  | 2011 | 2012                                       | 2011 |
| Qualified noncontributory defined benefit retirement plan | \$230                                       | 198  | 521  | 456  |
| 401(k) plan   | 88  | 75   | 198  | 232  |

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 nine months ended September 30, 2012 and 2011 are summarized as follows (in thousands):

|   | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |       |
|---|-------------------------------------|------|------------------------------------|-------|
|   | 2012                                | 2011 | 2012                               | 2011  |
| Service cost                                    | \$ 22                               | 23   | 66                                 | 89    |
| Interest cost                                   | 11                                  | 9    | 33                                 | 26    |
| Amortization of unrecognized net (gain) loss    | 5                                   | (8 ) | 15                                 | (20 ) |
| Amortization of unrecognized prior service cost | 7                                   | 7    | 21                                 | 25    |
| Net periodic pension cost                       | \$ 45                               | 31   | 135                                | 120   |

Amounts recognized in accumulated other comprehensive income at September 30, 2012 and December 31, 2011 for the nonqualified defined benefit retirement plan consists of (in thousands):

|                    | September 30, | December 31, |
|--------------------|---------------|--------------|
|                    | 2012          | 2011         |
| Net actuarial loss | \$ 141        | 156          |
| Past service cost  | 53            | 74           |
|                    | \$ 194        | 230          |

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## Note 10 - Stock Based Compensation

LCNB established an Ownership Incentive Plan (the "Plan") during 2002 that allows for stock-based awards to eligible employees, as determined by the Board of Directors. The awards may be in the form of stock options, share awards, and/or appreciation rights. The Plan provides for the issuance of up to 200,000 shares.

Options granted to date vest ratably over a five year period and expire ten years after the date of grant. Stock options outstanding at September 30, 2012 are as follows:

| Exercise Price Range | Outstanding Stock Options |                                 |   | Exercisable Stock Options |                                 |   |
|----------------------|---------------------------|---------------------------------|---|---------------------------|---------------------------------|---|
|                      | 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     | 29,110                    | \$ 9.00                         | 5.5   | 18,964                    | \$ 9.00                         | 5.1   |
| \$11.00 - \$12.99    | 74,290                    | 12.03                           | 6.9   | 29,159                    | 12.01                           | 4.8   |
| \$13.00 - \$14.99    | 8,912                     | 13.09                           | 0.3   | 8,912                     | 13.09                           | 0.3   |
| \$17.00 - \$18.99    | 24,158                    | 18.16                           | 2.4   | 24,158                    | 18.16                           | 2.4   |
|                      | 136,470                   | 12.54                           | 5.4   | 81,193                    | 13.25                           | 3.7   |

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

|                           | 2012     |                                 | 2011    |                                 |
|---------------------------|----------|---------------------------------|---------|---------------------------------|
|                           | Options  | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| Outstanding, January 1    | 124,123  | \$ 12.54                        | 99,040  | \$ 12.71                        |
| Granted                   | 14,491   | 12.60                           | 25,083  | 11.85                           |
| Exercised                 | (2,144 ) | 13.09                           | -       | -                               |
| Outstanding, September 30 | 136,470  | 12.54                           | 124,123 | 12.54                           |
| Exercisable, September 30 | 81,193   | 13.25                           | 57,746  | 14.06                           |

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 September 30, 2012 that were "in the money" (market price greater than exercise price) was \$233,000. The aggregate intrinsic value at that date for only the options that were exercisable was \$127,000. The aggregate intrinsic value for options outstanding at September 30, 2011 that were in the money was \$217,000 and the aggregate intrinsic value at that date for only the options that were exercisable was

\$87,000. The intrinsic value changes based upon fluctuations in the market value of LCNB's stock.

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## Note 10 - Stock Based Compensation (continued)

The fair value of options granted is estimated at the date of grant using the Black-Scholes option-pricing model. The following table shows the estimated weighted-average fair value of options granted and the assumptions used in calculating that value for the years indicated:

|   | 2012    |   | 2011    |   |
|---|---------|---|---------|---|
| Estimated weighted-average fair value of options granted              | \$ 2.80 |   | \$ 2.09 |   |
| Risk-free interest rate   | 0.84    | % | 2.84    | % |
| Average dividend  | \$ 0.64 |   | \$ 0.64 |   |
| Volatility factor of the expected market price of LCNB's common stock | 39.56   | % | 27.37   | % |
| Average life in years   | 6.5     |   | 6.5     |   |

Total expense related to options included in salaries and employee benefits in the consolidated statements of income for the three and nine months ended September 30, 2012 were \$10,000 and \$30,000, respectively, and \$13,000 and \$35,000 for the three and nine months ended September 30, 2011, respectively.

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## Note 11 - 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, warrant, and restricted stock. The diluted average number of common shares outstanding has been increased for the assumed exercise of stock options, warrant, and restricted stock with proceeds used to purchase treasury shares at the average market price for the period. The computations are as follows for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands, except share and per share data):

|   | For the Three Months<br>Ended September 30, |           | For the Nine Months<br>Ended September 30, |           |
|---|---|-----------|--|-----------|
|   | 2012  | 2011      | 2012                                       | 2011      |
| Income from continuing operations   | \$1,847                                     | 1,867     | 6,111                                      | 5,368     |
| Income from discontinued operations, net of tax   | -   | -         | -  | 793       |
| Net income  | \$1,847                                     | 1,867     | 6,111                                      | 6,161     |
| Weighted average number of shares outstanding used in the calculation of basic earnings per common share            | 6,721,699                                   | 6,690,963 | 6,713,959                                  | 6,690,157 |
| Add dilutive effect of:   |   |           |  |           |
| Stock options   | 10,089                                      | 5,003     | 8,898                                      | 4,426     |
| Stock warrant   | 65,887                                      | 54,841    | 64,143                                     | 51,985    |
|   | 75,976                                      | 59,844    | 73,041                                     | 56,411    |
| Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share | 6,797,675                                   | 6,750,807 | 6,787,000                                  | 6,746,568 |
| Basic earnings per common share:  |   |           |  |           |
| Continuing operations   | \$0.27                                      | 0.28      | 0.91                                       | 0.80      |
| Discontinued operations   | -   | -         | -  | 0.12      |
| Diluted earnings per common share:  |   |           |  |           |
| Continuing operations   | \$0.27                                      | 0.28      | 0.90                                       | 0.80      |
| Discontinued operations   | -   | -         | -  | 0.12      |

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Note 12 - 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.

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 2 inputs because, among other factors, the fund invests primarily in U.S. Government and Agency Obligations, which are considered to be level 2 investments. The investment in the other mutual fund is considered to have level 3 inputs because its shares are not traded in an active market, it does not publish a daily net asset value, and it is primarily a loan fund. Additionally, LCNB owns trust preferred securities in various financial institutions and equity securities in non-financial companies. Market quotations (level 1) are used to determine fair values for these investments.

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Note 12 - Fair Value Measurements (continued)

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 12 - Fair Value Measurements (continued)

The following table summarizes the valuation of LCNB's assets recorded at fair value by input levels as of September 30, 2012 and December 31, 2011 (in thousands):

|  | Fair Value<br>Measurements | Fair Value Measurements at the End of<br>the Reporting Period Using                 |   |  | Total<br>Gains<br>(Losses) |
|--|----------------------------|---|---|--|----------------------------|
|  |                            | Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |                            |
| September 30, 2012                                     |                            |   |   |  |                            |
| Recurring fair value measurements:                     |                            |   |   |  |                            |
| Investment securities available-for-sale:              |                            |   |   |  |                            |
| U.S. Treasury notes                                    | \$ 18,806                  | 18,806  | -   | -  |                            |
| U.S. Agency notes                                      | 93,152                     | -   | 93,152  | -  |                            |
| U.S. Agency mortgage-backed securities                 | 51,901                     | -   | 51,901  | -  |                            |
| Corporate securities                                   | 3,081                      | 3,081   | -   | -  |                            |
| Municipal securities:                                  |                            |   |   |  |                            |
| Non-taxable  | 73,728                     | -   | 73,728  | -  |                            |
| Taxable  | 21,306                     | -   | 21,306  | -  |                            |
| Mutual funds   | 2,169                      | -   | 1,169   | 1,000  |                            |
| Trust preferred securities                             | 304                        | 304   | -   | -  |                            |
| Equity securities                                      | 1,290                      | 1,290   | -   | -  |                            |
| Total recurring fair value measurements                | \$ 265,737                 | 23,481  | 241,256   | 1,000  |                            |
| Nonrecurring fair value measurements:                  |                            |   |   |  |                            |
| Impaired loans   | \$ 1,648                   | -   | 220   | 1,428  | -                          |
| Other real estate owned and repossessed assets (a) (b) | 2,314                      | -   | 2,314   | -  | (79 )                      |
| Total nonrecurring fair value measurements             | \$ 3,962                   | -   | 2,534   | 1,428  | (79 )                      |
| December 31, 2011                                      |                            |   |   |  |                            |
| Recurring fair value measurement:                      |                            |   |   |  |                            |



Investment securities  
available-for-sale:

|   |    |         |        |         |       |
|---|----|---------|--------|---------|-------|
| U.S. Treasury notes                     | \$ | 17,550  | 17,550 | -       | -     |
| U.S. Agency notes                       |    | 82,927  | -      | 82,927  | -     |
| U.S. Agency mortgage-backed securities  |    | 52,287  | -      | 52,287  | -     |
| Corporate securities                    |    | 6,365   | 4,152  | 2,213   | -     |
| Municipal securities:                   |    |         |        |         |       |
| Non-taxable                             |    | 69,703  | -      | 69,703  | -     |
| Taxable                                 |    | 21,907  | -      | 21,907  | -     |
| Mutual funds                            |    | 2,125   | -      | 1,125   | 1,000 |
| Trust preferred securities              |    | 564     | 564    | -       | -     |
| Equity securities                       |    | 578     | 578    | -       | -     |
| Total recurring fair value measurements | \$ | 254,006 | 22,844 | 230,162 | 1,000 |

Nonrecurring fair value  
measurements:

|  |    |       |   |       |       |    |
|--|----|-------|---|-------|-------|----|
| Impaired loans                                     | \$ | 2,563 | - | 1,300 | 1,263 | -  |
| Other real estate owned and repossessed assets (c) |    | 1,642 | - | 1,619 | 23    | 31 |
| Total nonrecurring fair value measurements         | \$ | 4,205 | - | 2,919 | 1,286 | 31 |

- (a) Two other real estate owned properties with a total carrying amount of \$1,619,000 were written down to their combined fair value of \$1,543,000, resulting in an impairment charge of \$76,000, which was included in other non-interest expense for the period.
- (b) Repossessed assets with a carrying value of \$23,000 were sold for a combined total of \$20,000, resulting in a net loss of \$3,000, which was included in other non-interest expense for the period.
- (c) Repossessed assets with a carrying value of \$117,000 were sold for a combined total of \$148,000, resulting in a net gain of \$31,000, which was included in other non-interest expense for the period.

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## Note 12 - Fair Value Measurements (continued)

Carrying amounts and estimated fair values of financial instruments as of September 30, 2012 and December 31, 2011 are as follows (in thousands):

|                                   | September 30, 2012 |               | December 31, 2011  |               |
|-----------------------------------|--------------------|---------------|--------------------|---------------|
|                                   | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
| <b>FINANCIAL ASSETS:</b>          |                    |               |                    |               |
| Cash and cash equivalents         | \$ 33,074          | 33,074        | 19,535             | 19,535        |
| Investment securities:            |                    |               |                    |               |
| Available-for-sale                | 265,737            | 265,737       | 254,006            | 254,006       |
| Held-to-maturity                  | 12,503             | 12,503        | 10,734             | 10,734        |
| Federal Reserve Bank stock        | 949                | 949           | 940                | 940           |
| Federal Home Loan Bank<br>stock   | 2,091              | 2,091         | 2,091              | 2,091         |
| Loans, net                        | 454,541            | 459,524       | 458,331            | 470,846       |
| <b>FINANCIAL<br/>LIABILITIES:</b> |                    |               |                    |               |
| Deposits                          | 701,080            | 705,803       | 663,562            | 669,383       |
| Short-term borrowings             | 12,076             | 12,076        | 21,596             | 21,596        |
| Long-term debt                    | 14,049             | 15,138        | 21,373             | 22,570        |

The fair value of off-balance-sheet financial instruments at September 30, 2012 and December 31, 2011 was not material.

Fair values of financial instruments are based on various assumptions, including the discount rate and estimates of future cash flows. Therefore, the fair values presented may not represent amounts that could be realized in actual transactions. In addition, because the required disclosures exclude certain financial instruments and all nonfinancial instruments, any aggregation of the fair value amounts presented would not represent the underlying value of LCNB. The following methods and assumptions were used to estimate the fair value of certain financial instruments:

**Cash and cash equivalents**

The carrying amounts presented are deemed to approximate fair value.

**Investment securities**

Fair values for securities, excluding Federal Home Loan Bank and Federal Reserve Bank stock, are based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and/or discounted cash flow analyses or other methods. The carrying value of Federal Home Loan Bank and Federal Reserve Bank stock approximates fair value based on the respective redemptive provisions.



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(Continued)

## Note 12 - Fair Value of Measurements (continued)

## Loans

Fair value is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities, incorporating assumptions of current and projected prepayment speeds. These current rates approximate market rates.

## Deposits

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities, which approximates market rates.

## Borrowings

The carrying amounts of federal funds purchased, repurchase agreements, and U.S. Treasury demand note borrowings are deemed to approximate fair value of short-term borrowings. For long-term debt, fair values are estimated based on the discounted value of expected net cash flows using current interest rates.

The following table summarizes the categorization by input level as of September 30, 2012 and December 31, 2011 of LCNB's financial assets and liabilities not recorded at fair value but for which fair value is disclosed (in thousands):

|  | Fair Value<br>Measurements | Fair Value Measurements at the End of<br>the Reporting Period Using                 |   |  |
|--|----------------------------|---|---|--|
|  |                            | Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| September 30, 2012                                   |                            |   |   |  |
| Assets:  |                            |   |   |  |
| Loans, net   | 457,876                    | -   | 457,876   | -  |
| Investment securities, non-taxable, held-to-maturity | 12,503                     | -   | -   | 12,503   |
| Federal Reserve Bank stock                           | 949                        | 949   | -   | -  |
| Federal Home Loan Bank stock                         | 2,091                      | 2,091   | -   | -  |
| Liabilities:   |                            |   |   |  |
| Deposits   | 705,803                    | -   | 705,803   | -  |
| Long-term debt                                       | 15,138                     | -   | 15,138  | -  |
| December 31, 2011                                    |                            |   |   |  |
| Assets:  |                            |   |   |  |
| Loans, net   | \$ 468,283                 | -   | 468,283   | -  |
| Investment securities, non-taxable, held-to-maturity | 10,734                     | -   | -   | 10,734   |

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|                              |         |       |         |   |
|------------------------------|---------|-------|---------|---|
| Federal Reserve Bank stock   | 940     | 940   | -       | - |
| Federal Home Loan Bank stock | 2,091   | 2,091 | -       | - |
| <b>Liabilities:</b>          |         |       |         |   |
| Deposits                     | 669,383 | -     | 669,383 | - |
| Long-term debt               | 22,570  | -     | 22,570  | - |

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(Continued)

## Note 13 – Discontinued Operations

LCNB sold its insurance agency subsidiary on March 23, 2011 and therefore its financial results are reported in the income statements as income from discontinued operations, net of taxes. Income from discontinued operations for the nine months ended September 30, 2011 includes the gain recognized from the sale less certain related closing costs, taxes, and a curtailment expense recognized in LCNB’s nonqualified defined benefit retirement plan due to the sale. The following table summarizes income from discontinued operations for the period indicated (in thousands):

For the Nine Months  
Ended September 30,  
2011

## Dakin Insurance Agency financial results:

|   |    |       |
|---|----|-------|
| Revenue   | \$ | 381   |
| Non-interest expenses   |    | 301   |
| Income from operations before income taxes                          |    | 80    |
| Gain from sale of insurance agency                                  |    | 1,503 |
| Closing costs related to sale                                       |    | (60)  |
| Curtailment expense on nonqualified defined benefit retirement plan |    | (191) |
| Provision for income taxes  |    | (539) |
| Total income (loss) from discontinued operations, net of taxes      | \$ | 793   |

There was no income from discontinued operations for the three months ended September 31, 2011.

## Note 14 – Acquisition

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 will be merged into LCNB in a stock and cash transaction valued at approximately \$19.6 million. Immediately following the merger of First Capital into LCNB, Citizens National Bank (“Citizens”), a wholly-owned subsidiary of First Capital, will be merged into LCNB National Bank. Citizens operates 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 will become branches of LCNB after the merger. As of December 31, 2011, First Capital had total assets of \$148.2 million, deposits of \$132.0 million, net loans of \$104.8 million and shareholders’ equity of \$13.7 million.

Under the terms of the Merger Agreement, the shareholders of First Capital common stock will be entitled to elect to receive, for each share of First Capital Common Stock, (i) \$30.76 in cash, (ii) 2.329 common shares of LCNB (subject to an adjustment based upon the average closing price of LCNB common shares for the 25 trading days prior to the effective date of the merger), or (iii) a combination of cash and LCNB common stock. A First Capital shareholder’s election to receive cash or stock is subject to allocation procedures that will ensure that no more than 50% and no less than 40% of the outstanding First Capital shares are exchanged for cash and that no more than 60% and no less than 50% of the outstanding First Capital shares are exchanged for LCNB common shares. Subject to adoption of the Merger Agreement by the shareholders of First Capital, approval of the merger by regulatory authorities, and the satisfaction of other customary closing conditions, the transaction is anticipated to be completed during the fourth quarter 2012 or the first quarter 2013.



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LCNB CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Continued)

Note 15 - Recent Accounting Pronouncements

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment." The provisions of ASU No. 2012-02 permit an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test, as is currently required by GAAP. ASU No. 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. As LCNB does not have any indefinite-lived intangible assets, other than goodwill, the adoption of ASU No. 2012-02 is expected to have no impact on its consolidated financial statements.



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

LCNB Corp.  
Lebanon, Ohio

We have reviewed the accompanying consolidated balance sheet of LCNB Corp. and subsidiaries (“LCNB”) as of September 30, 2012, and the related consolidated statements of income and comprehensive income for each of the three-month and nine-month periods ended September 30, 2012 and 2011, and the related consolidated statements of shareholders’ equity and cash flows for each of the nine-month periods ended September 30, 2012 and 2011. These interim financial statements are the responsibility of LCNB's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of LCNB as of December 31, 2011 and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated February 27, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2011, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ J.D. Cloud & Co. L.L.P.

Cincinnati, Ohio  
November 5, 2012

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LCNB CORP. AND SUBSIDIARIES

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

Forward Looking Statements

Certain matters disclosed herein may be deemed to be forward-looking statements that involve risks and uncertainties. Forward looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Such statements are often characterized by the use of qualifying words and their derivatives such as “expects,” “anticipates,” “believes,” “estimates,” “plans,” “projects” or other statements concerning opinions or judgments of LCNB and its management about future events. Factors that could influence the accuracy of such forward looking statements include, but are not limited to, regulatory policy changes, interest rate fluctuations, loan demand, loan delinquencies and losses, general economic conditions and other risks. Such forward-looking statements represent management's judgment as of the current date. Actual strategies and results in future time periods may differ materially from those currently expected. LCNB disclaims, however, any intent or obligation to update such forward-looking statements. LCNB intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Results of Operations

Net income for the three months ended September 30, 2012 was \$1,847,000 (total basic and diluted earnings per common share of \$0.27) and \$6,111,000 (total basic and diluted earnings per common share of \$0.91 and \$0.90, respectively) for the nine months ended September 30, 2012. This compares to net income from continuing operations of \$1,867,000 (total basic and diluted earnings per common share of \$0.28) and \$5,368,000 (total basic and diluted earnings per common share of \$0.80) for the same three and nine-month periods in 2011.

Net income for the nine months ended September 30, 2011 included income from discontinued operations of \$793,000, which consisted of a gain recognized on the sale of LCNB's insurance agency subsidiary, Dakin Insurance Agency, Inc., less certain related closing costs, taxes, and a curtailment expense recognized in LCNB's nonqualified defined benefit retirement plan due to the sale.

The provision for loan losses for the three and nine months ended September 30, 2012 was \$436,000 and \$742,000, respectively, down from \$588,000 and \$1,476,000 for the same periods in 2011. Credit quality continued to stabilize during 2012, resulting in a decline in the provision. Net loan charge-offs for the first nine months of 2012 and 2011 totaled \$807,000 and \$876,000, respectively. Non-accrual loans and loans past due 90 days or more and still accruing interest totaled \$2,799,000 or 0.61% of total loans at September 30, 2012, compared to \$3,707,000 or 0.80% of total loans at December 31, 2011. The decrease was primarily due to the transfer of a non-accrual commercial real estate loan to other real estate owned during the first quarter 2012 and to partial charge-offs recognized on various loans. Other real estate owned (which includes property acquired through foreclosure or deed-in-lieu of foreclosure and also includes property deemed to be in-substance foreclosed) and other repossessed assets increased from \$1,642,000 at December 31, 2011 to \$2,314,000 at September 30, 2012.

Net interest income for the three months and nine months ended September 30, 2012 decreased \$225,000 and \$307,000, respectively, from the comparative periods in 2011. The decreases for both periods were primarily due to decreases in the net interest margin, partially offset by increases in average interest-earning assets.

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LCNB CORP. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Non-interest income for the three and nine-month periods in 2012 was \$172,000 and \$513,000, respectively, greater than the comparative periods in 2011 primarily due to increases in gains from sales of investment securities and mortgage loans. One-time fees recognized by the trust department during the first quarter 2012 also contributed to the increase during the nine-month period. These increases were partially offset by a decrease in service charges and fees on deposit accounts.

Non-interest expense for the three months ended September 30, 2012 was \$128,000 greater than the comparative period in 2011 due to increases in various accounts. Non-interest expense for the nine months ended September 30, 2012 was \$186,000 less than the comparative period in 2011 primarily due to decreases in FDIC insurance premiums and other expenses, partially offset by increases in a number of other accounts. The decrease in other expenses in 2012 reflects the absences of losses recognized during 2011 on a standby letter of credit and certain environmental remediation costs.

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## LCNB CORP. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

## Net Interest Income

Three Months Ended September 30, 2012 vs. 2011.

LCNB's primary source of earnings is net interest income, which is the difference between earnings from loans and other investments and interest paid on deposits and other liabilities. The following table presents, for the three months ended September 30, 2012 and 2011, average balances for interest-earning assets and interest-bearing liabilities, the income or expense related to each item, and the resulting average yields earned or rates paid.

|   | Three Months Ended September 30,  |                                     |                           |   |                                   |                                     |                           |   |
|---|-----------------------------------|-------------------------------------|---------------------------|---|-----------------------------------|-------------------------------------|---------------------------|---|
|   | Average<br>Outstanding<br>Balance | 2012<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate |   | Average<br>Outstanding<br>Balance | 2011<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate |   |
|   | (Dollars in thousands)            |                                     |                           |   |                                   |                                     |                           |   |
| Loans (1)   | \$457,138                         | \$5,822                             | 5.05                      | % | \$454,192                         | \$6,294                             | 5.50                      | % |
| Interest-bearing demand deposits  | 10,175                            | 4                                   | 0.16                      | % | 10,641                            | 6                                   | 0.22                      | % |
| Federal Reserve Bank stock  | 949                               | -                                   | -                         | % | 941                               | -                                   | -                         | % |
| Federal Home Loan Bank stock  | 2,091                             | 22                                  | 4.17                      | % | 2,091                             | 21                                  | 3.98                      | % |
| Investment securities:  |                                   |                                     |                           |   |                                   |                                     |                           |   |
| Taxable   | 197,971                           | 941                                 | 1.89                      | % | 198,189                           | 1,036                               | 2.07                      | % |
| Non-taxable (2)   | 85,135                            | 932                                 | 4.34                      | % | 76,550                            | 938                                 | 4.86                      | % |
| Total earnings assets   | 753,459                           | 7,721                               | 4.07                      | % | 742,604                           | 8,295                               | 4.43                      | % |
| Non-earning assets  | 63,687                            |                                     |                           |   | 65,271                            |                                     |                           |   |
| Allowance for loan losses   | (2,925 )                          |                                     |                           |   | (3,030 )                          |                                     |                           |   |
| Total assets  | \$814,221                         |                                     |                           |   | \$804,845                         |                                     |                           |   |
| Interest-bearing deposits   | \$579,128                         | 1,050                               | 0.72                      | % | \$586,380                         | 1,371                               | 0.93                      | % |
| Short-term borrowings   | 14,544                            | 4                                   | 0.11                      | % | 12,050                            | 6                                   | 0.20                      | % |
| Long-term debt  | 17,561                            | 136                                 | 3.07                      | % | 21,834                            | 160                                 | 2.91                      | % |
| Total interest-bearing liabilities  | 611,233                           | 1,190                               | 0.77                      | % | 620,264                           | 1,537                               | 0.98                      | % |
| Demand deposits   | 114,053                           |                                     |                           |   | 101,513                           |                                     |                           |   |
| Other liabilities   | 7,369                             |                                     |                           |   | 6,725                             |                                     |                           |   |
| Capital   | 81,566                            |                                     |                           |   | 76,343                            |                                     |                           |   |
| Total liabilities and capital   | \$814,221                         |                                     |                           |   | \$804,845                         |                                     |                           |   |
| Net interest rate spread (3)  |                                   |                                     | 3.30                      | % |                                   |                                     | 3.45                      | % |
| Net interest income and net interest margin on a taxable-equivalent basis (4) |                                   | \$6,531                             | 3.44                      | % |                                   | \$6,758                             | 3.61                      | % |
|   | 123.27                            | %                                   |                           |   | 119.72                            | %                                   |                           |   |

Ratio of interest-earning assets  
to interest-bearing liabilities

- (1) Includes nonaccrual loans, if any.
- (2) Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax rate of 34%.
- (3) The net interest spread is the difference between the average rate on total interest-earning assets and interest-bearing liabilities.
- (4) The net interest margin is the taxable-equivalent net interest income divided by average interest-earning assets.

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## LCNB CORP. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The following table presents the changes in taxable-equivalent basis interest income and expense for each major category of interest-earning assets and interest-bearing liabilities and the amount of change attributable to volume and rate changes for the three months ended September 30, 2012 as compared to the same period in 2011. Changes not solely attributable to rate or volume have been allocated to volume and rate changes in proportion to the relationship of absolute dollar amounts of the changes in each.

|                                      | Volume | Three Months Ended<br>September 30, 2012 vs. 2011<br>Increase (decrease) due to: |        |
|--------------------------------------|--------|--|--------|
|                                      |        | Rate<br>(In thousands)   | Total  |
| <b>Interest-earning Assets:</b>      |        |  |        |
| Loans                                | \$ 41  | (513 )   | (472 ) |
| Interest-bearing demand deposits     | -      | (2 )   | (2 )   |
| Federal Reserve Bank stock           | -      | -  | -      |
| Federal Home Loan Bank stock         | -      | 1  | 1      |
| <b>Investment securities:</b>        |        |  |        |
| Taxable                              | (1 )   | (94 )  | (95 )  |
| Nontaxable                           | 99     | (105 )   | (6 )   |
| Total interest income                | 139    | (713 )   | (574 ) |
| <b>Interest-bearing Liabilities:</b> |        |  |        |
| Deposits                             | (17 )  | (304 )   | (321 ) |
| Short-term borrowings                | 1      | (3 )   | (2 )   |
| Long-term debt                       | (33 )  | 9  | (24 )  |
| Total interest expense               | (49 )  | (298 )   | (347 ) |
| Net interest income                  | \$ 188 | (415 )   | (227 ) |

Net interest income on a fully tax-equivalent basis for the three months ended September 30, 2012 totaled \$6,531,000, a decrease of \$227,000 from the comparable period in 2011. Total interest income decreased \$574,000, partially offset by a decrease in total interest expense of \$347,000.

The decrease in total interest income was due to a 36 basis point (one basis point equals 0.01%) decrease in the average rate earned on earning assets, partially offset by a \$10.9 million increase in average earning assets. The increase in interest earning assets was primarily due to a \$8.4 million increase in average investment securities and a \$2.9 million increase in average loans. The decrease in the average rate earned on earning assets was primarily due to general decreases in market interest rates.

The decrease in total interest expense was primarily due to a 21 basis point decrease in the average rate paid, primarily due to general decreases in market interest rates, and secondarily due to a \$9.0 million decrease in average interest-bearing liabilities.

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## LCNB CORP. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Nine Months Ended September 30, 2012 vs. 2011.

The following table presents, for the nine months ended September 30, 2012 and 2011, average balances for interest-earning assets and interest-bearing liabilities, the income or expense related to each item, and the resultant average yields earned or rates paid.

|   | Nine Months Ended September 30, |                            |                     |   |                             |                            |                     |   |
|---|---------------------------------|----------------------------|---------------------|---|-----------------------------|----------------------------|---------------------|---|
|   | Average Outstanding Balance     | 2012 Interest Earned/ Paid | Average Yield/ Rate |   | Average Outstanding Balance | 2011 Interest Earned/ Paid | Average Yield/ Rate |   |
|   | (Dollars in thousands)          |                            |                     |   |                             |                            |                     |   |
| Loans (1)   | \$458,548                       | \$17,950                   | 5.23                | % | \$457,663                   | \$19,289                   | 5.64                | % |
| Interest-bearing demand deposits  | 12,002                          | 19                         | 0.21                | % | 15,878                      | 28                         | 0.24                | % |
| Federal Reserve Bank stock  | 946                             | 28                         | 3.95                | % | 940                         | 28                         | 3.98                | % |
| Federal Home Loan Bank stock  | 2,091                           | 68                         | 4.34                | % | 2,091                       | 68                         | 4.35                | % |
| Investment securities:  |                                 |                            |                     |   |                             |                            |                     |   |
| Taxable   | 190,845                         | 2,810                      | 1.97                | % | 171,186                     | 2,826                      | 2.21                | % |
| Non-taxable (2)   | 82,395                          | 2,774                      | 4.50                | % | 78,773                      | 2,979                      | 5.06                | % |
| Total earnings assets   | 746,827                         | 23,649                     | 4.23                | % | 726,531                     | 25,218                     | 4.64                | % |
| Non-earning assets  | 64,053                          |                            |                     |   | 65,978                      |                            |                     |   |
| Allowance for loan losses   | (2,878 )                        |                            |                     |   | (2,861 )                    |                            |                     |   |
| Total assets  | \$808,002                       |                            |                     |   | \$789,648                   |                            |                     |   |
| Interest-bearing deposits   | \$576,636                       | 3,332                      | 0.77                | % | \$575,168                   | 4,454                      | 1.04                | % |
| Short-term borrowings   | 12,716                          | 12                         | 0.13                | % | 12,263                      | 23                         | 0.25                | % |
| Long-term debt  | 19,695                          | 440                        | 2.98                | % | 23,152                      | 499                        | 2.88                | % |
| Total interest-bearing liabilities  | 609,047                         | 3,784                      | 0.83                | % | 610,583                     | 4,976                      | 1.09                | % |
| Demand deposits   | 111,766                         |                            |                     |   | 100,077                     |                            |                     |   |
| Other liabilities   | 6,908                           |                            |                     |   | 5,602                       |                            |                     |   |
| Capital   | 80,281                          |                            |                     |   | 73,386                      |                            |                     |   |
| Total liabilities and capital   | \$808,002                       |                            |                     |   | \$789,648                   |                            |                     |   |
| Net interest rate spread (3)  |                                 |                            | 3.40                | % |                             |                            | 3.55                | % |
| Net interest income and net interest margin on a taxable-equivalent basis (4) |                                 | \$19,865                   | 3.55                | % |                             | \$20,242                   | 3.73                | % |
| Ratio of interest-earning assets to interest-bearing liabilities              | 122.62                          | %                          |                     |   | 118.99                      | %                          |                     |   |

- (1) Includes nonaccrual loans, if any. Income from tax-exempt loans is included in interest income on a tax-equivalent basis, using an incremental rate of 34%.
- (2) Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax rate of 34%.
- (3) The net interest spread is the difference between the average rate on total interest-earning assets and interest-bearing liabilities.
- (4) The net interest margin is the taxable-equivalent net interest income divided by average interest-earning assets.



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## LCNB CORP. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The following table presents the changes in taxable-equivalent basis interest income and expense for each major category of interest-earning assets and interest-bearing liabilities and the amount of change attributable to volume and rate changes for the nine months ended September 30, 2012 as compared to the same period in 2011.

|                                      | Nine Months Ended<br>September 30, 2012 vs. 2011<br>Increase (decrease) due to: |                        |          |
|--------------------------------------|---|------------------------|----------|
|                                      | Volume  | Rate<br>(In thousands) | Total    |
| <b>Interest-earning Assets:</b>      |   |                        |          |
| Loans                                | \$ 37   | (1,376 )               | (1,339 ) |
| Interest-bearing demand deposits     | (6 )  | (3 )                   | (9 )     |
| Federal Reserve Bank stock           | -   | -                      | -        |
| Federal Home Loan Bank stock         | -   | -                      | -        |
| <b>Investment securities:</b>        |   |                        |          |
| Taxable                              | 306   | (322 )                 | (16 )    |
| Nontaxable                           | 133   | (338 )                 | (205 )   |
| Total interest income                | 470   | (2,039 )               | (1,569 ) |
| <b>Interest-bearing Liabilities:</b> |   |                        |          |
| Deposits                             | 11  | (1,133 )               | (1,122 ) |
| Short-term borrowings                | 1   | (12 )                  | (11 )    |
| Long-term debt                       | (77 )   | 18                     | (59 )    |
| Total interest expense               | (65 )   | (1,127 )               | (1,192 ) |
| Net interest income                  | \$ 535  | (912 )                 | (377 )   |

Net interest income on a fully tax-equivalent basis for the first nine months of 2012 totaled \$19,865,000, a \$377,000 decrease from the same nine month period of 2011. Total interest income decreased \$1,569,000, largely offset by a \$1,192,000 decrease in total interest expense.

The decrease in total interest income was due to a 41 basis point decrease in the average rate earned on earning assets, partially offset by a \$20.3 million increase in average total earning assets. The increase in average earning assets was primarily due to a \$23.3 million increase in average investment securities. The decrease in the average rate earned on earning assets was primarily due to general decreases in market interest rates.

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LCNB CORP. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The decrease in total interest expense was due primarily to a 26 basis point decrease in the average rate paid on interest-bearing liabilities and, to a lesser extent, a \$1.5 million decrease in average interest-bearing liabilities. The decrease in the average rate paid also reflects a general decrease in market rates.

The decrease in average interest-bearing liabilities was due to a \$3.5 million decrease in average long-term borrowings.

Provision and Allowance For Loan Losses

The total provision for loan losses is determined based upon management's evaluation as to the amount needed to maintain the allowance for loan losses at a level considered appropriate in relation to the risk of losses inherent in the portfolio. In addition to historic charge-off percentages, factors taken into consideration to determine the adequacy of the allowance for loan losses include the nature, volume, and consistency of the loan portfolio, overall portfolio quality, a review of specific problem loans, and current economic conditions that may affect borrowers' ability to pay. The provision for loan losses for the three months ended September 30, 2012 and 2011 was \$436,000 and \$588,000, respectively, and \$742,000 and \$1,476,000 for the nine months ended September 30, 2012 and 2011, respectively. The decrease in the provision reflects a stabilization in the credit quality of the loan portfolio in part due to relatively stable regional market conditions.

Non-Interest Income

Three Months Ended September 30, 2012 vs. 2011.

Non-interest income for the third quarter of 2012 was \$172,000 greater than for the comparable period in 2011 primarily due to a \$154,000 increase in net gains on sales of securities and a \$116,000 increase in gains from sales of mortgage loans, both due to a higher volume of sales. These increases were partially offset by a \$46,000 decrease in service charges and fees on deposit accounts, a \$23,000 decrease in trust income, and a \$21,000 decrease in other operating income. Services charges and fees on deposit accounts decreased primarily due to decreased overdraft fees, partially offset by increases in check card income and other service charges.

Nine Months Ended September 30, 2012 vs. 2011.

Non-interest income for the first nine months of 2012 was \$513,000 greater than for the comparable period in 2011. The increase was due to a \$197,000 increase in trust income, a \$194,000 increase in net gains on sales of securities, and a \$268,000 increase in gains from sales of mortgage loans. Trust income increased primarily due to estate fees recognized during the first quarter 2012. Gains from sales of investment securities and mortgage loans increased for substantially the same reasons mentioned above. These increases were partially offset by a \$112,000 decrease in service charges and fees on deposit accounts for substantially the same reasons mentioned above.

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LCNB CORP. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Non-Interest Expense

Three Months Ended September 30, 2012 vs. 2011.

Total non-interest expense increased \$128,000 during the third quarter 2012 as compared to the third quarter 2011 primarily due to a \$76,000 increase in salaries and employee benefits and a \$100,000 increase in other non-interest expense. Salaries and employee benefits increased primarily due to increased costs in wages and LCNB's various retirement plans. The increase in other non-interest expense included increased ATM and telephone system costs, increased other real estate owned expenses due to increase in such properties, and increased losses from fraudulent check card transactions.

Nine Months Ended September 30, 2012 vs. 2011.

Total non-interest expense decreased \$186,000 during the nine months ended September 30, 2012 as compared to the same period in 2011. FDIC insurance premiums decreased by \$265,000 primarily due to the implementation of a new assessment base that uses total assets and tier one capital as opposed to deposits. Also contributing to the decrease in total non-interest expense is the absence during the 2012 period of a \$56,000 loss, net of recoveries, recognized during the first half 2011 on a standby letter of credit, \$52,000 in environmental remediation costs recognized during the first quarter 2011 for the lot on which the new Lebanon drive-up facility was constructed, and \$50,000 in NASDAQ® application fees recognized during the third quarter 2011. These 2011 costs were included in other non-interest expense.

Partially offsetting the above decreases were a \$63,000 increase in occupancy expenses and a \$39,000 increase in marketing expenses. Equipment expenses increased due to increased depreciation expense from data technology upgrades and marketing expenses increased due to increased use of television advertising and promotional activities. Other non-interest expense included increased ATM and telephone system costs and increased losses from fraudulent check card transactions. Also included in other non-interest expense is a \$76,000 write-down in other real estate owned properties recognized during the first quarter 2012.

Income Taxes

LCNB's effective tax rates for continuing operations for the nine months ended September 30, 2012 and 2011 were 24.9% and 23.4%, respectively. The difference between the statutory rate of 34.0% and the effective tax rate is primarily due to tax-exempt interest income from municipal securities and tax-exempt earnings from bank owned life insurance.

Financial Condition

Total assets at September 30, 2012 were \$25.6 million greater than at December 31, 2011, caused by a \$37.5 million increase in total deposits. The deposit growth was primarily invested in cash and cash equivalents, which grew \$13.5 million, and in investment securities, which grew \$13.5 million.

Net loans decreased \$3.8 million primarily due to declines in a variety of loan categories, which were partially offset by an \$11.6 million increase in the commercial real estate loan portfolio. These totals do not reflect \$19.3 million of residential real estate loans that were originated and sold to the Federal Home Loan Mortgage Corporation during 2012.



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## LCNB CORP. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The increase in total deposits was primarily due to a \$33.7 million increase in public fund deposits by local government entities. Public fund deposits can be relatively volatile due to seasonal tax collections and the financial needs of the local entities. The deposit growth was used to reduce short-term borrowings, which decreased \$9.5 million between September 30, 2012 and December 31, 2011, pay off a \$6.0 million Federal Home Loan Bank advance that matured in August 2012, fund growth in the investment portfolio, and enhance LCNB's liquidity position for anticipated future needs.

During June 2012, the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation issued three proposed rules that would significantly revise current regulatory capital requirements for financial institutions. Among other items, the proposals would:

- Introduce a new requirement that common equity Tier 1 capital be at least 4.5% of risk-weighted assets;
  - Increase the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6%;
- Introduce a new requirement to maintain a capital conservation buffer in excess of other minimum risk-based capital ratios of at least 2.5% of risk-weighted assets;
  - Revise capital definitions and risk-weighting categories for various assets; and
- Revise the prompt corrective action framework by increasing category thresholds to reflect the new requirements.

Financial institutions not meeting the 2.5% capital conservation buffer would be subject to limits on capital distributions, including dividend payments to shareholders and treasury share purchases, and would also be limited in awarding certain discretionary bonus payments to executive officers.

If issued as proposed, the new requirements would be phased-in starting in 2013 with full implementation in 2019. LCNB already meets the new fully phased-in capital requirements.

Liquidity

LCNB depends on dividends from its subsidiaries for the majority of its liquid assets, including the cash needed to pay dividends to its shareholders. National banking law limits the amount of dividends the Bank may pay to the sum of retained net income for the current year plus retained net income for the previous two years. Prior approval from the Office of the Comptroller of the Currency, the Bank's primary regulator, is necessary for the Bank to pay dividends in excess of this amount. In addition, dividend payments may not reduce capital levels below minimum regulatory guidelines. Management believes the Bank will be able to pay anticipated ordinary dividends to LCNB Corp. without needing to request approval. The Bank may need to request approval for a special dividend to LCNB Corp. for the specific purpose of funding the cash portion of the purchase price for the acquisition of First Capital Bancshares, Inc. The Bank is not aware of any reasons why it would not receive such approval.

Liquidity is the ability to have funds available at all times to meet the commitments of LCNB. Asset liquidity is provided by cash and assets which are readily marketable or pledgeable or which will mature in the near future. Liquid assets include cash and cash equivalents and securities available for sale. At September 30, 2012, LCNB's liquid assets amounted to \$298.8 million or 36.6% of total assets, an increase from \$273.5 million or 34.6% of total assets at December 31, 2011.

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LCNB CORP. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Liquidity is also provided by access to core funding sources, primarily core depositors in LCNB's market area. Approximately 76.9% of total deposits at September 30, 2012 were "core" deposits, compared to 79.9% of deposits at December 31, 2011. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit greater than \$100,000. The percentage of core deposits to total deposits decreased because of the growth in public fund deposits discussed above in relation to total growth in deposits.

Secondary sources of liquidity include LCNB's ability to sell loan participations, borrow funds from the Federal Home Loan Bank, purchase federal funds, issue repurchase agreements, or use a line of credit established with another bank.

Management closely monitors the level of liquid assets available to meet ongoing funding needs. It is management's intent to maintain adequate liquidity so that sufficient funds are readily available at a reasonable cost. LCNB experienced no liquidity or operational problems as a result of the current liquidity levels.

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## LCNB CORP. AND SUBSIDIARIES

## Item 3. Quantitative and Qualitative Disclosures about Market Risks

Market risk for LCNB is primarily interest rate risk. LCNB attempts to mitigate this risk through asset/liability management strategies designed to decrease the vulnerability of its earnings to material and prolonged changes in interest rates. LCNB does not use derivatives such as interest rate swaps, caps, or floors to hedge this risk. LCNB has not entered into any market risk instruments for trading purposes.

The Bank's Asset and Liability Management Committee ("ALCO") primarily uses a combination of Interest Rate Sensitivity Analysis ("IRSA") and Economic Value of Equity ("EVE") analysis for measuring and managing interest rate risk. IRSA is used to estimate the effect on net interest income during a one-year period of instantaneous and sustained movements in interest rates, also called interest rate shocks, of 100, 200, and 300 basis points. Management considers the results of the down 200 and down 300 basis point scenarios to not be meaningful in the current interest rate environment. The base projection uses a current interest rate scenario. As shown below, the September 30, 2012 IRSA indicates that an increase in interest rates would have a positive effect on net interest income ("NII") and a decrease in interest rates would have a negative effect on NII. The changes in NII for all rate assumptions are within LCNB's acceptable ranges.

| Rate Shock Scenario in<br>Basis Points | Amount    | \$ Change in<br>NII<br>(Dollars in thousands) | % Change in<br>NII |
|--|-----------|---|--------------------|
| Up 300                                 | \$ 26,270 | 1,492   | 6.02 %             |
| Up 200                                 | 25,725    | 947   | 3.82 %             |
| Up 100                                 | 25,193    | 415   | 1.67 %             |
| Base                                   | 24,778    | -   | - %                |
| Down 100                               | 24,518    | (260 )  | (1.05 )%           |

IRSA shows the effect on NII during a one-year period only. A more long-range model is the EVE analysis, which shows the estimated present value of future cash inflows from interest-earning assets less the present value of future cash outflows for interest-bearing liabilities for the same rate shocks. As shown below, the September 30, 2012 EVE analysis indicates that an increase in interest rates would have a negative effect on the EVE and a decrease in rates would have a positive effect on the EVE. The changes in eve for all rate assumptions are within LCNB's acceptable ranges.

| Rate Shock Scenario in<br>Basis Points | Amount    | \$ Change in<br>EVE<br>(Dollars in thousands) | % Change in<br>EVE |
|--|-----------|---|--------------------|
| Up 300                                 | \$ 80,130 | (3,109 )                                      | (3.74 )%           |
| Up 200                                 | 81,683    | (1,556 )                                      | (1.87 )%           |
| Up 100                                 | 82,569    | (670 )  | (0.80 )%           |
| Base                                   | 83,239    | -   | - %                |
| Down 100                               | 93,647    | 10,408  | 12.50 %            |

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LCNB CORP. AND SUBSIDIARIES

Item 3. Quantitative and Qualitative Disclosures about Market Risks (continued)

The IRSA and EVE simulations discussed above are not projections of future income or equity and should not be relied on as being indicative of future operating results. Assumptions used, including the nature and timing of interest rate levels, yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment or replacement of asset and liability cash flows, are inherently uncertain and, as a result, the models cannot precisely measure future net interest income or equity. Furthermore, the models do not reflect actions that borrowers, depositors, and management may take in response to changing economic conditions and interest rate levels.

Item 4. Controls and Procedures

a) Disclosure controls and procedures. The Chief Executive Officer and the Chief Financial Officer have carried out an evaluation of the effectiveness of LCNB's disclosure controls and procedures that ensure that information relating to LCNB required to be disclosed by LCNB in the reports that it files or submits under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to LCNB's management, including its principal executive officer and principal financial officer, as appropriate, in order to allow timely decisions to be made regarding required disclosures. Based upon this evaluation, these officers have concluded, that as of September 30, 2012, LCNB's disclosure controls and procedures were effective.

b) Changes in internal control over financial reporting. During the period covered by this report, there were no changes in LCNB's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, LCNB's internal control over financial reporting.



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PART II. OTHER INFORMATION

LCNB CORP. AND SUBSIDIARIES

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

No material changes

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the period of this report, LCNB did not sell any of its securities that were not registered under the Securities Act.

During the period covered by this report, LCNB did not purchase any shares of its equity securities.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

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## LCNB CORP. AND SUBSIDIARIES

| Item 6.     | Exhibits   |
|-------------|--|
| Exhibit No. | Exhibit Description  |
| 2           | Agreement and Plan of Merger dated as of October 9, 2012 by and between LCNB Corp. and First Capital Bancshares, Inc. – incorporated by reference to the Registrant’s Form 8-K filed on October 9, 2012, Exhibit 2.1.  |
| 3.1         | Amended and Restated Articles of Incorporation of LCNB Corp., as amended – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2010, Exhibit 3.1.   |
| 3.2         | Code of Regulations of LCNB Corp. – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, Exhibit 3(ii).  |
| 10.1        | LCNB Corp. Ownership Incentive Plan – incorporated by reference to Registrant’s Form DEF 14A Proxy Statement pursuant to Section 14(a), dated March 15, 2002, Exhibit A (000-26121).   |
| 10.2        | Form of Option Grant Agreement under the LCNB Corp. Ownership Incentive Plan – incorporated by reference to the Registrant’s Form 10-K for the fiscal year ended December 31, 2005, Exhibit 10.2.  |
| 10.3        | Nonqualified Executive Retirement Plan – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the period ended June 30, 2009, Exhibit 10.4.   |
| <u>31.1</u> | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>31.2</u> | Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>32</u>   | Certification of Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 101         | The following financial information from LCNB Corp.’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 is formatted in Extensible Business Reporting Language: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Shareholders’ Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements. |

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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.

LCNB Corp.

November 5, 2012

/s/ Stephen P. Wilson  
Stephen P. Wilson, Chief Executive Officer  
and  
Chairman of the Board of Directors

November 5, 2012

/s/Robert C. Haines, II  
Robert C. Haines, II, Executive Vice President  
and Chief Financial Officer