

LCNB CORP  
Form 10-Q  
August 08, 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 June 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

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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 August 6, 2012 was 6,720,907 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)

	June 30, 2012	December 31, 2011
	(Unaudited)	
<b>ASSETS:</b>		
Cash and due from banks	\$ 16,928	12,449
Interest-bearing demand deposits	9,968	7,086
Total cash and cash equivalents	26,896	19,535
Investment securities:		
Available-for-sale, at fair value	285,141	254,006
Held-to-maturity, at cost	11,474	10,734
Federal Reserve Bank stock, at cost	949	940
Federal Home Loan Bank stock, at cost	2,091	2,091
Loans, net	458,629	458,331
Premises and equipment, net	16,953	17,346
Goodwill	5,915	5,915
Bank owned life insurance	15,125	14,837
Other assets	8,402	7,835
<b>TOTAL ASSETS</b>	<b>\$ 831,575</b>	<b>791,570</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 117,813	106,793
Interest-bearing	592,843	556,769
Total deposits	710,656	663,562
Short-term borrowings	13,142	21,596
Long-term debt	20,391	21,373
Accrued interest and other liabilities	6,921	7,079
<b>TOTAL LIABILITIES</b>	<b>751,110</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 7,474,269 and 7,460,494 shares at June 30, 2012 and December 31, 2011, respectively	26,952	26,753
Retained earnings	59,989	57,877
Treasury shares at cost, 753,627 and 755,771 shares at June 30, 2012 and December 31, 2011, respectively	(11,665 )	(11,698 )
Accumulated other comprehensive income, net of taxes	5,189	5,028
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>80,465</b>	<b>77,960</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 831,575</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		Six Months Ended	
	2012	June 30, 2011	2012	June 30, 2011
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 5,920	6,477	12,128	12,995
Interest on investment securities –				
Taxable	982	914	1,869	1,790
Non-taxable	610	640	1,216	1,347
Other short-term investments	59	68	89	97
<b>TOTAL INTEREST INCOME</b>	<b>7,571</b>	<b>8,099</b>	<b>15,302</b>	<b>16,229</b>
<b>INTEREST EXPENSE:</b>				
Interest on deposits	1,117	1,499	2,282	3,083
Interest on short-term borrowings	5	7	8	17
Interest on long-term debt	150	161	304	339
<b>TOTAL INTEREST EXPENSE</b>	<b>1,272</b>	<b>1,667</b>	<b>2,594</b>	<b>3,439</b>
<b>NET INTEREST INCOME</b>	<b>6,299</b>	<b>6,432</b>	<b>12,708</b>	<b>12,790</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>91</b>	<b>224</b>	<b>306</b>	<b>888</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>6,208</b>	<b>6,208</b>	<b>12,402</b>	<b>11,902</b>
<b>NON-INTEREST INCOME:</b>				
Trust income	473	536	1,239	1,019
Service charges and fees on deposit accounts	909	952	1,787	1,853
Net gain on sales of securities	79	124	459	419
Bank owned life insurance income	139	148	287	294
Gains from sales of mortgage loans	102	24	209	57
Other operating income	53	51	110	108
<b>TOTAL NON-INTEREST INCOME</b>	<b>1,755</b>	<b>1,835</b>	<b>4,091</b>	<b>3,750</b>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	2,963	2,955	5,945	6,007
Equipment expenses	264	240	526	457
Occupancy expense, net	390	407	797	862
State franchise tax	196	196	402	392
Marketing	169	110	280	225
FDIC insurance premiums	104	188	215	468
Other non-interest expense	1,244	1,211	2,613	2,681
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>5,330</b>	<b>5,307</b>	<b>10,778</b>	<b>11,092</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>2,633</b>	<b>2,736</b>	<b>5,715</b>	<b>4,560</b>
<b>PROVISION FOR INCOME TAXES</b>	<b>646</b>	<b>713</b>	<b>1,451</b>	<b>1,059</b>
	1,987	2,023	4,264	3,501

INCOME FROM CONTINUING  
OPERATIONS

INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX	-	(31 )	-	793
NET INCOME	\$ 1,987	1,992	4,264	4,294
Dividends declared per common share	\$ 0.16	0.16	0.32	0.32
Basic earnings per common share:				
Continuing operations	\$ 0.30	0.30	0.64	0.52
Discontinued operations	-	-	-	0.12
Diluted earnings per common share:				
Continuing operations	\$ 0.29	0.30	0.63	0.52
Discontinued operations	-	-	-	0.12
Weighted average common shares outstanding:				
Basic	6,713,847	6,689,743	6,710,062	6,689,743
Diluted	6,789,776	6,746,791	6,781,614	6,744,375

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net Income	\$ 1,987	1,992	4,264	4,294
Other comprehensive income:				
Net unrealized gain on available-for-sale securities (net of taxes of \$490 and \$926 for the three months ended June 30, 2012 and 2011, respectively, and \$231 and \$696 for the six months ended June 30, 2012 and 2011, respectively)	954	1,798	449	1,351
Reclassification adjustment for net realized gain on sale of available-for-sale securities included in net income (net of taxes of \$26 and \$42 for the three months ended June 30, 2012 and 2011, respectively, and \$155 and \$143 for the six months ended June 30, 2012 and 2011, respectively)	(53 )	(82 )	(304 )	(276 )
Change in nonqualified pension plan unrecognized net gain (loss) and unrecognized prior service cost (net of taxes of \$3 and \$1 for the three months ended June 30, 2012 and 2011, respectively, and \$8 and \$2 for the six months ended June 30, 2012 and 2011, respectively)	9	(1 )	16	4
Nonqualified pension plan curtailment (net of taxes of \$80)	-	-	-	155
<b>TOTAL COMPREHENSIVE INCOME</b>	<b>\$ 2,897</b>	<b>3,707</b>	<b>4,425</b>	<b>5,528</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 Shares Outstanding	Common Stock	Retained Earnings	Treasury Shares	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance December 31, 2010	6,689,743	\$26,515	54,045	(11,698 )	1,845	70,707
Net income			4,294			4,294
Net unrealized gain (loss) on available-for-sale securities, net of taxes					1,351	1,351
Reclassification adjustment for net realized gain on sale of available-for-sale securities included in net income, net of taxes					(276 )	(276 )
Change in nonqualified pension plan unrecognized net gain (loss) and unrecognized prior service cost, net of taxes					4	4
Nonqualified pension plan curtailment entry, net of taxes					155	155
Compensation expense relating to stock options		22				22
Common stock dividends, \$0.32 per share			(2,141 )			(2,141 )
Balance June 30, 2011	6,689,743	\$26,537	56,198	(11,698 )	3,079	74,116
Balance December 31, 2011	6,704,723	\$26,753	57,877	(11,698 )	5,028	77,960
Net income			4,264			4,264
Net unrealized gain (loss) on available-for-sale securities, net of taxes					449	449
Reclassification adjustment for net realized gain on sale of available-for-sale securities included in net income, net of taxes					(304 )	(304 )
Change in nonqualified pension plan unrecognized net gain (loss) and unrecognized prior service cost, net of taxes					16	16
Dividend Reinvestment and Stock Purchase Plan	13,775	179				179
Exercise of stock options	2,144		(5 )	33		28
		20				20

Compensation expense relating to stock options						
Common stock dividends, \$0.32 per share			(2,147 )			(2,147 )
Balance June 30, 2012	6,720,642	\$26,952	59,989	(11,665 )	5,189	80,465

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

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LCNB CORP. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)  
(unaudited)

	Six Months Ended June 30,	
	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$4,264	4,294
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization, and accretion	1,558	1,351
Provision for loan losses	306	888
Curtailment charge for nonqualified defined benefit retirement plan	-	191
Increase in cash surrender value of bank owned life insurance	(287 )	(294 )
Realized (gain) loss from sales of securities available-for-sale	(459 )	(419 )
Realized (gain) loss from sales of premises and equipment	-	(5 )
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	(31 )
Origination of mortgage loans for sale	(11,394 )	(2,698 )
Realized gains from sales of mortgage loans	(209 )	(57 )
Proceeds from sales of mortgage loans	11,486	2,726
Compensation expense related to stock options	20	22
Changes in:		
Accrued income receivable	(122 )	21
Other assets	22	57
Other liabilities	(218 )	(335 )
<b>TOTAL ADJUSTMENTS</b>	<b>783</b>	<b>(86 )</b>
<b>NET CASH FLOWS FROM OPERATING ACTIVITIES</b>	<b>5,047</b>	<b>4,208</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sales of investment securities available-for-sale	31,484	18,982
Proceeds from maturities and calls of investment securities:		
Available-for-sale	16,680	15,729
Held-to-maturity	1,442	2,628
Purchases of investment securities:		
Available-for-sale	(79,400 )	(48,203 )
Held-to-maturity	(2,182 )	(1,730 )
Purchase of Federal Reserve Bank stock	(8 )	(2 )
Net (increase) decrease in loans	(1,212 )	(3,281 )
Proceeds from sale of other real estate owned and repossessed assets	20	148
Purchases of premises and equipment	(212 )	(1,692 )
Additions to other real owned	(16 )	-
Proceeds from sales of premises and equipment	-	13
Proceeds from sale of insurance agency, net of cash disposed	-	1,523
<b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>	<b>(33,404 )</b>	<b>(15,885 )</b>

<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase (decrease) in deposits	47,094	40,212
Net increase (decrease) in short-term borrowings	(8,454 )	(9,493 )
Proceeds from long-term debt	-	5,000
Principal payments on long-term debt	(982 )	(6,059 )
Proceeds from issuance of common stock	30	-
Proceeds from exercise of stock options	28	-
Cash dividends paid on common stock	(1,998 )	(2,141 )
<b>NET CASH FLOWS FROM FINANCING ACTIVITIES</b>	<b>35,718</b>	<b>27,519</b>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	<b>7,361</b>	<b>15,842</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>\$26,896</b>	<b>26,841</b>
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
<b>CASH PAID DURING THE YEAR FOR:</b>		
Interest	\$2,655	3,514
Income taxes	1,125	1,714
<b>SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:</b>		
Transfer from loans to other real estate owned and repossessed assets	564	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 six months ended June 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 June 30, 2012 and December 31, 2011 are summarized as follows (in thousands):

	June 30, 2012			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. Treasury notes	\$20,848	321	-	21,169
U.S. Agency notes	99,700	1,577	35	101,242
U.S. Agency mortgage-backed securities	56,814	1,498	15	58,297
Corporate securities	6,280	53	1	6,332
<b>Municipal securities:</b>				
Non-taxable	69,854	3,427	48	73,233
Taxable	19,983	1,195	-	21,178
Mutual funds	2,118	35	-	2,153
Trust preferred securities	498	26	9	515
Equity securities	977	78	33	1,022
	<b>\$277,072</b>	<b>8,210</b>	<b>141</b>	<b>285,141</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 fund	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 June 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 June 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 Fair Value	Unrealized Losses	Twelve Months or Greater Fair Value	Unrealized Losses
U.S. Treasury notes	\$-	-	-	-
U.S. Agency notes	16,819	35	-	-
U.S. Agency mortgage-backed securities	4,355	15	-	-
Corporate securities	2,192	1	-	-
Municipal securities:				
Non-taxable	5,272	30	2,148	18
Taxable	-	-	-	-
Mutual fund	-	-	-	-
Trust preferred securities	99	1	141	8
Equity securities	415	28	59	5
	\$29,152	110	2,348	31

Management has determined that the unrealized losses at June 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 June 30, 2012 and December 31, 2011 are as follows (in thousands):

	June 30, 2012	December 31, 2011
Commercial and industrial	\$ 25,350	30,990
Commercial, secured by real estate	230,285	219,188
Residential real estate	187,752	186,904
Consumer	12,498	14,562
Agricultural	1,641	2,835
Other loans, including deposit overdrafts	3,922	6,554
	461,448	461,033
Deferred net origination costs	133	229
	461,581	461,262
Less allowance for loan losses	2,952	2,931
Loans, net	\$ 458,629	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 June 30, 2012 and December 31, 2011 are as follows (in thousands):

	June 30, 2012	Dec 31, 2011
Non-accrual loans:		
Commercial and industrial	\$243	49
Commercial, secured by real estate	1,007	1,9
Commercial real estate	1,998	1,2
Non-accrual loans	3,248	3,6
of which 90 days or more and still accruing	73	39
Non-accrual and past-due 90 days or more and still accruing	3,321	3,7
and accruing restructured loans	13,447	14
	\$16,768	18
Percentage of total non-accrual and past-due 90 days or more and still accruing to total loans	0.72	% 0.8
Percentage of total non-accrual, past-due 90 days or more and still accruing, and accruing restructured loans to total loans	3.63	% 4.0

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 June 30, 2012 and December 31, 2011 are \$68,938,000 and \$67,410,000, respectively. Loans sold to the Federal Home Loan Mortgage Corporation during the three and six months ended June 30, 2012 totaled \$5,528,000 and \$11,394,000, respectively, and \$976,000 and \$2,698,000 during the three and six months ended June 30, 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 six months ended June 30 are as follows (in thousands)

	Commercial & Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
2012							
Allowance for loan losses:							
Balance, beginning of year	\$ 162	1,941	656	166	-	6	2,931
Provision charged to expenses	(10 )	(77 )	422	(39 )	-	10	306
Losses charged off	-	(206 )	(153 )	(57 )	-	(40 )	(456 )
Recoveries	-	71	7	68	-	25	171
Balance, end of period	\$ 152	1,729	932	138	-	1	2,952
Ending balance:							
Individually evaluated for impairment	\$ -	83	378	-	-	-	461
Collectively evaluated for impairment	152	1,646	554	138	-	1	2,491
Totals	\$ 152	1,729	932	138	-	1	2,952
Loans:							
Ending balance:							
Individually evaluated for impairment	\$ 242	10,232	5,614	8	-	-	16,096
Collectively evaluated for impairment	25,087	219,866	182,380	12,589	1,641	3,922	445,485
Totals	\$ 25,329	230,098	187,994	12,597	1,641	3,922	461,581
2011							
Allowance for loan losses:							
Balance, beginning of year	\$ 305	1,625	459	246	-	6	2,641
	321	279	250	23	-	15	888

Provision charged to expenses							
Losses charged off	(251 )	-	(132 )	(138 )	-	(58 )	(579 )
Recoveries	-	30	4	82	-	43	159
Balance, end of period	\$ 375	1,934	581	213	-	6	3,109
Ending balance:							
Individually evaluated for impairment	\$ 133	341	82	-	-	-	556
Collectively evaluated for impairment	242	1,593	499	213	-	6	2,553
Totals	\$ 375	1,934	581	213	-	6	3,109
Loans:							
Ending balance:							
Individually evaluated for impairment	\$ 780	11,920	533	-	-	-	13,233
Collectively evaluated for impairment	32,713	194,939	187,248	17,113	2,844	9,466	444,323
Totals	\$ 33,493	206,859	187,781	17,113	2,844	9,466	457,556

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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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## Note 3 – Loans (continued)

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

	Pass	OAEM	Substandard	Doubtful	Total
June 30, 2012					
Commercial & industrial	\$22,146	2,526	657	-	25,329
Commercial, secured by real estate	219,325	2,236	8,537	-	230,098
Residential real estate	178,178	2,632	7,184	-	187,994
Consumer	12,540	-	57	-	12,597
Agricultural	1,637	-	4	-	1,641
Other	3,922	-	-	-	3,922
Total	\$437,748	7,394	16,439	-	461,581
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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## Note 3 – Loans (continued)

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Total Loans Greater Than 90 Days and Accruing
June 30, 2012							
Commercial & industrial	\$-	-	242	242	25,087	25,329	-
Commercial, secured by real estate	468	81	1,007	1,556	228,542	230,098	-
Residential real estate	617	411	2,038	3,066	184,928	187,994	39
Consumer	71	20	34	125	12,472	12,597	34
Agricultural	-	-	-	-	1,641	1,641	-
Other	45	-	-	45	3,877	3,922	-
<b>Total</b>	<b>\$ 1,201</b>	<b>512</b>	<b>3,321</b>	<b>5,034</b>	<b>456,547</b>	<b>461,581</b>	<b>73</b>
December 31, 2011							
Commercial & industrial	\$2	-	495	497	30,476	30,973	-
Commercial, secured by real estate	-	83	1,769	1,852	217,210	219,062	-
Residential real 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	-
<b>Total</b>	<b>\$ 1,275</b>	<b>142</b>	<b>3,505</b>	<b>4,922</b>	<b>456,340</b>	<b>461,262</b>	<b>39</b>

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## Note 3 – Loans (continued)

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

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
June 30, 2012					
With no related allowance recorded:					
Commercial & industrial	\$243	572	-	2,054	43
Commercial real estate	12,920	13,364	-	12,326	229
Residential real estate	521	521	-	398	1
Consumer	8	8	-	8	-
Total	\$13,692	14,465	-	14,786	273
With an allowance recorded:					
Commercial & industrial	\$170	170	-	172	3
Commercial real estate	1,502	1,591	142	1,795	26
Residential real estate	733	733	319	717	1
Consumer	-	-	-	1	-
Total	\$2,405	2,494	461	2,685	30
Total:					
Commercial & industrial	\$413	742	-	2,226	46
Commercial real estate	14,422	14,955	142	14,121	255
Residential real estate	1,254	1,254	319	1,115	2
Consumer	8	8	-	9	-
Total	\$16,097	16,959	461	17,471	303
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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## Note 3 – Loans (continued)

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

	Three Months Ended June 30, 2012		2011		Six Months Ended June 30, 2012		2011	
	Number of Loans	Balance at Modification	Number of Loans	Balance at Modification	Number of Loans	Balance at Modification	Number of Loans	Balance at Modification
Commercial and industrial	-	-	-	\$ -	-	-	1	\$ 204
Commercial, secured by real estate	-	-	-	-	-	-	2	625
Residential real estate	1	143	-	-	2	173	-	-
Consumer	-	-	2	9	-	-	3	11
	1	143	2	\$ 9	2	173	6	\$ 840

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 six months ended June 30, 2012 and 2011.

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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):

	Six Months Ended June 30,	
	2012	2011
Balance, beginning of year	\$ 1,619	2,088
Additions	580	-
Reductions due to valuation write downs	76	-
Balance, end of period	\$ 2,123	2,088

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

	June 30, 2012		December 31, 2011	
	Number	Balance	Number	Balance
Commercial real estate	2	\$ 2,063	1	\$ 1,579
Residential real estate	2	60	1	40
	4	\$ 2,123	2	\$ 1,619

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## Note 5 – Borrowings

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

	Current Interest Rate		June 30, 2012	December 31, 2011
Fixed Rate Advances, due at maturity:				
Advance due August 2012	1.99 %	\$	6,000	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 %		1,820	2,326
Advance due March 2019	2.82 %		2,571	3,047
		\$	20,391	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 \$145 million and \$147 million at June 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 June 30, 2012 and December 31, 2011 are as follows (dollars in thousands):

	June 30, 2012			December 31, 2011		
	Amount		Rate	Amount		Rate
FHLB short-term advance	\$ -	-	%	12,000	0.04	%
Repurchase agreements	13,142	0.10	%	9,596	0.10	%
	\$ 13,142	0.10	%	21,596	0.07	%

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## Note 6 – Income Taxes

A reconciliation between the statutory income tax and LCNB's effective tax rate follows:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Statutory tax rate	34.0 %	34.0 %	34.0 %	34.0 %
Increase (decrease) resulting from:				
Tax exempt interest	(7.6 )%	(7.6 )%	(6.9 )%	(9.5 )%
Tax exempt income on bank owned life insurance	(1.8 )%	(1.8 )%	(1.7 )%	(2.2 )%
Other, net	(0.1 )%	1.5 %	- %	0.9 %
Effective tax rate	24.5 %	26.1 %	25.4 %	23.2 %

## 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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## 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 June 30, 2012 and December 31, 2011 are as follows (in thousands):

	June 30, 2012	December 31, 2011
Commitments to extend credit:		
Commercial loans	\$ 1,332	3,227
Other loans		
Fixed rate	2,560	1,391
Adjustable rate	1,194	2,099
Unused lines of credit:		
Fixed rate	3,750	3,883
Adjustable rate	51,966	55,274
Unused Bounce Protection amounts on demand and NOW accounts	9,772	9,810
Standby letters of credit	5,575	5,575
	\$ 76,149	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 June 30, 2012 and December 31, 2011, outstanding guarantees of approximately \$546,000 and \$546,000, respectively, 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 June 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)

Capital expenditures include the construction or acquisition of new office buildings, improvements to existing offices, purchases of furniture and equipment, and additions or improvements to LCNB's information technology system. Commitments for capital expenditures outstanding as of June 30, 2012 totaled approximately \$70,000.

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 ratio of Tier 1 capital to risk-weighted assets must be at least 4.0% and the ratio of Total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8.0%. The capital leverage ratio supplements the risk-based capital guidelines. Banks are required to maintain a minimum ratio of Tier 1 capital to adjusted quarterly average total assets of 3.0%.

For various regulatory purposes, financial institutions are classified into categories based upon capital adequacy. The highest "well-capitalized" category requires capital ratios of at least 10% for total risk-based, 6% for Tier 1 risk-based, and 5% for leverage. 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 June 30, 2012		At December 31, 2011	
Regulatory Capital:				
Shareholders' equity	\$ 80,465		77,960	
Goodwill and other intangibles	(6,044 )		(6,071 )	
Accumulated other comprehensive (income) loss	(5,190 )		(5,028 )	
Tier 1 risk-based capital	69,231		66,861	
Eligible allowance for loan losses	2,952		2,931	
Total risk-based capital	\$ 72,183		69,792	
Capital ratios:				
Total risk-based (required 8.00%)	14.86	%	14.54	%
Tier 1 risk-based (required 4.00%)	14.25	%	13.93	%
Leverage (required 3.00%)	8.65	%	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 six-month periods ended June 30, 2012 and 2011 are as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Qualified noncontributory defined benefit retirement plan	\$ 149	134	291	258
401(k) plan	74	82	110	157

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

The components of net periodic pension cost of the nonqualified defined benefit retirement plan for the three and six months ended June 30, 2012 and 2011 are summarized as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Service cost	\$22	22	44	66
Interest cost	11	8	22	17
Amortization of unrecognized net (gain) loss	5	(8 )	10	(12 )
Amortization of unrecognized prior service cost	7	7	14	18
Net periodic pension cost	\$45	29	90	89

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

	June 30, 2012	December 31, 2011
Net actuarial loss	\$ 142	156
Past service cost	64	74
	\$ 206	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 June 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	5.8	18,964	\$9.00	5.3
\$11.00 - \$12.99	74,290	12.03	7.2	29,159	12.01	5.0
\$13.00 - \$14.99	8,912	13.09	0.5	8,912	13.09	0.5
\$17.00 - \$18.99	24,158	18.16	2.7	24,158	18.16	2.7
	136,470	12.54	5.6	81,193	13.25	3.9

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, June 30	136,470	12.54	124,123	12.54
Exercisable, June 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 June 30, 2012 that were "in the money" (market price greater than exercise price) was \$225,000. The aggregate intrinsic value at that date for only the options that were exercisable was \$123,000. The aggregate intrinsic value for options outstanding at June 30, 2011 that were in the money was \$95,000 and the aggregate intrinsic value at that date for only the options that were exercisable was \$36,000. The intrinsic value changes based on changes 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 six months ended June 30, 2012 were \$11,000 and \$20,000, respectively, and \$11,000 and \$22,000 for the three and six months ended June 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 six months ended June 30, 2012 and 2011 (dollars in thousands, except share and per share data):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Income from continuing operations	\$ 1,987	2,023	4,264	3,501
Income from discontinued operations, net of tax	-	(31 )	-	793
Net income	\$ 1,987	1,992	4,264	4,294
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	6,713,847	6,689,743	6,710,062	6,689,743
Add dilutive effect of:				
Stock options	9,606	4,476	8,292	4,188
Stock warrant	66,323	52,572	63,260	50,444
	75,929	57,048	71,552	54,632
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share	6,789,776	6,746,791	6,781,614	6,744,375
Basic earnings per common share:				
Continuing operations	\$ 0.30	0.30	0.64	0.52
Discontinued operations	-	-	-	0.12
Diluted earnings per common share:				
Continuing operations	\$ 0.29	0.30	0.63	0.52
Discontinued operations	-	-	-	0.12

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Note 12 - Fair Value of Financial Instruments

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

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

## 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 June 30, 2012 and December 31, 2011 (in thousands):

	Fair Value Measurements	Fair Value Measurements at the End of the Reporting Period Using			Total Gains (Losses)
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
June 30, 2012					
Recurring fair value measurements:					
Investment securities available-for-sale:					
U.S. Treasury notes	\$ 21,169	21,169	-	-	
U.S. Agency notes	101,242	-	101,242	-	
U.S. Agency mortgage-backed securities	58,297	-	58,297	-	
Corporate securities	6,332	4,140	2,192	-	
Municipal securities:					
Non-taxable	73,233	-	73,233	-	
Taxable	21,178	-	21,178	-	
Mutual funds	2,153	-	1,153	1,000	
Trust preferred securities	515	515	-	-	
Equity securities	1,022	1,022	-	-	
Total recurring fair value measurements	\$ 285,141	26,846	257,295	1,000	
Nonrecurring fair value measurements:					
Impaired loans	\$ 1,944	-	830	1,114	-
Other real estate owned and repossessed assets (a) (b)	2,123	-	2,123	-	(79 )
Total nonrecurring fair value measurements	\$ 4,067	-	2,953	1,114	(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	-	

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

## Note 12 - Fair Value of Financial Instruments (continued)

The following table is a reconciliation of the beginning and ending balances of recurring fair value measurements that use significant unobservable inputs (level 3) for the six months ended June 30, 2011 (in thousands):

	Mutual Funds
Beginning balance	\$ 1,053
Purchases	500
Dividends reinvested	17
Net change in unrealized gains (losses) included in other comprehensive income	11
Ending balance	\$ 1,581

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

	June 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and cash equivalents	\$26,896	26,896	19,535	19,535
Investment securities:				
Available-for-sale	285,141	285,141	254,006	254,006
Held-to-maturity	11,474	11,474	10,734	10,734
Federal Reserve Bank stock	949	949	940	940
Federal Home Loan Bank stock	2,091	2,091	2,091	2,091
Loans, net	458,629	465,106	458,331	470,846
<b>FINANCIAL LIABILITIES:</b>				
Deposits	710,656	715,931	663,562	669,383
Short-term borrowings	13,142	13,142	21,596	21,596
Long-term debt	20,391	21,553	21,373	22,570

The fair value of off-balance-sheet financial instruments at June 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:

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

Note 12 - Fair Value of Financial Instruments (continued)

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.

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.

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

## Note 12 - Fair Value of Financial Instruments (continued)

The following table summarizes the categorization by input level as of June 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 Measurements	Fair Value Measurements at the End of the Reporting Period Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2012				
Assets:				
Loans, net	\$ 463,162	-	463,162	-
Investment securities, non-taxable, held-to-maturity	11,474	-	-	11,474
Federal Reserve Bank stock	949	949	-	-
Federal Home Loan Bank stock	2,091	2,091	-	-
Liabilities:				
Deposits	715,931	-	715,931	-
Long-term debt	21,553	-	21,553	-
December 31, 2011				
Assets:				
Loans, net	\$ 468,283	-	468,283	-
Investment securities, non-taxable, held-to-maturity	10,734	-	-	10,734
Federal Reserve Bank stock	940	940	-	-
Federal Home Loan Bank stock	2,091	2,091	-	-
Liabilities:				
Deposits	669,383	-	669,383	-
Long-term debt	22,570	-	22,570	-

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LCNB CORP. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)  
(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 six months ended June 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 (loss) from discontinued operations for the periods indicated (in thousands):

	For the Three Months Ended June 30, 2011	For the Six Months Ended June 30, 2011
Dakin Insurance Agency financial results:		
Revenue	\$ -	381
Non-interest expenses	(2 )	301
Income from operations before income taxes	2	80
Gain from sale of insurance agency	-	1,503
Closing costs related to sale	(13 )	(60 )
Curtailment expense on nonqualified defined benefit retirement plan	-	(191 )
Provision for income taxes	(20 )	(539 )
Total income (loss) from discontinued operations, net of taxes	\$ (31 )	793

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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 June 30, 2012, and the related consolidated statements of income and comprehensive income for each of the three-month and six-month periods ended June 30, 2012 and 2011, and the related consolidated statements of shareholders’ equity and cash flows for each of the six-month periods ended June 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  
August 6, 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” and 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 June 30, 2012 was \$1,987,000 (total basic and diluted earnings per common share of \$0.30 and \$0.29, respectively) and \$4,264,000 (total basic and diluted earnings per common share of \$0.64 and \$0.63, respectively) for the six months ended June 30, 2012. This compares to net income from continuing operations of \$2,023,000 (total basic and diluted earnings per common share of \$0.30) and \$3,501,000 (total basic and diluted earnings per common share of \$0.52) for the same three and six-month periods in 2011.

Net income for the six months ended June 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.

Net loan charge-offs for the first six months of 2012 and 2011 totaled \$285,000 and \$420,000, respectively. Non-accrual loans and loans past due 90 days or more and still accruing interest totaled \$3,321,000 or 0.72% of total loans at June 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. Consequently, 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 \$2,123,000 at June 30, 2012.

Net interest income for the three months and six months ended June 30, 2012 decreased \$133,000 and \$82,000, 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-month period in 2012 was \$80,000 less than the comparative period in 2011 primarily due to decreases in trust income, service charges and fees on deposit accounts, and gains from sales of investment securities. These decreases were partially offset by an increase in net gains recognized from sales of mortgage loans. Non-interest income for the six-month period in 2012 was \$341,000 greater than the comparative period in 2011 primarily due to one-time fees recognized by the trust department during the first quarter 2012 and increases in gains from sales of investment securities and mortgage loans. These increases were partially offset by a decrease in service charges and fees on deposit accounts.

Non-interest expense for the three months ended June 30, 2012 was \$23,000 greater than the comparative period in 2011. Non-interest expense for the six months ended June 30, 2012 was \$314,000 less than the comparative period in 2011 primarily due to decreases in FDIC insurance premiums and other expenses. 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 June 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 June 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 June 30, 2012				2011			
	Average Outstanding Balance (Dollars in thousands)	Interest Earned/ Paid	Average Yield/ Rate	%	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	%
Loans (1)	\$ 457,443	\$ 5,920	5.19	%	\$ 461,448	\$ 6,477	5.63	%
Interest-bearing demand deposits	10,650	9	0.34	%	26,263	17	0.26	%
Federal Reserve Bank stock	949	28	11.83	%	941	28	11.93	%
Federal Home Loan Bank stock	2,091	22	4.22	%	2,091	23	4.41	%
Investment securities:								
Taxable	200,162	982	1.97	%	164,484	914	2.23	%
Non-taxable (2)	82,277	924	4.50	%	77,029	970	5.05	%
Total earnings assets	753,572	7,885	4.20	%	732,256	8,429	4.62	%
Non-earning assets	63,315				66,961			
Allowance for loan losses	(2,893 )				(2,935 )			
Total assets	\$ 813,994				\$ 796,282			
Interest-bearing deposits	\$ 579,774	1,117	0.77	%	\$ 582,606	1,499	1.03	%
Short-term borrowings	12,665	5	0.16	%	11,997	7	0.23	%
Long-term debt	20,506	150	2.93	%	22,176	161	2.91	%
Total interest-bearing liabilities	612,945	1,272	0.83	%	616,779	1,667	1.08	%
Demand deposits	114,235				101,798			
Other liabilities	6,816				4,918			
Capital	79,998				72,787			
Total liabilities and capital	\$ 813,994				\$ 796,282			
Net interest rate spread (3)			3.37	%			3.54	%



Net interest income and net interest margin on a taxable-equivalent basis (4)	\$ 6,613	3.52 %	\$ 6,762	3.70 %
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Ratio of interest-earning assets to interest-bearing liabilities	122.94 %	118.72 %
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- (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 June 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.

	Three Months Ended June 30, 2012 vs. 2011 Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning Assets:			
Loans	\$(56 )	(501 )	(557 )
Interest-bearing demand deposits	(12 )	4	(8 )
Federal Reserve Bank stock	-	-	-
Federal Home Loan Bank stock	-	(1 )	(1 )
Investment securities:			
Taxable	183	(115 )	68
Nontaxable	63	(109 )	(46 )
Total interest income	178	(722 )	(544 )
Interest-bearing Liabilities:			
Deposits	(7 )	(375 )	(382 )
Short-term borrowings	-	(2 )	(2 )
Long-term debt	(12 )	1	(11 )
Total interest expense	(19 )	(376 )	(395 )
Net interest income	\$197	(346 )	(149 )

Net interest income on a fully tax-equivalent basis for the three months ended June 30, 2012 totaled \$6,613,000, a decrease of \$149,000 from the comparable period in 2011. Total interest income decreased \$544,000, partially offset by a decrease in total interest expense of \$395,000.

The decrease in total interest income was due to a 42 basis point (one basis point equals 0.01%) decrease in the average rate earned on earning assets, partially offset by a \$21.3 million increase in average earning assets. The increase in interest earning assets was primarily due to a \$40.9 million increase in average investment securities, partially offset by a \$15.6 million decrease in average interest-bearing demand deposits. 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 25 basis point decrease in the average rate paid, 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)

Six Months Ended June 30, 2012 vs. 2011.

The following table presents, for the six months ended June 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.

	Average Outstanding Balance	2012 Interest Earned/ Paid	Six Months Ended June 30,		2011 Interest Earned/ Paid	Average Yield/ Rate	
			Average Yield/ Rate	Average Outstanding Balance			
				(Dollars in thousands)			
Loans (1)	\$459,261	\$12,128	5.31	% \$459,428	\$12,995	5.70	%
Interest-bearing demand deposits	12,926	15	0.23	% 18,540	22	0.24	%
Federal Reserve Bank stock	945	28	5.96	% 940	28	6.01	%
Federal Home Loan Bank stock	2,091	46	4.42	% 2,091	47	4.53	%
Investment securities:							
Taxable	187,242	1,869	2.01	% 157,459	1,790	2.29	%
Non-taxable (2)	81,010	1,842	4.57	% 79,903	2,041	5.15	%
Total earnings assets	743,475	15,928	4.31	% 718,361	16,923	4.75	%
Non-earning assets	64,242			66,434			
Allowance for loan losses	(2,855 )			(2,775 )			
Total assets	\$804,862			\$782,020			
Interest-bearing deposits	\$575,377	2,282	0.80	% \$569,469	3,083	1.09	%
Short-term borrowings	11,791	8	0.14	% 12,384	17	0.28	%
Long-term debt	20,775	304	2.94	% 23,822	339	2.87	%
Total interest-bearing liabilities	607,943	2,594	0.86	% 605,675	3,439	1.15	%
Demand deposits	110,610			99,346			
Other liabilities	6,678			5,115			
Capital	79,631			71,884			
Total liabilities and capital	\$804,862			\$782,020			
Net interest rate spread (3)			3.45	%		3.60	%
Net interest income and net interest margin on a taxable-equivalent basis (4)		\$13,334	3.61	%	\$13,484	3.79	%
Ratio of interest-earning assets to interest-bearing liabilities	122.29	%			118.61	%	

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- (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 six months ended June 30, 2012 as compared to the same period in 2011.

	Six Months Ended June 30, 2012 vs. 2011		
	Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
<b>Interest-earning Assets:</b>			
Loans	\$(5 )	(862 )	(867 )
Interest-bearing demand deposits	(7 )	-	(7 )
Federal Reserve Bank stock	-	-	-
Federal Home Loan Bank stock	-	(1 )	(1 )
<b>Investment securities:</b>			
Taxable	313	(234 )	79
Nontaxable	28	(227 )	(199 )
Total interest income	329	(1,324 )	(995 )
<b>Interest-bearing Liabilities:</b>			
Deposits	32	(833 )	(801 )
Short-term borrowings	(1 )	(8 )	(9 )
Long-term debt	(44 )	9	(35 )
Total interest expense	(13 )	(832 )	(845 )
Net interest income	\$342	(492 )	(150 )

Net interest income on a fully tax-equivalent basis for the first half of 2012 totaled \$13,334,000, a \$150,000 decrease from the first half of 2011. Total interest income decreased \$995,000, largely offset by an \$845,000 decrease in total interest expense.

The decrease in total interest income was due to a 44 basis point decrease in the average rate earned on earning assets, partially offset by a \$25.1 million increase in average total earning assets. The increase in average earning assets was due to a \$30.9 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 29 basis point decrease in the average rate paid on interest-bearing liabilities, partially offset by a \$2.3 million increase in average interest-bearing liabilities. The increase in average interest-bearing liabilities was due to a \$5.9 million increase in average interest-bearing deposits primarily resulting from an increase in public funds. The decrease in the average rate paid also reflects a general decrease in market rates.

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 June 30, 2012 and 2011 was \$91,000 and \$224,000, respectively, and \$306,000 and \$888,000 for the six months ended June 30, 2012 and 2011, respectively. The decrease in the provision reflects a decrease in net charge-offs coupled with relatively stable regional market conditions.

Non-Interest Income

Three Months Ended June 30, 2012 vs. 2011.

Non-interest income for the second quarter of 2012 was \$80,000 less than for the comparable period in 2011 primarily due to a \$63,000 decrease in trust income, a \$43,000 decrease in service charges and fees on deposit accounts, and a \$45,000 decrease in net gains on sales of securities. Trust income decreased primarily due to a decrease in the market value of trust assets. Services charges and fees decreased primarily due to decreased overdraft fees, partially offset by an increase in check card income. Net gains on sales of securities decreased during the 2012 period primarily due to a lower volume of securities sold. These decreases were partially offset by a \$78,000 increase in gains from sales of mortgage loans, primarily due to a greater volume of loans sold during the 2012 period as borrowers refinanced loans for lower interest rates.

Six Months Ended June 30, 2012 vs. 2011.

Non-interest income for the first half of 2012 was \$341,000 greater than for the comparable period in 2011. The increase was due to a \$220,000 increase in trust income and a \$152,000 increase in gains from sales of mortgage loans. Trust income increased, despite the decrease during the second quarter, primarily due to estate fees recognized during the first quarter 2012. Gains from sales of mortgage loans increased for substantially the same reasons mentioned above. These increases were partially offset by a \$66,000 decrease in service charges and fee 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 June 30, 2012 vs. 2011.

Total non-interest expense increased \$23,000 during the second quarter 2012 as compared to the second quarter 2011 primarily due to a \$24,000 increase in equipment expenses, a \$59,000 increase in marketing expenses, and a \$33,000 increase in other non-interest expense. Equipment expenses increased primarily due to increased depreciation expense from data technology upgrades. Marketing expenses increased due to increased use of television advertising and promotional activities. Other non-interest expense increased due to smaller increases in a variety of expenses. These increases were partially offset by an \$84,000 decrease in FDIC insurance premiums primarily due to the implementation of a new assessment base that uses total assets and tier one capital as opposed to deposits.

Six Months Ended June 30, 2012 vs. 2011.

Total non-interest expense decreased \$314,000 during the first half of 2012 as compared to the first half of 2011 primarily due to a \$253,000 decrease in FDIC insurance premiums for the same reason described above. An additional \$68,000 decrease in other non-interest expense reflects 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 and \$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.

Income Taxes

LCNB's effective tax rates for continuing operations for the six months ended June 30, 2012 and 2011 were 25.4% and 23.2%, 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 June 30, 2012 were \$40.0 million greater than at December 31, 2011, caused by a \$47.1 million increase in total deposits. The deposit growth was primarily invested in cash and cash equivalents, which grew \$7.4 million, and in investment securities, which grew \$31.9 million.

Net loans increased \$298,000, but the mix between loan categories changed during the first half of 2012. The commercial real estate loan portfolio increased \$11.1 million and residential real estate loans increased \$848,000. All other loan categories experienced decreases during 2012. The \$848,000 increase in residential real estate loans does not reflect \$11.4 million of residential real estate loans that were originated and sold to the Federal Home Loan Mortgage Corporation during the first half of 2012.

The increase in total deposits was primarily due to a \$39.1 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 \$8.5 million between June 30, 2012 and December 31, 2011, fund growth in the investment portfolio, and enhance LCNB's liquidity position for anticipated future needs.

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LCNB CORP. AND SUBSIDIARIES

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

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, as defined, 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 dividends to LCNB without needing to request 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 June 30, 2012, LCNB's liquid assets amounted to \$312.0 million or 37.5% of total assets, an increase from \$273.5 million or 34.6% of total assets at December 31, 2011.

Liquidity is also provided by access to core funding sources, primarily core depositors in LCNB's market area. Approximately 76.3% of total deposits at June 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.



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LCNB CORP. AND SUBSIDIARIES

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

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 June 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 Basis Points	Amount	\$ Change in NII (Dollars in thousands)	% Change in NII
Up 300	\$ 27,733	1,360	5.16 %
Up 200	27,222	849	3.22 %
Up 100	26,740	367	1.39 %
Base	26,373	-	- %
Down 100	26,091	(282 )	(1.07 )%

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 June 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 change in EVE for the up 300 basis points scenario is outside LCNB's policy range of a 25% change, but management has determined the change is acceptable in the current economic environment.

Rate Shock Scenario in Basis Points	Amount	\$ Change in EVE (Dollars in thousands)	% Change in EVE
Up 300	\$ 58,441	(25,958 )	(30.76 %)
Up 200	66,506	(17,893 )	(21.20 )%
Up 100	75,079	(9,320 )	(11.04 )%
Base	84,399	-	- %
Down 100	94,057	9,658	11.44 %



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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 June 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

Not applicable

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

Not applicable

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

Not applicable

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## LCNB CORP. AND SUBSIDIARIES

## Item 6. Exhibits

Exhibit No.	Exhibit Description
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 June 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.

August 6, 2012

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

August 6, 2012

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