

LCNB CORP
Form 10-Q
October 31, 2006

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

FORM 10-Q

(Mark One)

(X)

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

For the quarterly period ended September 30, 2006

()

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

For the transition period from

to

Commission File Number 000-26121

LCNB Corp.

(Exact name of registrant as specified in its charter)

Ohio

31-1626393

(State or other jurisdiction of

(I.R.S. Employer

incorporation or organization)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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 October 30, 2006 was 3,227,408 shares.

LCNB Corp.

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September 30, 2006, and December 31, 2005

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LCNB CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

September 30,

December 31,

2006

2005

(Unaudited)

ASSETS:

Cash and due from banks

\$
16,920

	13,415
Federal funds sold and interest-bearing demand deposits	
	4,820
	1,909
Total cash and cash equivalents	
	21,740
	15,324
Securities available for sale, at market value	
	107,150
	133,505
Federal Reserve Bank stock and Federal Home	
Loan Bank stock, at cost	
	3,292

	3,181
Loans, net	
	386,309
	357,651
Premises and equipment, net	
	12,055
	12,571
Intangibles, net	
	1,602
	1,575
Bank-owned life insurance	
	10,862
	10,515

Other assets

6,999

5,179

TOTAL ASSETS

\$

550,009

539,501

LIABILITIES:

Deposits

Noninterest-bearing

\$

78,275

82,030

Interest-bearing

414,925

	399,445
Total deposits	
	493,200
	481,475
Long-term debt	
	-
	2,073
Accrued interest and other liabilities	
	4,909
	3,931
TOTAL LIABILITIES	
	498,109
	487,479

SHAREHOLDERS EQUITY:

Preferred stock no par value, authorized 1,000,000 shares,

none outstanding

-

-

Common stock no par value, authorized 8,000,000 shares,

issued and outstanding 3,551,884 shares

10,560

10,560

Surplus

10,573

10,562

Retained earnings

	41,412
	39,612
Treasury shares at cost, 324,476 and 274,676 shares at	
September 30, 2006 and December 31, 2005, respectively	
	(9,888)
	(8,011)
Accumulated other comprehensive loss, net of taxes	
	(757)
	(701)
TOTAL SHAREHOLDERS EQUITY	
	51,900
	52,022
TOTAL LIABILITIES AND	

SHAREHOLDERS EQUITY

\$
550,009

539,501

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

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands)

(Unaudited)

Three Months Ended

Nine Months Ended

September 30,

September 30,

2006

2005

2006

2005

INTEREST INCOME:

Interest and fees on loans

\$

6,489

5,632

18,624

16,446

Dividends on Federal Reserve Bank

and Federal Home Loan Bank stock

38

30

130

106

Interest on investment securities

Taxable

678

733

2,024

1,992

Non-taxable

464

542

1,491

1,531

Other short-term investments

154

40

18

	349
	287
TOTAL INTEREST INCOME	
	7,823
	6,977
	22,618
	20,362
INTEREST EXPENSE:	
Interest on deposits	
	3,289
	2,269
	8,856
	6,387
	19

Interest on borrowings

14

64

85

130

TOTAL INTEREST EXPENSE

3,303

2,333

8,941

6,517

NET INTEREST INCOME

4,520

4,644

20

13,677

13,845

PROVISION FOR LOAN LOSSES

66

46

100

262

NET INTEREST INCOME AFTER

PROVISION FOR LOAN LOSSES

4,454

4,598

13,577

13,583

NON-INTEREST INCOME:

Trust income

504

516

1,447

1,261

Service charges and fees

1,071

1,056

3,075

2,996

Net loss on sales of securities

-

	(8)
	(12)
	(8)
Insurance agency income	
	391
	344
	1,239
	1,064
Bank-owned life insurance income	
	117
	132
	347
	366
	23

Other operating income

9

174

135

296

TOTAL NON-INTEREST INCOME

2,092

2,214

6,231

5,975

NON-INTEREST EXPENSE:

Salaries and wages

2,009

1,893

5,912

5,599

Pension and other employee benefits

501

498

1,517

1,479

Equipment expenses

267

268

788

801

Occupancy expense, net

367

317

1,018

959

State franchise tax

154

151

467

453

Marketing

85

70

26

	280
	313
Intangible amortization	
	162
	149
	459
	442
Other non-interest expense	
	984
	1,025
	3,050
	2,954
TOTAL NON-INTEREST EXPENSE	

4,529

4,371

13,491

13,000

INCOME BEFORE INCOME TAXES

2,017

2,441

6,317

6,558

PROVISION FOR INCOME TAXES

511

620

1,593

1,639

NET INCOME

\$
1,506

1,821

4,724

4,919

Dividends declared per common share

\$
0.30

0.29

0.90

0.87

Earnings per common share:

Basic

\$
0.47

29

	0.55
	1.45
	1.49
Diluted	
	0.47
	0.55
	1.45
	1.48
Average shares outstanding:	
Basic	
	3,236,066
	3,297,848
	3,253,192

	3,311,763
Diluted	
	3,237,284
	3,299,129
	3,254,431
	3,313,083

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

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

Three Months Ended

Nine Months Ended

September 30,

September 30,

2006

2005

2006

2005

Net Income

\$
1,506

1,821

4,724

4,919

Other comprehensive income (loss):

Net unrealized gain (loss) on available-for-sale

securities (net of taxes of \$218 and \$49 for the three months ended September 30, 2006 and 2005, respectively, and net of taxes of \$33 and \$382 for the nine months ended September 30, 2006 and 2005, respectively)

(95)

(64)

(742)

Reclassification adjustment for net realized

(gain) loss on sale of available-for-sale securities

included in net income (net of taxes of \$3 for the three months ended September 30, 2005 and net of taxes of \$4 and \$3 for the nine months ended September 30, 2006 and 2005, respectively)

-

5

8

5

TOTAL COMPREHENSIVE INCOME

\$

35

1,929

1,731

4,668

4,182

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

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)

(Unaudited)

Accumulated

Other

Total

Common

Retained

Treasury

Comprehensive

Shareholders

Shares

Surplus

Earnings

Shares

Income (Loss)

Equity

Balance January 1, 2006

\$

10,560

10,562

39,612

(8,011)

(701)

52,022

Net income

4,724

4,724

Change in estimated fair value of
 securities available for sale, net of tax
 and reclassification adjustment

	(56)
	(56)
Compensation expense relating to stock options	
	11
	11
Treasury shares purchased	
	(1,877)
	(1,877)
Cash dividends declared, \$0.90 per share	

	(2,924)
	(2,924)
Balance September 30, 2006	
	\$
	10,560
	10,573
	41,412
	(9,888)
	(757)
	51,900
Balance January 1, 2005	

	\$
	10,560
	10,553
	36,735
	(6,078)
	526
	52,296
Net income	
	4,919
	4,919
Change in estimated fair value of securities available for sale, net of tax and reclassification adjustment	
	(737)
	41

	(737)
Compensation expense relating to stock options	
	6
	6
Treasury shares purchased	
	(1,419)
	(1,419)
Cash dividends declared, \$0.87 per share	
	(2,877)
	(2,877)

Balance September 30, 2005

\$
10,560
10,559
38,777
(7,497)
(211)
52,188

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

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

Nine Months Ended

September 30,

2006

2005

CASH FLOWS FROM OPERATING ACTIVITIES:

Net income

\$

4,724

4,919

Adjustments to reconcile net income to net cash flows from

operating activities

Depreciation, amortization, and accretion

1,680

1,958

Provision for loan losses

100

262

Federal Home Loan Bank stock dividends

(111)

(87)

Bank-owned life insurance income

(347)

(366)

Realized loss on sales of securities available for sale

12

8

Realized loss (gain) on sale of premises and equipment

32

(83)

Mortgage loans originated for sale

(2,471)

(5,643)

Realized gains from sales of mortgage loans

(41)

(95)

Proceeds from sales of mortgage loans

2,485

47

5,673

Compensation expense related to stock options

11

6

(Increase) decrease in income receivable

(238)

(434)

(Increase) decrease in other assets

(886)

330

Increase (decrease) in other liabilities

34

6

TOTAL ADJUSTMENTS

260

1,535

NET CASH FLOWS FROM OPERATING ACTIVITIES

4,984

6,454

CASH FLOWS FROM INVESTING ACTIVITIES:

Proceeds from sales of securities available for sale

8,204

10,988

Proceeds from maturities of securities available for sale

34,162

28,540

Purchases of securities available for sale

(16,218)

(61,389)

Net decrease (increase) in loans

(29,754)

(17,761)

Net cash paid for acquisition

(515)

-

Proceeds from sale of other real estate acquired through foreclosure

84

-

Purchases of premises and equipment

(332)

(1,508)

Proceeds from sales of premises and equipment

6

327

NET CASH FLOWS FROM INVESTING ACTIVITIES

(4,363)

(40,803)

CASH FLOWS FROM FINANCING ACTIVITIES:

Net change in deposits

11,725

17,088

Net change in short-term borrowings

921

432

Principal payments on long-term debt

(2,050)

(48)

Cash dividends paid

(2,924)

(2,877)

Purchases of treasury shares

(1,877)

(1,419)

NET CASH FLOWS FROM FINANCING ACTIVITIES

5,795

13,176

NET CHANGE IN CASH AND CASH EQUIVALENTS

6,416

(21,173)

CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD

15,324

43,115

CASH AND CASH EQUIVALENTS AT END OF PERIOD

\$

21,740

21,942

SUPPLEMENTAL CASH FLOW INFORMATION:

CASH PAID DURING THE YEAR FOR:

Interest

\$

8,947

6,543

Income taxes

1,646

1,676

SUPPLEMENTAL DISCLOSURES OF

NON-CASH INVESTING ACTIVITY:

Transfer from loans to real estate acquired through foreclosure

752

32

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

LCNB Corp. and Subsidiaries

Notes to the 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 subsidiaries, Lebanon Citizens National Bank ("Lebanon Citizens") and Dakin Insurance Agency, Inc. ("Dakin"). The accompanying unaudited consolidated financial statements include the accounts of LCNB, Lebanon Citizens, and Dakin.

The unaudited interim consolidated financial statements, which have been reviewed by J.D. Cloud & Co. L.L.P., LCNB's independent registered public accounting firm, in accordance with standards established by the Public Company Accounting Oversight Board, as indicated by their report included herein and which does not express an opinion on those statements, have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, the unaudited interim consolidated financial statements include all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation of financial position, results of operations, and cash flows for the interim periods, as required by Regulation S-X, Rule 10-01.

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

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

Results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year ending December 31, 2006. 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 2005 Form 10-K filed with the SEC.

Note 2 - Acquisition

On May 31, 2006, Dakin purchased the existing book of business of Altemeier Oliver & Company Agency, Inc. (AOC), an independent insurance agency located in Blue Ash, Ohio. The acquisition of AOC was accounted for using the purchase accounting method and the results of operations of AOC have been included in the consolidated financial statements of LCNB since the acquisition date. The acquired assets consisted solely of a customer list intangible asset. This intangible asset will be amortized on a straight-line basis over a ten year period.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 3 - Earnings Per Share

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	\$ 1,506	1,821	4,724	4,919
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	3,236,066	3,297,848	3,253,192	3,311,763
Add- Dilutive effect of stock options	1,218	1,281	1,239	1,320
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per				

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common share

		3,237,284	3,299,129	3,254,431	3,313,083
Basic earnings per common share	\$	0.47	0.55	1.45	1.49
Diluted earnings per common share	\$	0.47	0.55	1.45	1.48

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 4 - Investment Securities

The amortized cost and estimated market value of available-for-sale investment securities at September 30, 2006 and December 31, 2005 are summarized as follows (thousands):

	Amortized Cost	September 30, 2006		Market Value
		Unrealized Gains	Unrealized Losses	
U.S. Treasury notes	\$ 1,197	-	24	1,173
U.S. Agency notes	36,297	11	359	35,949
U.S. Agency mortgage-backed securities	17,785	1	703	17,083
Municipal securities:				
Non-taxable	47,129	319	323	47,125
Taxable	5,874	19	95	5,798
Marketable equity securities	14	8	-	22
	\$ 108,296	358	1,504	107,150

	Amortized	December 31, 2005		Market
		Unrealized	Unrealized	

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	Cost	Gains	Losses	Value
U.S. Treasury notes	\$ 4,181	-	55	4,126
U.S. Agency notes	47,669	1	471	47,199
U.S. Agency mortgage-backed securities	21,480	7	629	20,858
Municipal securities:				
Non-taxable	55,637	484	295	55,826
Taxable	5,600	4	108	5,496
	\$ 134,567	496	1,558	133,505

Information concerning securities with gross unrealized losses at September 30, 2006, aggregated by length of time that individual securities have been in a continuous loss position, is as follows (thousands):

	<u>Less than Twelve Months</u>		<u>Twelve Months or More</u>	
	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses
U.S. Treasury notes	\$ -	-	1,173	24
U.S. Agency notes	4,986	6	28,923	353
U.S. Agency mortgage-				
backed securities	440	2	16,180	701
Municipal securities:				
Non-taxable	5,542	37	18,997	286
Taxable	-	-	3,523	95
	\$ 10,968	45	68,796	1,459

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LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 4 - Investment Securities (continued)

The decline in fair values is primarily due to increases in market interest rates. Unrealized losses on securities at September 30, 2006 have not been recognized into income currently because management has the intent and ability to hold the securities for a period of time sufficient to allow for any anticipated recovery in fair values. Therefore, no individual declines are deemed to be other than temporary.

Note 5 - Loans

Major classifications of loans at September 30, 2006 and December 31, 2005 are as follows (thousands):

	September 30, 2006	December 31, 2005
Commercial and industrial	\$ 35,442	34,607
Commercial, secured by real estate	138,887	124,823
Residential real estate	171,137	161,656
Consumer	38,853	35,879
Agricultural	3,049	1,978
Other loans	104	152
Lease financing	16	37

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	387,488	359,132
Deferred net origination costs	872	669
	388,360	359,801
Less allowance for loan losses	2,051	2,150
Loans, net	\$ 386,309	357,651

Changes in the allowance for loan losses for the nine months ended September 30, 2006 and 2005 were as follows (thousands):

	Nine Months Ended September 30,	
	2006	2005
Balances, beginning of year	\$ 2,150	2,150
Provision for loan losses	100	262
Charge-offs	(495)	(557)
Recoveries	296	296
Balances, end of period	\$ 2,051	2,151

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LCNB Corp. and Subsidiaries**Notes to the Consolidated Financial Statements****(Unaudited)****(Continued)****Note 5 - Loans (continued)**

Charge-offs for the nine months ended September 30, 2006 consisted primarily of consumer loans, and checking and NOW account overdrafts, but also included some residential and commercial real estate loans. Charge-offs for the nine months ended September 30, 2005 consisted primarily of checking and NOW account overdrafts and consumer loans.

Non-accrual, past-due, and restructured loans as of September 30, 2006 and December 31, 2005 were as follows (thousands):

	September 30, 2006	December 31, 2005
Non-accrual loans	\$ 380	785
Past-due 90 days or more and still accruing	108	61
Restructured loans	3,594	1,717
Total	\$ 4,082	2,563

Non-accrual loans at September 30, 2006 consisted of one loan secured by farmland, one real estate mortgage loan, and one commercial loan. Non-accrual loans at December 31, 2005 consisted of two real estate mortgage loans.

Loans past-due 90 days or more and still accruing interest at September 30, 2006 consisted of one real estate mortgage loan and consumer loans. Loans past-due 90 days or more at December 31, 2005 consisted primarily of consumer loans.

Restructured loans at September 30, 2006 and December 31, 2005 include a commercial loan secured by a combination of mortgages and other collateral. The principal balance of this loan at September 30, 2006 and December 31, 2005 was \$1,262,000 and \$1,717,000, respectively. The reduction in the balance as of September 30, 2006 is due to principal payments received. Restructured loans at September 30, 2006 include two additional commercial loans to a single borrower that are secured by commercial real estate.

Real estate acquired through foreclosure was \$752,000 and \$85,000 at September 30, 2006 and December 31, 2005, respectively, and is included in other assets in the consolidated balance sheets. Real estate acquired at September 30, 2006 consisted of one single-family residential home. Real estate acquired at December 31, 2005 consisted of two single-family residential homes that were sold in 2006.

Mortgage loans sold to and serviced for the Federal Home Loan Mortgage Corporation ("FHLMC") are not included in the accompanying balance sheets. The unpaid principal balances of those loans at September 30, 2006 and December 31, 2005 were \$43,762,000 and \$46,244,000, respectively. Loans sold to the FHLMC during the three and nine months ended September 30, 2006 totaled \$346,000 and \$2,471,000, respectively, and \$2,847,000 and \$5,643,000 during the three and nine months ended September 30, 2005, respectively.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 6 Long-Term Debt and Other Borrowings

On March 31, 2006, a \$2 million advance from the Federal Home Loan Bank, bearing an interest rate of 5.54%, matured and was paid in full by LCNB.

At September 30, 2006 and December 31, 2005, accrued interest and other liabilities included U.S. Treasury demand note borrowings of approximately \$1,952,000 and \$1,031,000, respectively. The interest rate on these borrowings is variable and was 5.10% and 4.00% at September 30, 2006 and December 31, 2005, respectively.

Note 7 Regulatory Capital

Lebanon Citizens 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%.

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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, Lebanon Citizens 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 Lebanon Citizens' or LCNB's category. A summary of the regulatory capital and capital ratios of LCNB follows:

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 7 Regulatory Capital (continued)

	At September 30, 2006	At December 31, 2005
	(Dollars in thousands)	
Regulatory Capital:		
Shareholders' equity	\$ 51,900	52,022
Goodwill and other intangibles	(1,401)	(1,348)
Net unrealized securities losses	757	701
Tier 1 risk-based capital	51,256	51,375
Eligible allowance for loan losses	2,051	2,150
Total risk-based capital	\$ 53,307	53,525
Capital ratios:		
Total risk-based (required 8.00%)	14.07%	14.94%
Tier 1 risk-based (required 4.00%)	13.53%	14.34%
Leverage (required 3.00%)	9.27%	9.55%

Note 8 - Commitments and Contingent Liabilities

LCNB is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments included commitments to extend credit and stand-by letters of 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 and stand-by letters of credit is represented by the contract amount of those instruments.

LCNB uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Financial instruments whose contract amounts represent off-balance-sheet credit risk at September 30, 2006 and December 31, 2005 were as follows (thousands):

	September 30, 2006	December 31, 2005
Commitments to extend credit	\$ 93,892	74,753
Standby letters of credit	5,759	5,946

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LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 8 Commitments and Contingent Liabilities (continued)

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. They include amounts not drawn on line of credit loans, commitments to make new loans, and unused overdraft protection amounts on demand and NOW accounts. Commitments generally have fixed expiration dates or other termination clauses. At September 30, 2006, \$19,956,000 of such commitments were for fixed rate products and unused overdraft protection amounts and \$73,936,000 were for adjustable rate products.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. At September 30, 2006 and December 31, 2005, outstanding guarantees of \$1,705,000 and \$1,892,000, respectively, were issued to developers and contractors. These guarantees generally are fully secured and have varying maturities. In addition, LCNB has a participation in a letter of credit securing payment of principal and

interest on a bond issue. The participation amount at September 30, 2006 and December 31, 2005 was approximately \$4.1 million. The letter of credit will expire on July 15, 2009. It is secured by an assignment of rents and the underlying real property.

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.

At September 30, 2006, LCNB is committed under various contracts to expend approximately \$625,000 to complete certain building and office renovation projects and computer upgrades.

Management believes that LCNB has sufficient liquidity to fund its commitments.

LCNB and its subsidiaries 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.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 9 - Stock Options

Under the Ownership Incentive Plan (the "Plan") LCNB may grant stock-based awards to eligible employees. 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 100,000 shares. As of September 30, 2006, only stock options have been granted under the Plan. Options granted to date vest ratably over a five year period and expire ten years after the date of grant. Stock options outstanding at September 30, 2006 were as follows:

		Outstanding		Exercisable			
		Weighted		Weighted			
		Average		Average			
Exercise		Exercise		Exercise	Number	Expiration	
<u>Price</u>	<u>Number</u>	<u>Price</u>	<u>Number</u>	<u>Price</u>	<u>Exercised</u>	<u>Date</u>	
\$ 26.1875	5,528	\$ 26.1875	3,317	\$ 26.1875	-	Feb, 2013	
35.3150	4,054	35.3150	1,622	35.3150	-	Jan, 2014	
37.9000	3,967	37.9000	-	-	-	Jan, 2016	
	13,549	32.3478	4,939	29.1850	-		

The estimated weighted-average fair value of the options granted in 2006 was \$9.01 per option. The fair value was estimated at the date of grant using the Black-Scholes option-pricing model and the following assumptions:

Risk-free interest rate	4.64%
Average dividend yield	3.04%
Volatility factor of the expected market price of the Company's common stock	22.70%
Average life	8.5 years

Compensation expense recognized in the consolidated statements of income for all stock options granted prior to January 1, 2005 is determined using the modified prospective approach as allowed by SFAS No. 123 (revised). Total expense related to options included in salaries and wages in the consolidated statements of income for the three and nine months ended September 30, 2006 were \$4,000 and \$11,000, respectively and \$2,000 and \$6,000 for the three and nine months ended September 30, 2005, respectively.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 10 Employee Benefits

LCNB has a noncontributory defined benefit retirement plan that covers all regular full-time employees. The components of net periodic pension cost for the three and nine months ended September 30, 2006 and 2005, are summarized as follows (thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Service cost	\$ 162	156	484	468
Interest cost	83	74	248	222
Expected return on plan assets	(92)	(82)	(273)	(242)
Amortization of net loss	-	1	1	1
Net periodic pension cost	153	149	460	449

LCNB previously disclosed in its consolidated financial statements for the year ended December 31, 2005, that it expected to contribute \$875,000 to its pension plan in 2006. As of September 30, 2006, a contribution of \$857,000 had been made to the pension plan. LCNB does not expect to make any further contributions during the remainder of 2006.

LCNB's Board of Directors adopted a 401(k) plan on March 13, 2006 to provide a retirement savings vehicle for eligible employees of LCNB and its subsidiaries. Participants may choose to make before-tax and/or Roth after-tax

contributions to their 401(k) plans. All contributions are immediately 100% vested. LCNB pays certain administrative costs of the 401(k) Plan, but does not match employee contributions.

Note 11 Recent Accounting Pronouncements

Statement of Financial Accounting Standards (SFAS) No. 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140*, was issued by the Financial Accounting Standards Board (FASB) in February, 2006. It amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* . This statement is effective for all financial instruments acquired or issued after the beginning of an entity 's first fiscal year that begins after September 15, 2006. LCNB has not entered into any transactions covered by SFAS No. 155 and is not affected by the pronouncement.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 11 Recent Accounting Pronouncements (continued)

SFAS No. 156, *Accounting for Servicing of Financial Assets*, was issued by the FASB in March, 2006. It amends SFAS No. 140 and requires that a separately recognized mortgage servicing asset or liability be initially measured at fair value. After initial recognition, an entity may choose either the amortization method or the fair value method for subsequent measurement. Under the amortization method, the servicing asset or liability is amortized to income over the estimated life of the asset or liability. Under the fair value method, the servicing asset or liability is measured at fair value at each financial reporting date and changes in fair value are recognized to income. This statement is effective at the beginning of the first fiscal year beginning after September 15, 2006. Management does not anticipate that adoption of SFAS No. 156 will have a material affect on LCNB's income due to the limited number of loans currently being sold in the secondary market.

SFAS No. 157, *Fair Value Measurements*, was issued by the FASB in September, 2006. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but increases consistency and comparability in the use of fair value measurements and calculations. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and for interim periods within those fiscal years. Management does not anticipate that the adoption of SFAS No. 157 will have a material effect on LCNB's consolidated balance sheet or income statement.

SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, was issued by the FASB in September, 2006. It requires an employer to recognize the overfunded or underfunded status, measured as the difference between the fair value of the plan assets and the benefit obligation, of a defined benefit postretirement plan as an asset or liability in its balance sheet. For a pension plan, the benefit obligation is the projected benefit obligation. SFAS No. 158 also requires an employer to recognize changes in the funded status of a defined benefit postretirement plan through

comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. An employer with publicly traded equity securities, such as LCNB, will be required to initially recognize the funded status of a defined benefit postretirement plan as of the end of the year ending after December 15, 2006. Based on information available at December 31, 2005, LCNB would have reduced Accumulated Other Comprehensive Income (Loss) by approximately \$560,000, net of tax. The actual impact of adopting SFAS No. 158 will be dependent upon the then current fair value of plan assets and the amount of the projected benefit obligation measured as of the adoption date.

Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109, was issued by the FASB in July, 2006. It provides additional guidance for financial statement recognition of tax positions taken in tax returns. The interpretation is effective for fiscal years beginning after December 15, 2006. Management does not anticipate that the guidance in the interpretation will have a material effect on LCNB's consolidated financial results.

LCNB Corp. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

(Continued)

Note 11 Recent Accounting Pronouncements (continued)

The Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*, (SAB No. 108) in September, 2006. SAB No. 108 provides interpretive guidance on how the effects of a carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatements. SAB No. 108 is effective for fiscal years ending after November 15, 2006. Management does not anticipate that the guidance in this bulletin will have a material effect on LCNB's consolidated financial statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

LCNB Corp. and subsidiaries

Lebanon, Ohio

We have reviewed the accompanying consolidated balance sheet of LCNB Corp. and subsidiaries as of September 30, 2006, and the related consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2006 and 2005, and the related consolidated statements of shareholders equity and cash flows for the nine-month periods ended September 30, 2006 and 2005. These financial statements are the responsibility of the Company's management.

We conducted our review 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 referred to above for them to be in conformity with U.S. generally accepted accounting principles.

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We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of LCNB Corp. and subsidiaries as of December 31, 2005 (presented herein), and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated February 16, 2006, 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, 2005, 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

October 26, 2006

LCNB Corp. and Subsidiaries

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

Forward Looking Statements

Certain matters disclosed herein may be deemed to be forward-looking statements that involve risks and uncertainties. Forward looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Such statements are often characterized by the use of qualifying words and their derivatives such as expects, anticipates, believes, estimates, plans, projects, or other statements concerning opinions or judgments of the Company 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.

Acquisition

On May 31, 2006, Dakin purchased the existing book of business of Altemeier Oliver & Company Agency, Inc. (AOC), an independent insurance agency located in Blue Ash, Ohio. The acquisition of AOC was accounted for using the purchase accounting method and the results of operations of AOC have been included in the consolidated financial statements of LCNB since the acquisition date. The acquired assets consisted solely of a customer list intangible asset. This intangible asset will be amortized on a straight-line basis over a ten year period.

Results of Operations

LCNB earned \$1,506,000 or \$0.47 per diluted share for the three months ended September 30, 2006, compared to \$1,821,000 or \$0.55 per diluted share for the three months ended September 30, 2005. The return on average assets (ROAA) for the third quarter, 2006 was 1.08% and the return on average equity (ROAE) was 11.47%, compared with an ROAA of 1.34% and an ROAE of 13.78% for the third quarter of 2005. The decrease in net income for the third quarter, 2006 is primarily attributable to a decrease in net interest income, a decrease in non-interest income, and an increase in non-interest expense.

LCNB earned \$4,724,000 or \$1.45 per diluted share during the first nine months of 2006 compared to \$4,919,000 or \$1.48 per diluted share for the first nine months of 2005. The ROAA and ROAE for the first nine months of 2006 were 1.16% and 12.09%, respectively. The comparable ratios for the first nine months of 2005 were 1.23% and 12.55%, respectively. The provision for loan losses for the 2006 period was less than the provision recorded during the 2005 period and non-interest income for the first nine months of 2006 was greater than the amount for the comparable 2005 period. These positive effects on net income were partially offset by a decrease in net interest income and an increase in non-interest expense.

LCNB Corp. and Subsidiaries

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

Net Interest Income

Three Months Ended September 30, 2006 vs. 2005.

LCNB's primary source of earnings is net interest income, which is the difference between earnings from loans and other investments and interest paid on deposits and other liabilities. The following table presents, for the three months ended September 30, 2006 and 2005, average balances for interest-earning assets and interest-bearing liabilities, the income or expense related to each item, and the resulting average yields earned or rates paid.

	Three Months Ended September 30,					
	2006			2005		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Loans (1)	\$ 381,228	\$ 6,489	6.75%	\$ 350,073	\$ 5,632	6.38%
Federal funds sold and interest-bearing demand deposits	11,433	154	5.34%	4,852	40	3.27%
Federal Reserve Bank stock	647	-	-%	647	-	-%
Federal Home Loan Bank stock	2,607	38	5.78%	2,468	30	4.82%
Investment securities:						

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Taxable	65,730	678	4.09%	80,602	733	3.61%
Non-taxable (2)	47,115	703	5.92%	56,919	821	5.72%
Total earnings assets	508,760	8,062	6.29%	495,561	7,256	5.81%
Non-earning assets	45,696			45,731		
Allowance for loan losses	(2,052)			(2,154)		
Total assets	\$ 552,404			\$ 539,138		
Interest-bearing deposits	\$ 417,017	3,289	3.13%	\$ 398,953	2,269	2.26%
Short-term debt	1,046	13	4.93%	3,640	35	3.81%
Long-term debt	32	1	12.40%	2,097	29	5.49%
Total interest-bearing liabilities	418,095	3,303	3.13%	404,690	2,333	2.29%
Demand deposits	78,863			79,207		
Other liabilities	3,361			2,821		
Capital	52,085			52,420		
Total liabilities and capital	\$ 552,404			\$ 539,138		
Net interest rate spread (3)			3.16%			3.52%
Net interest income and net interest margin on a taxable-equivalent basis (4)		\$ 4,759	3.71%		\$ 4,923	3.94%
Ratio of interest-earning assets to interest-bearing liabilities		121.69%			122.45%	

(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 three months ended September 30, 2006 as compared to the same period in 2005. 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 September 30, 2006 vs. 2005		
	Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning Assets:			
Loans	\$ 519	338	857
Federal funds sold and interest-bearing			
demand deposits	78	36	114
Federal Home Loan Bank stock	2	6	8
Investment securities:			
Taxable	(146)	91	(55)
Nontaxable	(145)	27	(118)
Total interest income	308	498	806
Interest-bearing Liabilities:			
Deposits	107	913	1,020
Short-term borrowings	(30)	8	(22)

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Long-term debt	(44)	16	(28)
Total interest expense	33	937	970
Net interest income	\$ 275	(439)	(164)

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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 on a fully tax-equivalent basis for the three months ended September 30, 2006 totaled \$4,759,000, a decrease of \$164,000 from the comparable period in 2005. Total interest expense increased \$970,000, which was partially offset by an increase in total interest income of \$806,000.

The increase in total interest income was due to a 48 basis point (one basis point equals 0.01%) increase in the average rate earned on earning assets and to a \$13.2 million increase in average interest earning assets, from \$495.6 million for the three months ended September 30, 2005 to \$508.8 million for the same period in 2006. The increase in interest earning assets was primarily from loan growth, which increased by \$31.2 million on an average basis. The loan growth was partially offset by a \$24.7 million decrease in average investment securities. The increase in the average rate earned on earning assets was primarily due to general increases in market interest rates.

The increase in total interest expense was primarily due to an 84 basis point increase in the average rate paid, which was primarily due to general increases in market interest rates.

The net interest margin narrowed 23 basis points in the third quarter, 2006 compared to the third quarter, 2005. The tighter margin reflects highly competitive market pricing conditions for both loans and deposits and a relatively flat yield curve between short-term and long-term interest rates. As a result, average deposit rates increased faster than average loan rates.

Nine Months Ended September 30, 2006 vs. 2005.

The following table presents, for the nine months ended September 30, 2006 and 2005, 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.

LCNB Corp. and Subsidiaries

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

	Nine Months Ended September 30,					
	2006			2005		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Loans (1)	\$ 370,813	\$ 18,624	6.72%	\$ 344,495	\$ 16,447	6.38%
Federal funds sold and interest-						
bearing demand deposits	9,338	349	5.00%	13,813	287	2.78%
Federal Reserve Bank stock	647	19	3.93%	647	19	3.93%
Federal Home Loan Bank stock	2,571	111	5.77%	2,440	87	4.77%
Investment securities:						
Taxable	67,506	2,024	4.01%	75,428	1,992	3.53%
Non-taxable (2)	50,925	2,259	5.93%	54,124	2,320	5.73%
Total earnings assets	501,800	23,386	6.23%	490,947	21,152	5.76%
Non-earning assets	44,744			44,417		
Allowance for loan losses	(2,088)			(2,156)		
Total assets	\$ 544,456			\$ 533,208		
Interest-bearing deposits	\$ 407,589	8,856	2.90%	\$ 397,770	6,387	2.15%
Short-term debt	1,561	55	4.71%	1,606	42	3.50%
Long-term debt	700	30	5.73%	2,113	88	5.57%
Total	409,850	8,941	2.92%	401,489	6,517	2.17%

interest-bearing liabilities				
Demand deposits	79,399		76,786	
Other liabilities	2,969		2,524	
Capital	52,238		52,409	
Total liabilities and capital	\$ 544,456		\$ 533,208	
Net interest rate spread (3)		3.31%		3.59%
Net interest income and net interest margin on a taxable-equivalent basis (4)				
	\$ 14,445	3.85%	\$ 14,635	3.99%
Ratio of interest-earning assets to interest-bearing liabilities	122.44%		122.28%	

(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.

LCNB Corp. and Subsidiaries

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

Operations (continued)

The following table presents the changes in taxable-equivalent basis interest income and expense for each major category of interest-earning assets and interest-bearing liabilities and the amount of change attributable to volume and rate changes for the nine months ended September 30, 2006 as compared to the same period in 2005.

	Nine Months Ended September 30, 2006 vs. 2005		
	Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning Assets:			
Loans	\$ 1,295	882	2,177
Federal funds sold and interest-bearing			
demand deposits	(114)	176	62
Federal Home Loan Bank stock	5	19	24
Investment securities:			
Taxable	(222)	254	32
Nontaxable	(140)	79	(61)
Total interest income	824	1,410	2,234
Interest-bearing Liabilities:			
Deposits	161	2,308	2,469
Short-term borrowings	(1)	14	13
Long-term debt	(60)	2	(58)

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Total interest expense	100	2,324	2,424
Net interest income	\$ 724	(914)	(190)

Net interest income on a fully tax-equivalent basis for the first nine months of 2006 totaled \$14,445,000, a \$190,000 decrease from the same period in 2005. Total interest expense increased \$2,424,000 and was partially offset by an increase in total interest income of \$2,234,000.

The increase in total interest income was due to a 47 basis point increase in the average rate earned on earning assets, from 5.76% for the first nine months of 2005 to 6.23% for the comparable period in 2006, and to a \$10.9 million increase in average total earning assets. The increase in average earning assets was due to a \$26.3 million increase in average loans, partially offset by a \$4.5 decrease in federal funds sold and interest-bearing demand deposits and an \$11.1 million decrease in investment securities.

LCNB Corp. and Subsidiaries

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

Operations (continued)

The increase in total interest expense was due primarily to a 75 basis point increase in the average rate paid on interest-bearing liabilities. The net interest margin narrowed 14 basis points during the first nine months of 2006 compared to the first nine months of 2005 for substantially the same reasons previously discussed.

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 credit losses at a level considered appropriate in relation to the risk of losses inherent in the portfolio. The total loan loss provision and the other changes in the allowance for loan losses are shown below.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(In thousands)			
Balance, beginning of period	\$ 2,051	2,154	2,150	2,150
Charge-offs	(171)	(154)	(495)	(557)
Recoveries	105	105	296	296
Net charge-offs	(66)	(49)	(199)	(261)
Provision for loan losses	66	46	100	262
Balance, end of period	\$ 2,051	2,151	2,051	2,151

Charge-offs for the nine months ended September 30, 2006 consisted primarily of consumer loans, and checking and NOW account overdrafts, but also included some residential and commercial real estate loans. Charge-offs for the nine months ended September 30, 2005 consisted primarily of checking and NOW account overdrafts and consumer loans.

LCNB Corp. and Subsidiaries

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

Operations (continued)

The following table sets forth information regarding the past due, non-accrual and renegotiated loans of LCNB at the dates indicated:

	September 30, 2006	December 31, 2005
	(In thousands)	
Non-accrual loans	\$ 380	785
Past-due 90 days or more and still accruing	108	61
Restructured loans	3,594	1,717
Total	\$ 4,082	2,563

Non-accrual loans at September 30, 2006 consisted of one loan secured by farmland, one real estate mortgage loan, and one commercial loan. Non-accrual loans at December 31, 2005 consisted of two real estate mortgage loans.

Loans past-due 90 days or more and still accruing interest at September 30, 2006 consisted of one real estate mortgage loan and consumer loans. Loans past-due 90 days or more at December 31, 2005 consisted primarily of consumer loans.

Restructured loans at September 30, 2006 and December 31, 2005 include a commercial loan secured by a combination of mortgages and other collateral. The principal balance of this loan at September 30, 2006 and December 31, 2005 was \$1,262,000 and \$1,717,000, respectively. The reduction in the balance as of September 30, 2006 is due to principal payments received. Restructured loans at September 30, 2006 include two additional commercial loans to a single borrower that are secured by commercial real estate.

Non -Interest Income

Three Months Ended September 30, 2006 vs. 2005.

Non-interest income of \$2,092,000 for the third quarter of 2006 was \$122,000, or 5.5%, less than for the same period in 2005 primarily due to a decline in other operating income attributed to a non-recurring \$85,000 gain on the sale a branch property in 2005, a loss on abandonment of an ATM, and a reduction in gains from sales of mortgage loans.

This unfavorable variance was partially offset by a \$47,000 increase in insurance agency income due to new business and policies obtained from AOC.

LCNB Corp. and Subsidiaries

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

Nine Months Ended September 30, 2006 vs. 2005.

Non-interest income of \$6,231,000 for the first nine months of 2006 was \$256,000, or 4.3%, greater than for the same period in 2005 primarily due to a \$186,000 increase in trust income, a \$175,000 increase in insurance agency income, and a \$79,000 increase in service charges and fees. The increase in trust income was primarily due to an increase in brokerage income resulting from new business and from trust fee modifications and new business. Insurance agency income increased due to an increase in contingency income recognized during the first quarter, new business, and new policies obtained from the AOC acquisition. Service charges and fees increased primarily due to an increase in check card income, which grew because of the increasing popularity of check cards as a retail payment method. Partially offsetting these increases in income were a decrease in gains from sales of mortgage loans, the 2005 non-recurring gain on the branch property, and the loss on the ATM abandonment described above.

Non-Interest Expense

Three Months Ended September 30, 2006 vs. 2005.

Total non-interest expense increased \$158,000, or 3.6%, during the third quarter, 2006 compared to the third quarter, 2005, primarily due to a \$116,000 increase in salaries and wages, reflecting additional employees and routine salary and wage increases.

Nine Months Ended September 30, 2006 vs. 2005.

Total non-interest expense increased \$491,000, or 3.8%, during the nine months ended September 30, 2006 compared to the same period in 2005 primarily due to a \$313,000 increase in salaries and wages and a \$91,000 increase in ATM

expense, which is included in other non-interest expense. Salaries and wages increased for substantially the same reasons discussed above. The increase in ATM expense is primarily due to fee adjustments from a vendor related to prior periods that were recognized during the first quarter, 2006.

Income Taxes

LCNB's effective tax rates for the nine months ended September 30, 2006 and 2005 were 25.2% and 25.0%, 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.

LCNB Corp. and Subsidiaries

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

Operations (continued)

Financial Condition

Securities available for sale of \$107.2 million at September 30, 2006, declined by approximately \$26.4 million from the balance at December 31, 2005. This decline reflects management's decision to invest most of the funds received from investment maturities and calls into loan growth.

Gross loans, before the allowance for loan losses, at September 30, 2006 were \$388.4 million, approximately \$28.6 million greater than at December 31, 2005. Commercial loans secured by real estate comprised \$14.1 million of the increase, residential real estate loans comprised \$9.5 million of the increase, and consumer loans comprised another \$3.0 million of the increase.

Interest-bearing deposits at September 30, 2006 totaled \$414.9 million, approximately \$15.5 million greater than at December 31, 2005. NOW accounts increased \$28.5 million, partially offset by declines in money market deposit accounts, regular savings, and time deposits. The increase in the NOW account classification was primarily due to a \$29.0 million increase in public fund NOW account deposits by local and state governmental entities.

Long-term debt at September 30, 2006 was \$2.1 million less than the balance at December 31, 2005. The decrease is primarily due to the maturation and payment in full of a \$2.0 million Federal Home Loan Bank note on March 31, 2006.

LCNB Corp. and Subsidiaries

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

The following table highlights the changes in the balance sheets. The analysis uses quarterly averages to give a better indication of balance sheet trends.

CONDENSED QUARTERLY AVERAGE BALANCE SHEETS

	September 30, 2006	June 30, 2006	March 31, 2006
	(In thousands)		
ASSETS			
Interest earning:			
Federal funds sold and			
interest-bearing demand deposits	\$ 11,433	9,903	6,625
Investment securities	116,099	119,956	129,020
Loans	381,228	368,541	362,465
Total interest-earning assets	508,760	498,400	498,110
Noninterest-earning:			
Cash and due from banks	14,985	13,949	15,269
All other assets	30,711	29,911	29,422
Allowance for credit losses	(2,052)	(2,052)	(2,160)
TOTAL ASSETS	\$ 552,404	540,208	540,641
LIABILITIES			
Interest-bearing:			
Interest-bearing deposits	\$ 417,017	404,434	401,141

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Short-term borrowings	1,046	854	2,803
Long-term debt	32	48	2,043
Total interest-bearing liabilities	418,095	405,336	405,987
Noninterest-bearing:			
Noninterest-bearing deposits	78,863	79,779	79,546
All other liabilities	3,361	2,813	2,756
TOTAL LIABILITIES	500,319	487,928	488,289
SHAREHOLDERS' EQUITY	52,085	52,280	52,352
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 552,404	540,208	540,641

LCNB Corp. and Subsidiaries

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

Operations (continued)

Average total interest-earning assets increased approximately \$10.4 million during the third quarter, 2006 compared to the second quarter, 2006. Loans increased \$12.7 million and investment securities decreased \$3.9 million for substantially the same reasons discussed above.

Average total interest-bearing liabilities increased approximately \$12.8 million during the third quarter, 2006, compared to the second quarter, 2006. Interest-bearing deposits grew \$12.6 million for substantially the same reasons discussed above.

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 Lebanon Citizens 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, Lebanon Citizens' primary regulator, would be necessary for Lebanon Citizens to pay dividends in excess of this amount. In addition, dividend payments may not reduce capital levels below minimum regulatory guidelines. Management believes Lebanon Citizens 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 September 30, 2006, LCNB's liquid assets amounted to \$128.9 million or 23.4% of total gross assets, a decrease from \$148.8 million or 27.6% at

December 31, 2005. Liquid assets decreased, despite a \$6.4 million increase in cash and cash equivalents, due to the \$26.4 million decrease in securities available for sale. The decrease in liquidity was used primarily to fund new lending activity.

Liquidity is also provided by access to core funding sources, primarily core depositors in the bank's market area. Approximately 75.7% of total deposits at September 30, 2006 were core deposits, a decrease from 80.7% at December 31, 2005. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit greater than \$100,000. Core deposits decreased because of the previously discussed increase in public fund deposits and decreases in demand accounts, money market deposit accounts, regular savings, and time deposit accounts.

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

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

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LCNB Corp. and Subsidiaries

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

Recent Accounting Pronouncements

Statement of Financial Accounting Standards (SFAS) No. 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140*, was issued by the Financial Accounting Standards Board (FASB) in February, 2006. It amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging*

Activities and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. LCNB has not entered into any transactions covered by SFAS No. 155 and is not affected by the pronouncement.

SFAS No. 156, *Accounting for Servicing of Financial Assets*, was issued by the FASB in March, 2006. It amends SFAS No. 140 and requires that a separately recognized mortgage servicing asset or liability be initially measured at fair value. After initial recognition, an entity may choose either the amortization method or the fair value method for subsequent measurement. Under the amortization method, the servicing asset or liability is amortized to income over the estimated life of the asset or liability. Under the fair value method, the servicing asset or liability is measured at fair value at each financial reporting date and changes in fair value are recognized to income. This statement is effective at the beginning of the first fiscal year beginning after September 15, 2006. Management does not anticipate that adoption of SFAS No. 156 will have a material effect on LCNB's income due to the limited number of loans currently being sold in the secondary market.

SFAS No. 157, *Fair Value Measurements*, was issued by the FASB in September, 2006. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but increases consistency and comparability in the use of fair value measurements and calculations. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and for interim periods within those fiscal years. Management does not anticipate that the adoption of SFAS No. 157 will have a material effect on LCNB's consolidated balance sheet or income statement.

LCNB Corp. and Subsidiaries

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

SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*—an amendment of FASB Statements No. 87, 88, 106, and 132(R), was issued by the FASB in September, 2006. It requires an employer to recognize the overfunded or underfunded status, measured as the difference between the fair value of the plan assets and the benefit obligation, of a defined benefit postretirement plan as an asset or liability in its balance sheet. For a pension plan, the benefit obligation is the projected benefit obligation. SFAS No. 158 also requires an employer to recognize changes in the funded status of a defined benefit postretirement plan through comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. An employer with publicly traded equity securities, such as LCNB, will be required to initially recognize the funded status of a defined benefit postretirement plan as of the end of the year ending after December 15, 2006. Based on information available at December 31, 2005, LCNB would have reduced Accumulated Other Comprehensive Income (Loss) by approximately \$560,000, net of tax. The actual impact of adopting SFAS No. 158 will be dependent upon the then current fair value of plan assets and the amount of the projected benefit obligation measured as of the adoption date.

Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*—an interpretation of FASB Statement No. 109, was issued by the FASB in July, 2006. It provides additional guidance for financial statement recognition of tax positions taken in tax returns. The interpretation is effective for fiscal years beginning after December 15, 2006. Management does not anticipate that the guidance in the interpretation will have a material effect on LCNB's consolidated financial results.

The Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*, (SAB No. 108) in September, 2006. SAB No. 108 provides interpretive guidance on how the effects of a carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatements. SAB No. 108 is effective for fiscal years ending after November 15, 2006. Management does not anticipate that the guidance in this bulletin will

have a material effect on LCNB's consolidated financial statements.

LCNB Corp. and Subsidiaries

Item 3. Quantitative and Qualitative Disclosures about Market Risks

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. The IRSA model 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. The base projection uses a current interest rate scenario. As shown below, the September 30, 2006 IRSA indicates that an increase in interest rates would have a positive effect on net interest income, and a decrease in rates would have a negative effect on net interest income. The changes in net interest income for the up and down 100, 200, and 300 basis point rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in <u>Basis Points</u>	Amount	\$ Change in Net Interest	% Change in Net Interest
	<u>(In thousands)</u>	<u>Income</u>	<u>Income</u>
Up 300	\$ 19,122	247	1.31%
Up 200	19,047	172	0.91%
Up 100	18,968	93	0.49%
Base	18,875	-	-%
Down 100	18,731	(144)	-0.76%
Down 200	18,506	(369)	-1.95%
Down 300	18,221	(654)	-3.47%

IRSA shows the affect on net interest income 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. The EVE analysis at September 30, 2006 is shown below. The changes in the economic value of equity for these rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in <u>Basis Points</u>	Amount	\$ Change in	% Change in
	<u>(In thousands)</u>	<u>EVE</u>	<u>EVE</u>
Up 300	\$ 93,945	(10,815)	-10.32%
Up 200	97,791	(6,969)	-6.65%
Up 100	101,530	(3,230)	-3.08%
Base	104,760	-	-%
Down 100	106,615	1,855	1.77%
Down 200	107,572	2,812	2.68%
Down300	108,382	3,622	3.46%

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.

LCNB Corp. and Subsidiaries

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. Based upon this evaluation, these officers have concluded, that as of September 30, 2006, 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.

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

On April 17, 2001, LCNB's Board of Directors authorized three separate stock repurchase programs, two phases of which continue. The shares purchased will be held for future corporate purposes.

Under the "Market Repurchase Program" LCNB was originally authorized to purchase up to 100,000 shares of its stock through market transactions with a selected stockbroker. On November 14, 2005, the Board of Directors extended the Market Repurchase Program by increasing the shares authorized for repurchase to 200,000 total shares. Through September 30, 2006, 145,222 shares had been purchased under this program. The following table shows information relating to the repurchase of shares under the Market Repurchase Program during the three months ended September 30, 2006:

Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
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	Total Number of Shares Purchased	Average Price Paid Per Share		
July 1-31, 2006	15,200	\$37.45	15,200	65,778
August 1-31, 2006	11,000	37.50	11,000	54,778
September 1-30, 2006	-	-	-	54,778
Total	26,200	37.47	26,200	54,778

The "Private Sale Repurchase Program" is available to shareholders who wish to sell large blocks of stock at one time. Because LCNB's stock is not widely traded, a shareholder releasing large blocks may not be able to readily sell all shares through normal procedures. Purchases of blocks will be considered on a case-by-case basis and will be made at prevailing market prices. There is no limit to the number of shares that may be purchased under this program. A total of 178,344 shares have been purchased under this program since its inception. No shares were purchased during the third quarter, 2006.

PART II. OTHER INFORMATION

LCNB Corp. and Subsidiaries

Item 3. Defaults Upon Senior Securities - Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders - Not Applicable

Item 5. Other Information - Not Applicable

Item 6. Exhibits

<u>Exhibit No.</u>	<u>Title</u>
3(i)	Articles of Incorporation incorporated by reference to Form 10-Q for the quarterly period ended March 31, 2005, Exhibit 3(i).
3(ii)	Regulations incorporated by reference to 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.
10.2	Form of Option Grant Agreement under the LCNB Corp. Ownership Incentive Plan incorporated by reference to Form 10-K for the fiscal year

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Ended December 31, 2005, Exhibit 10.2.

- 15 Letter regarding unaudited interim financial information.
- 31.1 Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Chief Financial Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.

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.

October 30, 2006

/s/ Stephen P. Wilson

Stephen P. Wilson, President, CEO &

Chairman of the Board of Directors

October 30, 2006

/s/Steve P. Foster

Steve P. Foster, Executive Vice President

and Chief Financial Officer

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