

LCNB CORP  
Form 10-Q  
May 09, 2013

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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 March 31, 2013

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 May 6, 2013 was 7,625,920 shares.

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LCNB CORP. AND SUBSIDIARIES  
FOR THE THREE MONTHS ENDED MARCH 31, 2013

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## PART I – FINANCIAL INFORMATION

Item 1. Financial Statements  
 LCNB CORP. AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (Dollars in thousands)

	March 31, 2013 (Unaudited)	December 31, 2012
<b>ASSETS:</b>		
Cash and due from banks	\$ 24,500	11,260
Interest-bearing demand deposits	3,813	2,215
Total cash and cash equivalents	28,313	13,475
<b>Investment securities:</b>		
Available-for-sale, at fair value	277,559	258,506
Held-to-maturity, at cost	22,831	15,424
Federal Reserve Bank stock, at cost	1,106	949
Federal Home Loan Bank stock, at cost	2,854	2,091
Loans, net	546,263	450,346
Premises and equipment, net	20,156	16,564
Goodwill	14,319	5,915
Bank owned life insurance	20,774	16,915
Other assets	12,229	8,452
<b>TOTAL ASSETS</b>	<b>\$ 946,404</b>	<b>788,637</b>
<b>LIABILITIES:</b>		
<b>Deposits:</b>		
Noninterest-bearing	\$ 158,648	133,848
Interest-bearing	662,222	537,623
Total deposits	820,870	671,471
Short-term borrowings	11,609	13,756
Long-term debt	13,128	13,705
Accrued interest and other liabilities	6,593	7,699
<b>TOTAL LIABILITIES</b>	<b>852,200</b>	<b>706,631</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 8,379,387 and 7,485,527 shares at March 31, 2013 and December 31, 2012, respectively	39,517	27,107
Retained earnings	62,352	61,843
Treasury shares at cost, 753,627 shares at March 31, 2013 and December 31, 2012	(11,665 )	(11,665 )
Accumulated other comprehensive income, net of taxes	4,000	4,721
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>94,204</b>	<b>82,006</b>
<b>TOTAL LIABILITES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 946,404</b>	<b>788,637</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 March 31,	
	2013	2012
<b>INTEREST INCOME:</b>		
Interest and fees on loans	\$ 6,580	6,208
Interest on investment securities:		
Taxable	834	887
Non-taxable	623	606
Other investments	39	30
<b>TOTAL INTEREST INCOME</b>	<b>8,076</b>	<b>7,731</b>
<b>INTEREST EXPENSE:</b>		
Interest on deposits	983	1,165
Interest on short-term borrowings	3	3
Interest on long-term debt	112	154
<b>TOTAL INTEREST EXPENSE</b>	<b>1,098</b>	<b>1,322</b>
<b>NET INTEREST INCOME</b>	<b>6,978</b>	<b>6,409</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>149</b>	<b>215</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>6,829</b>	<b>6,194</b>
<b>NON-INTEREST INCOME:</b>		
Trust income	575	766
Service charges and fees on deposit accounts	979	878
Net gain on sales of securities	587	380
Bank owned life insurance income	172	148
Gains from sales of mortgage loans	129	107
Other operating income	65	57
<b>TOTAL NON-INTEREST INCOME</b>	<b>2,507</b>	<b>2,336</b>
<b>NON-INTEREST EXPENSE:</b>		
Salaries and employee benefits	3,294	2,982
Equipment expenses	292	262
Occupancy expense, net	506	407
State franchise tax	216	206
Marketing	144	111
FDIC premiums	128	111
Other non-interest expense	2,511	1,369
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>7,091</b>	<b>5,448</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>2,245</b>	<b>3,082</b>
<b>PROVISION FOR INCOME TAXES</b>	<b>517</b>	<b>805</b>
<b>NET INCOME</b>	<b>\$ 1,728</b>	<b>2,277</b>
Dividends declared per common share	\$ 0.16	0.16

Earnings per common share:

Basic	\$ 0.23	0.34
Diluted	0.23	0.34

Weighted average common shares outstanding:

Basic	7,513,101	6,706,295
Diluted	7,610,626	6,773,451

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 March 31,	
	2013	2012
Net income	\$1,728	2,277
Other comprehensive income:		
Net unrealized gain (loss) on available-for-sale securities (net of taxes of \$176 and \$259 for the three months ended March 31, 2013 and 2012, respectively)	(342 )	(505 )
Reclassification adjustment for net realized gain on sales of available-for-sale securities included in net income, net of taxes	(387 )	(251 )
Change in nonqualified pension plan unrecognized net loss and unrecognized prior service cost (net of taxes of \$5 and \$5 for the three months ended March 31, 2013 and 2012, respectively)	8	7
Total comprehensive income	\$1,007	1,528

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 (Loss)	Total Shareholders' Equity
Balance December 31, 2011	6,704,723	\$26,753	57,877	(11,698 )	5,028	77,960
Net income			2,277			2,277
Net unrealized gain (loss) on available-for-sale securities, net of taxes					(505 )	(505 )
Reclassification adjustment for net realized gain on sales of available-for-sale securities included in net income, net of taxes					(251 )	(251 )
Change in nonqualified pension plan unrecognized net gain and unrecognized prior service cost, net of taxes					7	7
Dividend Reinvestment and Stock Purchase Plan	6,968	89				89
Compensation expense relating to stock options		9				9
Common stock dividends, \$0.16 per share			(1,073 )			(1,073 )
Balance March 31, 2012	6,711,691	26,851	59,081	(11,698 )	4,279	78,513
Balance December 31, 2012	6,731,900	\$27,107	61,843	(11,665 )	4,721	82,006
Net income			1,728			1,728
Net unrealized gain (loss) on available-for-sale securities, net of tax					(342 )	(342 )
Reclassification adjustment for net realized gain on sales of available-for-sale securities included in net income, net of taxes					(387 )	(387 )
Change in nonqualified pension plan unrecognized net gain and unrecognized prior service cost, net of taxes					8	8
Dividend Reinvestment and Stock Purchase Plan	5,049	80				80
	888,811	12,321				12,321

Acquisition of First Capital Bancshares, Inc.						
Compensation expense relating to stock options		9				9
Common stock dividends, \$0.16 per share			(1,219 )			(1,219 )
Balance March 31, 2013	7,625,760	39,517	62,352	(11,665 )	4,000	94,204

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)

	Three Months Ended March 31,	
	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$1,728	2,277
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization and accretion	740	775
Provision for loan losses	149	215
Increase in cash surrender value of bank owned life insurance	(172 )	(148 )
Realized gain from sales of securities available-for-sale	(587 )	(380 )
Realized (gain) loss from sales and write-downs of other real estate owned and repossessed assets	(230 )	81
Origination of mortgage loans for sale	(7,175 )	(5,866 )
Realized gains from sales of mortgage loans	(129 )	(107 )
Proceeds from sales of mortgage loans	7,241	5,914
Compensation expense related to stock options	9	9
(Increase) decrease due to changes in assets and liabilities:		
Accrued income receivable	(671 )	(578 )
Other assets	(53 )	144
Other liabilities	(928 )	(178 )
<b>TOTAL ADJUSTMENTS</b>	<b>(1,806 )</b>	<b>(119 )</b>
<b>NET CASH FLOWS FROM OPERATING ACTIVITIES</b>	<b>(78 )</b>	<b>2,158</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sales of investment securities available-for-sale	23,337	29,944
Proceeds from maturities and calls of investment securities:		
Available-for-sale	5,059	5,514
Held-to-maturity	1,353	413
Purchases of investment securities:		
Available-for-sale	(26,725 )	(34,944 )
Held-to-maturity	(8,376 )	(131 )
Purchase of Federal Reserve Bank stock	-	(8 )
Net decrease in loans	2,865	3,458
Proceeds from sale of other real estate owned and repossessed assets	865	14
Purchases of premises and equipment	(204 )	(47 )
Net cash acquired from acquisition	9,771	-
<b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>	<b>7,945</b>	<b>4,213</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	12,626	12,004
Net decrease in short-term borrowings	(2,147 )	(11,006 )
Principal payments on long-term debt	(2,369 )	(642 )
Proceeds from issuance of common stock	11	15
Cash dividends paid on common stock	(1,150 )	(999 )

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NET CASH FLOWS FROM FINANCING ACTIVITIES	6,971	(628 )
NET CHANGE IN CASH AND CASH EQUIVALENTS	14,838	5,743
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	13,475	19,535
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$28,313	25,278

SUPPLEMENTAL CASH FLOW INFORMATION:

CASH PAID DURING THE YEAR FOR:

Interest	\$1,171	1,361
Income taxes	440	-

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:

Transfer from loans to other real estate owned and repossessed assets	6	543
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The accompanying notes to consolidated financial statements are an integral part of these statements.

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

Note 1 - Basis of Presentation

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

The unaudited interim consolidated financial statements, 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 months ended March 31, 2013 are not necessarily indicative of the results to be expected for the full year ending December 31, 2013. 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 2012 Annual Report on Form 10-K filed with the SEC.

Note 2 – Acquisition

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

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

## Note 2 – Acquisition (continued)

Under the terms of the Merger Agreement, each shareholder of First Capital common stock was entitled to elect to receive, for each share of First Capital Common Stock, (i) \$30.76 in cash, (ii) 2.329 common shares of LCNB (subject to an adjustment based upon the average closing price of LCNB common shares for the 25 trading days prior to the effective date of the merger), or (iii) a combination of cash and LCNB common stock. A First Capital shareholder's election to receive cash or stock was subject to allocation procedures that ensured that no more than 50% and no less than 40% of the outstanding First Capital shares were exchanged for cash and that no more than 60% and no less than 50% of the outstanding First Capital shares were exchanged for LCNB common shares.

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

## Consideration Paid:

Common shares issued (888,811)	\$12,354
Cash paid to shareholders	7,828
Total value of consideration paid	20,182

## Identifiable Assets Acquired:

Cash and cash equivalents	17,632
Investment securities:	
Available-for-sale	21,606
Held-to-maturity	384
Federal Reserve Bank stock	157
Federal Home Loan Bank stock	763
Loans, net	98,899
Premises and equipment, net	3,729
Bank owned life insurance	3,687
Core deposit intangible	2,574
Other real estate owned	127
Deferred income taxes	504
Other assets	1,150
Total identifiable assets acquired	151,212

## Liabilities Assumed:

Deposits	136,823
Long-term debt	1,792
Other liabilities	819
Total liabilities assumed	139,434

Total Identifiable Net Assets Acquired	11,778
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Goodwill resulting from merger	\$8,404
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LCNB CORP. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)  
(Continued)

## Note 2 – Acquisition (continued)

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

The following table details the acquired loans that are accounted for in accordance with FASB ASC 310-30 (in thousands):

Contractually required principal at acquisition	\$ 103,456
Contractual cash flows not expected to be collected (nonaccretable difference)	(3,409 )
Expected cash flows at acquisition	100,047
Interest component of expected cash flows (accretable discount)	(1,148 )
Fair value of acquired loans	\$98,899

In accordance with U.S. GAAP, there was no carryover of the allowance for loan losses that had been previously recorded by Citizens.

Direct costs related to the acquisition were expensed as incurred and are recorded in other non-interest expense in the consolidated statements of income. During the first quarter 2013 LCNB incurred \$1,055,000 in merger and acquisition integration expenses related to the transaction, including \$496,000 in merger related costs and \$559,000 for converting Citizens data processing system to LCNB's system.

The results of operations are included in the consolidated income statement from the date of the merger. The estimated amount of Citizens revenue and net income, excluding merger and data conversion costs, included in LCNB's consolidated income statement for the first quarter 2013 was \$1,260,000 and \$393,000 respectively.

The following table presents unaudited pro forma information as if the merger with First Capital had occurred on January 1, 2012 (in thousands). This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments, amortization of the core deposit intangible, and related income tax effects. It does not include merger and data conversion costs. The pro forma information does not necessarily reflect the results of operations that would have occurred had the merger with First Capital occurred in 2012. In particular, expected operational cost savings are not reflected in the pro forma amounts.

	Three Months Ended March 31,	
	2013	2012
Total revenue	\$9,688	10,466
Net income	2,115	2,555
Basic earnings per common share	0.28	0.34
Diluted earnings per common share	0.27	0.33





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

## Note 3 - Investment Securities

The amortized cost and fair value of available-for-sale investment securities at March 31, 2013 and December 31, 2012 are summarized as follows (in thousands):

	March 31, 2013			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. Treasury notes	\$ 19,447	246	-	19,693
U.S. Agency notes	100,668	1,021	190	101,499
U.S. Agency mortgage-backed securities	53,116	1,166	126	54,156
Certificates of deposit with other banks	1,494	15	-	1,509
<b>Municipal securities:</b>				
Non-taxable	75,766	3,157	179	78,744
Taxable	16,684	919	11	17,592
Mutual funds	2,201	22	-	2,223
Trust preferred securities	149	3	4	148
Equity securities	1,751	261	17	1,995
	<b>\$271,276</b>	<b>6,810</b>	<b>527</b>	<b>277,559</b>

	December 31, 2012			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. Treasury notes	\$ 18,462	224	-	18,686
U.S. Agency notes	89,372	1,364	130	90,606
U.S. Agency mortgage-backed securities	51,121	1,444	24	52,541
Corporate securities	3,032	35	-	3,067
<b>Municipal securities:</b>				
Non-taxable	70,504	3,497	119	73,882
Taxable	14,851	993	3	15,841
Mutual fund	2,138	30	-	2,168
Trust preferred securities	250	2	7	245
Equity securities	1,390	106	26	1,470
	<b>\$251,120</b>	<b>7,695</b>	<b>309</b>	<b>258,506</b>

The fair value of held-to-maturity investment securities, consisting of non-taxable and taxable municipal securities, approximates amortized cost at March 31, 2013 and December 31, 2012.

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

Information concerning securities with gross unrealized losses at March 31, 2013, 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 More Fair Value	Unrealized Losses
U.S. Agency notes	\$23,040	190	-	-
U.S. Agency mortgage-backed securities	11,255	126	-	-
Municipal securities:				
Non-taxable	13,130	178	453	1
Taxable	1,922	11	-	-
Mutual funds	57	-	-	-
Trust preferred securities	47	3	49	1
Equity securities	111	3	101	14
	\$49,562	511	603	16

Management has determined that the unrealized losses at March 31, 2013 are primarily due to fluctuations in market interest rates and do not reflect credit quality deterioration of the securities. Because the Company does not have the intent to sell the investments and it is more likely than not that the Company will not be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

## Note 4 - Loans

Major classifications of loans at March 31, 2013 and December 31, 2012 are as follows (in thousands):

	March 31, 2013	December 31, 2012
Commercial and industrial	\$ 35,452	26,236
Commercial, secured by real estate	283,144	230,256
Residential real estate	214,282	183,132
Consumer	13,860	10,554
Agricultural	1,805	1,668
Other loans, including deposit overdrafts	1,146	1,875
	549,689	453,721
Deferred net origination (fees) costs	(22)	62
	549,667	453,783
Less allowance for loan losses	3,404	3,437
Loans, net	\$ 546,263	450,346



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

## Note 4 – Loans (continued)

Non-accrual, past-due, and accruing restructured loans as of March 31, 2013 and December 31, 2012 are as follows (in thousands):

	March 31, 2013		December 31, 2012	
Non-accrual loans:				
Commercial and industrial	\$ 181		264	
Commercial, secured by real estate	1,414		788	
Residential real estate	1,578		1,231	
Total non-accrual loans	3,173		2,283	
Past-due 90 days or more and still accruing	180		128	
Total non-accrual and past-due 90 days or more and still accruing	3,353		2,411	
Accruing restructured loans	13,693		13,343	
Total	\$ 17,046		15,754	
Percentage of total non-accrual and past-due 90 days or more and still accruing to total loans	0.61	%	0.53	%
Percentage of total non-accrual, past-due 90 days or more and still accruing, and accruing restructured loans to total loans	3.10	%	3.47	%

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 March 31, 2013 and December 31, 2012 were \$87,710,000 and \$71,568,000, respectively. Loans sold during the three months ended March 31, 2013 and 2012 totaled \$7,175,000 and \$5,866,000, respectively.

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

## Note 4 – Loans (continued)

The allowance for loan losses and recorded investment in loans for the three months ended March 31 are as follows (in thousands):

	Commercial & Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
<b>2013</b>							
Allowance for loan losses:							
Balance, beginning of year	\$ 320	2,296	712	108	-	1	3,437
Provision charged to expenses	20	87	14	22	-	6	149
Losses charged off	(83 )	(30 )	(27 )	(63 )	-	(16 )	(219 )
Recoveries	-	-	5	23	-	9	37
Balance, end of period	\$ 257	2,353	704	90	-	-	3,404
Individually evaluated for impairment							
	\$ 71	657	157	-	-	-	885
Collectively evaluated for impairment							
	186	1,696	547	90	-	-	2,519
Balance, end of period	\$ 257	2,353	704	90	-	-	3,404
<b>Loans:</b>							
Individually evaluated for impairment							
	\$ 181	14,006	1,294	7	-	-	15,488
Collectively evaluated for impairment							
	35,234	268,838	213,190	13,966	1,805	1,146	534,179
Balance, end of period	\$ 35,415	282,844	214,484	13,973	1,805	1,146	549,667
<b>2012</b>							
Allowance for loan losses:							
Balance, beginning of year	\$ 162	1,941	656	166	-	6	2,931
	7	61	155	(6 )	-	(2 )	215

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Provision charged to expenses							
Losses charged off	-	(205)	(117)	(46)	-	(20)	(388)
Recoveries	-	70	7	38	-	17	132
Balance, end of period	\$ 169	1,867	701	152	-	1	2,890
Individually evaluated for impairment	\$ -	263	150	-	-	-	413
Collectively evaluated for impairment	169	1,604	551	152	-	1	2,477
Balance, end of period	\$ 169	1,867	701	152	-	1	2,890
Loans:							
Individually evaluated for impairment	\$ 2,922	13,900	629	9	-	-	17,460
Collectively evaluated for impairment	27,735	204,602	186,378	13,375	2,357	5,074	439,521
Balance, end of period	\$ 30,657	218,502	187,007	13,384	2,357	5,074	456,981

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Note 4 – Loans (continued)

The Company 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 the Company 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 4 – Loans (continued)

An analysis of the Company's loan portfolio by credit quality indicators at March 31, 2013 and December 31, 2012 is as follows (in thousands):

	Pass	OAEM	Substandard	Doubtful	Total
March 31, 2013					
Commercial & industrial	\$31,083	1,793	2,358	181	35,415
Commercial, secured by real estate	262,682	1,797	18,365	-	282,844
Residential real estate	206,546	2,322	5,616	-	214,484
Consumer	13,931	-	42	-	13,973
Agricultural	1,771	-	34	-	1,805
Other	1,146	-	-	-	1,146
Total	\$517,159	5,912	26,415	181	549,667
December 31, 2012					
Commercial & industrial	\$22,965	1,804	1,177	264	26,210
Commercial, secured by real estate	218,246	2,653	9,022	107	230,028
Residential real estate	172,589	2,353	8,130	298	183,370
Consumer	10,549	-	62	20	10,631
Agricultural	1,665	-	3	-	1,668
Other	1,876	-	-	-	1,876
Total	\$427,890	6,810	18,394	689	453,783

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## Note 4 – Loans (continued)

A loan portfolio aging analysis at March 31, 2013 and December 31, 2012 is as follows (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans Receivable	Total Loans Greater Than 90 Days and Accruing
March 31, 2013							
Commercial & industrial	\$-	-	181	181	35,234	35,415	-
Commercial, secured by real estate	378	-	1,301	1,679	281,165	282,844	127
Residential real estate	945	223	1,376	2,544	211,940	214,484	49
Consumer	60	11	4	75	13,898	13,973	4
Agricultural	-	-	-	-	1,805	1,805	-
Other	63	-	-	63	1,083	1,146	-
Total	\$1,446	234	2,862	4,542	545,125	549,667	180
December 31, 2012							
Commercial & industrial	\$-	1	264	265	25,945	26,210	-
Commercial, secured by real estate	346	79	788	1,213	228,815	230,028	-
Residential real estate	791	212	1,172	2,175	181,195	183,370	103
Consumer	61	57	25	143	10,488	10,631	25
Agricultural	-	-	-	-	1,668	1,668	-
Other	72	-	-	72	1,804	1,876	-
Total	\$1,270	349	2,249	3,868	449,915	453,783	128

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Note 4 – Loans (continued)

Impaired loans at March 31, 2013 and December 31, 2012 are as follows (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2013					
With no related allowance recorded:					
Commercial & industrial	\$-	-	-	-	-
Commercial real estate	9,480	9,875	-	9,516	89
Residential real estate	534	727	-	591	3
Consumer	-	-	-	3	-
Total	\$10,014	10,602	-	10,110	92
With an allowance recorded:					
Commercial & industrial	\$181	249	71	202	-
Commercial real estate	4,526	4,654	657	4,548	32
Residential real estate	760	786	157	764	3
Consumer	7	7	-	7	-
Total	\$5,474	5,696	885	5,521	35
Total:					
Commercial & industrial	\$181	249	71	202	-
Commercial real estate	14,006	14,529	657	14,064	121
Residential real estate	1,294	1,513	157	1,355	6
Consumer	7	7	-	10	-
Total	\$15,488	16,298	885	15,631	127
December 31, 2012					
With no related allowance recorded:					
Commercial & industrial	\$-	-	-	975	43
Commercial real estate	9,541	9,936	-	9,310	350
Residential real estate	417	417	-	397	5
Consumer	20	20	-	23	2
Total	\$9,978	10,373	-	10,705	400
With an allowance recorded:					
Commercial & industrial	\$264	822	159	374	-
Commercial real estate	4,258	4,360	660	4,765	171
Residential real estate	658	853	85	707	2
Consumer	-	-	-	4	-
Total	\$5,180	6,035	904	5,850	173
Total:					

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Commercial & industrial	\$264	822	159	1,349	43
Commercial real estate	13,799	14,296	660	14,075	521
Residential real estate	1,075	1,270	85	1,104	7
Consumer	20	20	-	27	2
Total	\$15,158	16,408	904	16,555	573

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## Note 4 – Loans (continued)

One residential real estate loan was modified and classified as a troubled debt restructuring in each of the three-month periods ended March 31, 2013 and 2012 with a balance of \$80,000 and \$30,000, respectively, at the date of modification.

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

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

A restructured automobile loan with a balance of \$13,000 was charged off during the first quarter 2013, which was within twelve months of the loan's modification date. There were no other troubled debt restructurings that subsequently defaulted within twelve months of the restructuring date for the three months ended March 31, 2013 and 2012.

## Note 5 – 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):

	Three Months Ended	
	March 31,	
	2013	2012
Balance, beginning of period	\$ 2,189	1,619
Additions	-	543
Addition due to merger	127	-
Reductions due to sales	(612 )	-
Reductions due to valuation write-downs	(17 )	(76 )
Balance, end of period	\$ 1,687	2,086

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## Note 5 – Other Real Estate Owned (continued)

Other real estate owned at March 31, 2013 and December 31, 2012 consisted of (dollars in thousands):

	March 31, 2013		December 31, 2012	
	Number	Amount	Number	Amount
Commercial, secured by real estate	2	\$ 1,443	2	\$ 1,875
Residential real estate	5	244	8	314
	7	\$ 1,687	10	\$ 2,189

## Note 6 – Premises and Equipment

Premises and equipment at March 31, 2013 and December 31, 2012 are summarized as follows (in thousands):

	March 31, 2013	December 31, 2012
Land	\$ 5,315	4,708
Buildings	18,467	15,616
Equipment	11,672	11,280
Construction in progress	84	-
Total	35,538	31,604
Less accumulated depreciation	15,382	15,040
Premises and equipment, net	\$ 20,156	16,564

Depreciation charged to expense was \$341,000 and \$299,000 for the three months ended March 31, 2013 and 2012, respectively.

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## Note 7 – Borrowings

Funds borrowed from the Federal Home Loan Bank of Cincinnati at March 31, 2013 and December 31, 2012 are as follows (dollars in thousands):

	Current Interest Rate		March 31, 2013	December 31, 2012
Fixed Rate Advances, due at maturity:				
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	%	1,050	1,308
Advance due March 2019	2.82	%	2,078	2,397
			\$ 13,128	13,705

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 \$179 million and \$142 million at March 31, 2013 and December 31, 2012, respectively. Additionally, LCNB is required to hold minimum levels of FHLB stock, based on the outstanding borrowings.

Short-term borrowings at March 31, 2013 and December 31, 2012 are as follows (dollars in thousands):

	March 31, 2013		December 31, 2012	
	Amount	Rate	Amount	Rate
Line of credit	\$ -	-	\$ 2,661	0.75
Repurchase agreements	11,609	0.10	11,095	0.10
	\$ 11,609	0.10	\$ 13,756	0.23

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## Note 8 – Income Taxes

A reconciliation between the statutory income tax and the Company's effective tax rate is as follows:

	For the three months ended			
	March 31,			
	2013		2012	
Statutory tax rate	34.0	%	34.0	%
Increase (decrease) resulting from -				
Tax exempt interest	(9.1	)%	(6.4	)%
Tax exempt income on bank owned life insurance	(2.6	)%	(1.6	)%
Other, net	0.7	%	0.1	%
Effective tax rate	23.0	%	26.1	%

## Note 9 - Commitments and Contingent Liabilities

LCNB is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated 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 9 - 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 March 31, 2013 and December 31, 2012 are as follows (in thousands):

	March 31, 2013	December 31, 2012
Commitments to extend credit:		
Commercial loans	\$ 15,170	13,625
Other loans:		
Fixed rate	3,039	4,602
Adjustable rate	2,340	1,238
Unused lines of credit:		
Fixed rate	3,869	3,368
Adjustable rate	63,375	45,199
Unused overdraft protection amounts on demand and NOW accounts	9,556	9,665
Standby letters of credit	5,375	5,109
	\$ 102,724	82,806

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 March 31, 2013 and December 31, 2012, outstanding guarantees of approximately \$346,000 were issued to developers and contractors. These guarantees generally are fully secured and have varying maturities. In addition, LCNB has a participation in four letters of credit securing payment of principal and interest on a bond issue. The participation amounts at March 31, 2013 and December 31, 2012 totaled approximately \$5.0 million and \$4.8 million, respectively. The letters of credit have a final maturity date of July 15, 2015, 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.

Capital expenditures include the construction or acquisition of new office buildings, improvements to LCNB's offices, purchases of furniture and equipment, and additions or improvements to LCNB's information technology system.

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## Note 9 - Commitments and Contingent Liabilities (continued)

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

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

## Note 10 – 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 capital leverage ratio supplements the risk-based capital guidelines.

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

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

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

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## Note 10 – Regulatory Capital (continued)

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

	At March 31, 2013	At December 31, 2012
Regulatory Capital:		
Shareholders' equity	\$ 94,204	82,006
Goodwill and other intangibles	(16,924)	(6,019)
Accumulated other comprehensive income	(4,000)	(4,721)
Tier 1 risk-based capital	73,280	71,266
Eligible allowance for loan losses	3,404	3,437
Total risk-based capital	\$ 76,684	74,703
Capital ratios:		
Total risk-based (8% required)	13.40%	15.86%
Tier 1 risk-based (4% required)	12.80%	15.13%
Leverage (3% required)	8.13%	8.98%

## Note 11 – Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income for the three months ended March 31, 2013 and 2012 are as follows (in thousands):

	Unrealized Gains and Losses on Available- for-Sale Securities	Changes in Pension Plan Assets and Benefit Obligations	Total
2013			
Balance at beginning of period	\$ 4,875	(154 )	4,721
Before reclassifications	(342 )	8	(334 )
Reclassifications	(387 )	-	(387 )
Balance at end of period	4,146	(146 )	4,000
2012			
Balance at beginning of period	5,180	(152 )	5,028
Before reclassifications	(505 )	7	(498 )
Reclassifications	(251 )	-	(251 )
Balance at end of period	4,424	(145 )	4,279



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## Note 11 – Accumulated Other Comprehensive Income (continued)

Reclassifications out of accumulated other comprehensive income during the three months ended March 31, 2013 and 2012 and the affected line items in the consolidated statements of income are as follows (in thousands):

	Three Months Ended March 31,	
	2013	2012
Realized gain on sale of securities	\$ 587	380
Provision for income taxes	200	129
Reclassification adjustment, net of taxes	\$ 387	251

## Note 12 – Retirement Plans

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

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

Funding and administrative costs of the qualified noncontributory defined benefit retirement plan and 401(k) plan charged to salaries and employee benefits in the consolidated statements of income for the three-month periods ended March 31, 2013 and 2012 are as follows (in thousands):

	Three Months Ended March 31,	
	2013	2012
Qualified noncontributory defined benefit retirement plan	\$ 31	142
401(k) plan	79	36

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.

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## Note 12 – Retirement Plans (continued)

The components of net periodic pension cost of the nonqualified defined benefit retirement plan for the three months ended March 31, 2013 and 2012 are summarized as follows (in thousands):

	Three Months Ended March 31,	
	2013	2012
Service cost	\$ 18	22
Interest cost	11	11
Amortization of unrecognized net (gain)/loss	6	5
Amortization of unrecognized prior service cost	7	7
Net periodic pension cost	\$ 42	45

Amounts recognized in accumulated other comprehensive income, net of deferred federal income taxes, at March 31, 2013 and December 31, 2012 for the nonqualified defined benefit retirement plan consists of (in thousands):

	December	
	March 31, 2013	31, 2012
Net actuarial loss	\$ 121	125
Past service cost	24	29
	\$ 145	154

Citizens National Bank had a qualified noncontributory defined benefit pension plan which covered employees hired before May 1, 2005. LCNB assumed this plan at the time of the merger.

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## Note 13 - 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 March 31, 2013 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	25,360	\$ 9.00	5.8	20,285	\$ 9.00	5.8
11.00 - \$ \$12.99	65,708	12.04	7.3	33,716	12.04	6.7
17.00 - \$ \$18.99	19,518	18.15	2.5	19,518	18.15	2.5
	110,586	12.42	6.1	73,519	12.82	5.3

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

	2013		2012	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding, January 1	110,586	\$ 12.42	124,123	\$ 12.54
Granted	-	-	14,491	12.60
Exercised	-	-	-	-
Outstanding, March 31	110,586	12.42	138,614	12.55
Exercisable, March 31	73,519	12.82	83,337	13.25

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 March 31, 2013 that were "in the money" (market price greater than exercise price) was \$499,000. The aggregate intrinsic value at that date for only the options that were exercisable was \$312,000. The aggregate intrinsic value for options outstanding at March 31, 2012 that were in the money was \$216,000 and the aggregate intrinsic value at that date for only the options that were exercisable was \$119,000. The intrinsic value changes based on changes in the market value of the Company's stock.

Total expense related to options included in salaries and wages in the consolidated statements of income for each of the three months ended March 31, 2013 and 2012 was \$9,000.

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## Note 14 - 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 months ended March 31, 2013 and 2012 (dollars in thousands, except share and per share data):

	For the Three Months Ended March 31,	
	2013	2012
Net income	\$1,728	2,277
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	7,513,101	6,706,295
Add dilutive effect of:		
Stock options	14,312	7,103
Stock warrant	83,213	60,053
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share	7,610,626	6,773,451
Earnings per common share:		
Basic	\$0.23	0.34
Diluted	0.23	0.34

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Note 15 - Fair Value Measurements

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

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

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

The majority of LCNB's investment securities are classified as available-for-sale. The securities are reported at fair value on a recurring basis 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, the Company has invested in two mutual funds that invest in debt securities or loans that qualify for credit under the Community Reinvestment Act. The investment in one of the mutual funds is considered to have level 1 inputs because it is publically traded in an active market and it publishes a daily net asset value. The investment in the other mutual fund is considered to have level 2 inputs because, although its shares are not traded in an active market, an investor can have its interest in the fund redeemed for the balance of its capital account at any quarter-end assuming the fund is given a 60 day notice. The investment in this fund is carried at cost and approximates fair value. A third mutual fund invests in U.S. Government securities. It is considered to have level 1 inputs because it is publically traded in an active market and it publishes a daily net asset value. Additionally, LCNB owns trust preferred securities in various financial institutions and equity securities in various financial and non-financial companies. Market quotations (level 1) are used to determine fair value for these investments.

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

Note 15 - 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 15 - Fair Value Measurements (continued)

The following table summarizes the valuation of LCNB's assets recorded at fair value by input levels as of March 31, 2013 and December 31, 2012 (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)	
March 31, 2013					
Recurring fair value measurements:					
Investment securities available-for-sale:					
U.S. Treasury notes	\$ 19,693	19,693	-	-	-
U.S. Agency notes	101,499	-	101,499	-	-
U.S. Agency mortgage-backed securities	54,156	-	54,156	-	-
Certificates of deposit with other banks	1,509	-	1,509	-	-
Municipal securities:					
Non-taxable	78,744	-	78,744	-	-
Taxable	17,592	-	17,592	-	-
Mutual funds	2,223	1,223	1,000	-	-
Trust preferred securities	148	148	-	-	-
Equity securities	1,995	1,995	-	-	-
Total recurring fair value measurements	\$ 277,559	23,059	254,500	-	-
Nonrecurring fair value measurements:					
Impaired loans	\$ 4,589	-	707	3,882	-
Other real estate owned and repossessed assets (a)	1,687	-	1,687	-	230
Total nonrecurring fair value measurements	\$ 6,276	-	2,394	3,882	230
December 31, 2012					
Recurring fair value measurement:					
Investment securities available-for-sale:					
U.S. Treasury notes	\$ 18,686	18,686	-	-	-
U.S. Agency notes	90,606	-	90,606	-	-
U.S. Agency mortgage-backed securities	52,541	-	52,541	-	-
Corporate securities	3,067	3,067	-	-	-
Municipal securities:					
Non-taxable	73,882	-	73,882	-	-

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Taxable	15,841	-	15,841	-	-
Mutual funds	2,168	1,168	1,000	-	-
Trust preferred securities	245	245	-	-	-
Equity securities	1,470	1,470	-	-	-
Total recurring fair value measurements	\$ 258,506	24,636	233,870	-	-
Nonrecurring fair value measurements:					
Impaired loans	\$ 4,276	-	161	4,115	-
Other real estate owned and repossessed assets (b)	2,189	-	2,189	-	(295 )
Total nonrecurring fair value measurements	\$ 6,465	-	2,350	4,115	(295 )

- (a) Two other real estate owned properties with a total carrying amount of \$173,000 were written down to their combined fair value of \$156,000, resulting in an impairment charge of \$17,000. Four other real estate owned properties with a total carrying amount of \$612,000 were sold for a combined total of \$857,000, resulting in a net gain of \$245,000. A repossessed asset with a carrying value of \$6,000 was sold for \$8,000, resulting in a net gain of \$2,000. The write-downs, losses, and gains were included in other non-interest expense for the period.
- (b) Eight other real estate owned properties with a total carrying amount of \$1,809,000 were written down to their combined fair value of \$1,525,000, resulting in an impairment charge of \$284,000. Another property was sold at a loss of \$8,000. 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. The write-downs and losses were 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 15 - Fair Value Measurements (continued)

Carrying amounts and estimated fair values of financial instruments as of March 31, 2013 and December 31, 2012 are as follows (in thousands):

	March 31, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and cash equivalents	28,313	28,313	13,475	13,475
Investment securities:				
Available-for-sale	277,559	277,559	258,506	258,506
Held-to-maturity	22,831	22,831	15,424	15,424
Federal Reserve Bank stock	1,106	1,106	949	949
Federal Home Loan Bank stock	2,854	2,854	2,091	2,091
Loans, net	546,263	554,993	450,346	453,060
<b>FINANCIAL LIABILITIES:</b>				
Deposits	820,870	825,318	671,471	675,964
Short-term borrowings	11,609	11,609	13,756	13,756
Long-term debt	13,128	14,066	13,705	14,724

The fair value of off-balance-sheet financial instruments at March 31, 2013 and December 31, 2012 was not material.

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

**Cash and cash equivalents**

The carrying amounts presented are deemed to approximate fair value.

**Investment securities**

Fair values for securities, excluding Federal Home Loan Bank and Federal Reserve Bank stock, are based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and/or discounted cash flow analyses. 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.



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

## Note 15 - Fair Value Measurements (continued)

## Deposits

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

## Borrowings

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

The following table summarizes the categorization by input level as of March 31, 2013 and December 31, 2012 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)
March 31, 2013				
Assets:				
Loans, net	\$ 550,404	-	550,404	-
Investment securities, non-taxable, held-to-maturity	22,831	-	-	22,831
Federal Reserve Bank stock	1,106	1,106	-	-
Federal Home Loan Bank stock	2,854	2,854	-	-
Liabilities:				
Deposits	825,318	-	825,318	-
Long-term debt	14,066	-	14,066	-
December 31, 2012				
Assets:				
Loans, net	\$ 448,784	-	448,784	-
Investment securities, non-taxable, held-to-maturity	15,424	-	-	15,424
Federal Reserve Bank stock	949	949	-	-
Federal Home Loan Bank stock	2,091	2,091	-	-
Liabilities:				
Deposits	675,964	-	675,964	-



Long-term debt	14,724	-	14,724	-
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LCNB CORP. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)  
(Continued)

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 March 31, 2013, and the related consolidated statements of income, comprehensive income, shareholders’ equity, and cash flows for the three-month periods ended March 31, 2013 and 2012. These interim financial statements are the responsibility of the Company'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, 2012, 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 25, 2013, 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, 2012, 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  
May 6, 2013

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LCNB CORP. AND SUBSIDIARIES

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

Forward Looking Statements

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

Results of Operations

Net income for the three months ended March 31, 2013 was \$1,728,000 (total basic and diluted earnings per share of \$0.23). This compares to net income of \$2,277,000 (total basic and diluted earnings per share of \$0.34) for the same three month period in 2012.

On January 11, 2013, First Capital Bancshares, Inc. ("First Capital"), a one-bank holding company located in Chillicothe, Ohio, merged into LCNB. Immediately following this merger, Citizens National Bank ("Citizens"), a wholly-owned subsidiary of First Capital, was merged into LCNB National Bank. The acquisition was accounted for using the acquisition method in accordance with applicable accounting guidance. Accordingly, assets acquired and liabilities assumed were measured at their fair values as of the date of the transaction. The excess of the estimated fair value of LCNB common shares issued and cash paid to First Capital shareholders over the net fair values of the assets acquired and liabilities assumed was recorded as goodwill, which approximated \$8.4 million. The results of operations are included in the consolidated income statement from the date of the merger. Expenses for the first quarter 2013 include expenditures totaling about \$1,055,000 for costs associated with the merger and converting Citizens' data processing system to LCNB's system.

Net interest income for the first quarter 2013 was \$569,000 greater than results for the first quarter 2012 primarily due to the increased volume of average interest earning assets provided by the merger, partially offset by a decrease in the net interest margin.

The provision for loan losses for the first quarter 2013 was \$66,000 less than for the same period in 2012. Net loan charge-offs for the first quarter 2013 and 2012 totaled \$182,000 and \$256,000, respectively. Non-accrual loans and loans past due 90 days or more and still accruing interest totaled \$3,353,000 or 0.61% of total loans at March 31, 2013, compared to \$2,411,000 or 0.53% of total loans at December 31, 2012. 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 decreased from \$2,189,000 at December 31, 2012 to \$1,687,000 at March 31, 2013 primarily due to the sale of commercial real estate property during the quarter.

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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 first quarter 2013 was \$171,000 greater than the comparable period in 2012 primarily due to increases in service charges and fees on deposit accounts primarily resulting from the merger and gains recognized on the sale of investment securities. The increases were partially offset by a decrease in trust income due to the absence of one-time fees recognized in 2012.

Non-interest expense for the first quarter 2013 was \$1,643,000 more than the comparable period in 2012 primarily due the recognition of \$1,055,000 in costs related to the merger with Citizens. Salaries and employee benefits, as well as a variety of other expense items, increased significantly due to the increased number of employees and offices resulting from the merger. These expense increases were partially offset by a gain recognized on the sale of other real estate owned property during the quarter.

## Net Interest Income

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 March 31, 2013 and 2012, 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.

	Three Months Ended March 31,							
	Average Outstanding Balance	2013 Interest Earned/ Paid	Average Yield/ Rate		Average Outstanding Balance	2012 Interest Earned/ Paid	Average Yield/ Rate	
	(Dollars in thousands)							
Loans (1)	\$536,518	6,580	4.97	%	\$461,079	6,208	5.42	%
Federal funds sold	3,115	1	0.13	%	-	-	-	%
Interest-bearing demand deposits	13,166	7	0.22	%	15,202	6	0.16	%
Federal Reserve Bank stock	1,104	-	-	%	941	-	-	%
Federal Home Loan Bank stock	2,743	31	4.58	%	2,091	24	4.62	%
Investment securities:								
Taxable	188,749	834	1.79	%	174,323	887	2.05	%
Non-taxable (2)	93,033	944	4.12	%	79,742	918	4.63	%
Total interest-earning assets	838,428	8,397	4.06	%	733,378	8,043	4.41	%
Non-earning assets	89,527				65,168			
Allowance for loan losses	(3,349 )				(2,816 )			
Total assets	\$924,606				\$795,730			
Interest-bearing deposits	\$645,950	983	0.62	%	570,980	1,165	0.82	%
Short-term borrowings	11,623	3	0.10	%	10,917	3	0.11	%
Long-term debt	13,396	112	3.39	%	21,044	154	2.94	%
Total interest-bearing liabilities	670,969	1,098	0.66	%	602,941	1,322	0.88	%
Demand deposits	153,026				106,985			

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Other liabilities	7,276			6,541			
Capital	93,335			79,263			
Total liabilities and capital	\$924,606			\$795,730			
Net interest rate spread (3)		3.40	%		3.53	%	
Net interest income and net interest margin on a tax-equivalent basis (4)		7,299	3.53	%	6,721	3.69	%
Ratio of interest-earning assets to interest-bearing liabilities	124.96	%		121.63	%		

- (1) Includes nonaccrual loans if any.
- (2) Income from tax-exempt securities is included in interest income on a tax-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 rate spread is the difference between the average rate on total interest-earning assets and interest-bearing liabilities.
- (4) The net interest margin is the tax-equivalent net interest income divided by average interest-earning assets.

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## LCNB CORP. AND SUBSIDIARIES

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

The following table presents the changes in tax-equivalent 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 March 31, 2013 as compared to the same period in 2012. 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 March 31, 2013 vs. 2012		
	Volume	Rate (In thousands)	Total
<b>Interest-earning Assets:</b>			
Loans	\$ 957	(585 )	372
Federal funds sold	1	-	1
Interest-bearing demand deposits	(1 )	2	1
Federal Reserve Bank stock	-	-	-
Federal Home Loan Bank stock	7	-	7
<b>Investment securities:</b>			
Taxable	70	(123 )	(53 )
Nontaxable	142	(116 )	26
<b>Total interest income</b>	<b>1,176</b>	<b>(822 )</b>	<b>354</b>
<b>Interest-bearing Liabilities:</b>			
Deposits	140	(322 )	(182 )
Short-term borrowings	-	-	-
Long-term debt	(62 )	20	(42 )
<b>Total interest expense</b>	<b>78</b>	<b>(302 )</b>	<b>(224 )</b>
<b>Net interest income</b>	<b>\$ 1,098</b>	<b>(520 )</b>	<b>578</b>

Net interest income on a tax-equivalent basis for the three months ended March 31, 2013 totaled \$7,299,000, an increase of \$578,000 from the comparable period in 2012. Total tax-equivalent interest income increased \$354,000 and total interest expense declined \$224,000.

The increase in total interest income was primarily due to a \$105.1 million increase in average total earning assets, partially offset by a 35 basis point (a basis point equals 0.01%) decrease in the average rate earned on earning assets. The increase in average interest earning assets was primarily due to interest-earning assets acquired through the merger with First Capital. The decrease in the average rate earned reflects a general decrease in market rates.

The decrease in total interest expense was primarily due to a 22 basis point decrease in the average rate paid on interest-bearing liabilities, partially offset by a \$68.0 million increase in average interest-bearing liabilities. The increase in average interest-bearing liabilities was primarily due to a \$75.0 million increase in average interest-bearing deposits primarily due to the merger, partially offset by a \$7.6 million decrease in average long-term debt. Long-term debt decreased because of the payment in full of a \$6.0 million Federal Home Loan Bank advance in August

2012. The decrease in the average rate paid on deposits also reflects a general decrease in market rates.

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LCNB CORP. AND SUBSIDIARIES

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

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 March 31, 2013 and 2012 was \$149,000 and \$215,000, respectively. The decrease in the provision reflects a decrease in net charge-offs coupled with relatively stable regional market conditions.

The fair value of loans acquired through the merger was estimated by discounting at current rates the cash flows expected to be received on Citizens' loan portfolio. Since the estimation of cash flows recognized the probability that LCNB would not be able to collect all contractually required principal and interest payments, Citizens' allowance for loan losses was not carried forward.

Non-Interest Income

Total non-interest income for the first quarter 2013 was \$171,000 greater than for the first quarter 2012 primarily due to a \$101,000 increase in service charges and fees on deposit accounts and a \$207,000 increase in gains from sales of securities. Service charges and fees on deposit accounts increased primarily due to a greater number of deposit accounts resulting from the merger. The results also reflect a continuing downward trend in overdraft fee income and a continuing upward trend in check card fee income. Gains from sales of securities increased due to the sale of \$22.8 million in securities in 2013, the fair values of which had benefited from the continuing decline in general market rates. Approximately \$29.6 million of securities with relatively lower unrealized gains were sold during the 2012 period. Partially offsetting these increases was a \$191,000 decrease in trust income primarily due to the absence of one-time estate fees recognized during the first quarter 2012.

Non-Interest Expense

Non-interest expense for the first quarter 2013 was \$1,643,000 greater than for the first quarter 2012 due primarily to a \$312,000 increase in salaries and employee benefits and a \$1,142,000 increase in other non-interest expense. The increase in salaries and employee benefits primarily reflects the additional staff needed to operate the six additional offices LCNB acquired as a result of the merger. Other non-interest expense for the first quarter 2013 includes \$1,055,000 in costs related to the merger and converting Citizens' data processing system to LCNB's system. Partially offsetting the merger related costs in other non-interest expense for the 2013 period was a \$274,000 decrease in net costs related to other real estate owned including a gain recognized in 2013 on the sale of commercial real estate property and a decrease in impairment write-downs.

Income Taxes

LCNB's effective tax rates for continuing operations for the three months ended March 31, 2013 and 2012 were 23.0% and 26.1%, 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 income from bank owned life insurance.



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LCNB CORP. AND SUBSIDIARIES

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

Financial Condition

The carrying values of loans, securities available-for-sale, premises and equipment, and deposits were greatly influenced by the merger. See Note 2 to the Financial Statements for a description of the merger and a summary of the fair values of First Capital's assets and liabilities added to LCNB's consolidated balance sheet.

In addition to the merger, a \$27.9 million increase in public fund deposits by local government entities was a secondary reason for the increase in total deposits. Public fund deposits can be relatively volatile due to seasonal tax collections and the financial needs of the local entities.

Common stock in the shareholders' equity section of the consolidated balance sheet at March 31, 2013 was \$12.4 million greater than the balance shown for December 31, 2012 due to the merger. LCNB issued 888,811 shares of stock, valued at \$12.4 million on the date of the merger, and paid approximately \$7.8 million in cash to effect the merger.

Liquidity

LCNB depends on dividends from its subsidiary 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, interest-bearing deposits in other banks, and securities available for sale. At March 31, 2013, LCNB's liquid assets amounted to \$305.9 million or 32.3% of total assets. Liquid assets at December 31, 2012 totaled \$272.0 million, or 34.5% of total assets.

Liquidity is also provided by access to core funding sources, primarily core deposits in the bank's market area. Approximately 82.5% of total deposits at March 31, 2013 were core deposits, compared to 83.6% of deposits at December 31, 2012. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit equal to or greater than \$100,000. The percentage of core deposits to total deposits decreased because of the growth in public fund deposits discussed above in relation to total growth in deposits.

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

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

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## LCNB CORP. AND SUBSIDIARIES

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

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

The Bank's Asset and Liability Management Committee ("ALCO") primarily uses a combination of Interest Rate Sensitivity Analysis ("IRSA") and Economic Value of Equity ("EVE") analysis for measuring and managing interest rate risk. IRSA is used to estimate the effect on net interest income during a one-year period of instantaneous and sustained movements in interest rates, also called interest rate shocks, of 100, 200, and 300 basis points. Management considers the results of any significant downward scenarios to not be meaningful in the current interest rate environment. The base projection uses a current interest rate scenario. As shown below, the March 31, 2013 IRSA indicates that an increase in interest rates at all shock levels would have a positive effect on net interest income ("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	\$ 31,527	2,051	6.96	%
Up 200	30,820	1,344	4.56	%
Up 100	30,134	658	2.23	%
Base	29,476	-	-	%

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 March 31, 2013 EVE analysis indicates that an increase in interest rates would have a negative effect on the EVE. The changes in the EVE for all rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in Basis Points	Amount	\$ Change in EVE (Dollars in thousands)	% Change in EVE	
Up 300	\$ 90,504	(8,258 )	(8.36	)%
Up 200	92,756	(6,006 )	(6.08	)%
Up 100	95,579	(3,183 )	(3.22	)%
Base	98,762	-	-	%

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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 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 March 31, 2013, 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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LCNB CORP. AND SUBSIDIARIES

PART II -- OTHER INFORMATION

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

2	Agreement and Plan of Merger dated as of October 9, 2012 by and between LCNB Corp. and First Capital Bancshares, Inc. – incorporated by reference to the Registrant’s Form 8-K filed on October 9, 2012, Exhibit 2.1.
3.1	Amended and Restated Articles of Incorporation of LCNB Corp., as amended – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2010, Exhibit 3.1.
3.2	Code of Regulations of LCNB Corp. – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, Exhibit 3(ii).
10.1	LCNB Corp. Ownership Incentive Plan – incorporated by reference to Registrant’s Form DEF 14A Proxy Statement pursuant to Section 14(a), dated March 15, 2002, Exhibit A (000-26121).
10.2	Form of Option Grant Agreement under the LCNB Corp. Ownership Incentive Plan – incorporated by reference to the Registrant’s Form 10-K for the fiscal year ended December 31, 2005, Exhibit 10.2.
10.3	Nonqualified Executive Retirement Plan – incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q for the period ended June 30, 2009, Exhibit 10.4.
<u>31.1</u>	Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31.2</u>	Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32</u>	Certification of Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from LCNB Corp.’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 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.

May 6, 2013

/s/ Stephen P. Wilson  
Stephen P. Wilson, CEO &  
Chairman of the Board of Directors

May 6, 2013

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