LCNB CORP
Form 10-Q
November 08, 2016

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

FORM 10-Q

(Mark One)
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
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 001-35292
LCNB Corp.
(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
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, 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 November 7, 2016 was 9,983,332 shares.

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LCNB CORP. AND SUBSIDIARIES

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
(Dollars in thousands, except per share data)

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS:		
Cash and due from banks	$ 17,059	14,155
Interest-bearing demand deposits	16,154	832
Total cash and cash equivalents	33,213	14,987
Investment securities:		
Available-for-sale, at fair value	346,391	377,978
Held-to-maturity, at cost	42,037	22,633
Federal Reserve Bank stock, at cost	2,732	2,732
Federal Home Loan Bank stock, at cost	3,638	3,638
Loans, net	807,864	767,809
Premises and equipment, net	26,347	22,100
Goodwill	30,183	30,183
Core deposit and other intangibles	4,777	5,396
Bank owned life insurance	27,114	22,561
Other assets	9,240	10,514
TOTAL ASSETS	$ 1,333,536	1,280,531
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 259,043	250,306
Interest-bearing	899,878	836,854
Total deposits	1,158,921	1,087,160
Short-term borrowings	16,989	37,387
Long-term debt	662	5,947
Accrued interest and other liabilities	10,058	9,929
TOTAL LIABILITIES	1,186,630	1,140,423
COMMITMENTS AND CONTINGENT LIABILITIES	—	—
SHAREHOLDERS' EQUITY:		
Preferred shares – no par value, authorized 1,000,000 shares, none outstanding	—	—
Common shares – no par value; authorized 19,000,000 and 12,000,000 shares at September 30, 2016 and December 31, 2015, respectively; issued 10,747,322 and 10,679,174 shares at September 30, 2016 and December 31, 2015, respectively	76,367	76,908
Retained earnings	78,682	74,629
Treasury shares at cost, 753,627 shares at September 30, 2016 and December 31, 2015	(11,665)	(11,665)

Accumulated other comprehensive income, net of taxes	3,522	236
TOTAL SHAREHOLDERS' EQUITY	146,906	140,108
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 1,333,536	1,280,531

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

The consolidated condensed balance sheet as of December 31, 2015 has been derived from the audited consolidated balance sheet as of that day.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME:				
Interest and fees on loans	$8,876	8,540	26,395	26,572
Interest on investment securities:				
Taxable	1,152	1,094	3,528	2,983
Non-taxable	813	732	2,365	2,087
Other investments	54	43	236	205
TOTAL INTEREST INCOME	10,895	10,409	32,524	31,847
INTEREST EXPENSE:				
Interest on deposits	872	834	2,565	2,187
Interest on short-term borrowings	8	5	30	13
Interest on long-term debt	5	73	22	222
TOTAL INTEREST EXPENSE	885	912	2,617	2,422
NET INTEREST INCOME	10,010	9,497	29,907	29,425
PROVISION FOR LOAN LOSSES	372	240	858	986
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	9,638	9,257	29,049	28,439
NON-INTEREST INCOME:				
Trust income	871	754	2,471	2,406
Service charges and fees on deposit accounts	1,276	1,314	3,712	3,655
Net gain on sales of securities	307	—	957	332
Bank owned life insurance income	193	156	553	470
Gains from sales of loans	73	34	175	288
Other operating income	126	128	370	372
TOTAL NON-INTEREST INCOME	2,846	2,386	8,238	7,523
NON-INTEREST EXPENSE:				
Salaries and employee benefits	4,642	4,340	13,737	13,011
Equipment expenses	279	324	767	914
Occupancy expense, net	550	570	1,707	1,749
State franchise tax	279	251	836	753
Marketing	162	176	530	559
Amortization of intangibles	189	189	564	510
FDIC insurance premiums	168	136	495	432
Other real estate owned	222	188	607	243
Merger-related expenses	—	49	—	641
Other non-interest expense	2,102	1,865	6,110	5,351
TOTAL NON-INTEREST EXPENSE	8,593	8,088	25,353	24,163
INCOME BEFORE INCOME TAXES	3,891	3,555	11,934	11,799
PROVISION FOR INCOME TAXES	995	922	3,106	3,209
NET INCOME	$2,896	2,633	8,828	8,590

Dividends declared per common share	$0.16	0.16	0.48	0.48
Earnings per common share:				
Basic	$0.29	0.26	0.89	0.89
Diluted	0.29	0.26	0.88	0.88
Weighted average common shares outstanding:				
Basic	$9,962,571	9,898,233	9,930,182	9,637,344
Diluted	9,977,592	10,005,788	9,974,319	9,742,839

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$2,896	2,633	8,828	8,590
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities (net of taxes of $357 and $1,015 for the three months ended September 30, 2016 and 2015, respectively, and $1,975 and $940 for the nine months ended September 30, 2016 and 2015, respectively.)	(691)	1,972	3,835	1,825
Reclassification adjustment for net realized (gain) loss on sale of available-for-sale securities included in net income (net of taxes of $104 and $- for the three months ended September 30, 2016 and 2015, respectively, and $325 and $113 for the nine months ended September 30, 2016 and 2015, respectively)	(203)	—	(632)	(219)
Change in nonqualified pension plan unrecognized net loss and unrecognized prior service cost (net of taxes of $15 and $15 for the three months ended September 30, 2016 and 2015, respectively, and $43 and $44 for the nine months ended September 30, 2016 and 2015, respectively)	27	28	83	84
Other comprehensive income (loss), net of tax	(867)	2,000	3,286	1,690
TOTAL COMPREHENSIVE INCOME	$2,029	4,633	12,114	10,280

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

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LCNB CORP. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF SHAREHOLDERS' EQUITY
(Dollars in thousands, except per share amounts)
(Unaudited)

	Common Shares Outstanding	Common Stock	Retained Earnings	Treasury Shares	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance at December 31, 2014	9,311,318	$67,181	69,394	(11,665)	785	125,695
Net income			8,590			8,590
Other comprehensive income, net of taxes					1,690	1,690
Dividend Reinvestment and Stock Purchase Plan	18,395	289				289
Acquisition of BNB Bancorp, Inc	560,132	9,063				9,063
Exercise of stock options	13,449	152				152
Excess tax benefit on exercise of stock options		13				13
Compensation expense relating to stock options		13				13
Common stock dividends, $0.48 per share			(4,654)			(4,654)
Balance at September 30, 2015	9,903,294	$76,711	73,330	(11,665)	2,475	140,851
Balance at December 31, 2015	9,925,547	$76,908	74,629	(11,665)	236	140,108
Net income			8,828			8,828
Other comprehensive income, net of taxes					3,286	3,286
Dividend Reinvestment and Stock Purchase Plan	16,758	282				282
Repurchase of stock warrants		(1,545)				(1,545)
Exercise of stock options	51,390	592				592
Excess tax benefit on exercise of stock options		58				58
Compensation expense relating to stock options		4				4
Compensation expense relating to restricted stock		68				68
Common stock dividends, $0.48 per share			(4,775)			(4,775)
Balance at September 30, 2016	9,993,695	$76,367	78,682	(11,665)	3,522	146,906

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

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

	Nine Months Ended September 30, 2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$8,828	8,590
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization, and accretion	2,672	2,108
Provision for loan losses	858	986
Increase in cash surrender value of bank owned life insurance	(553)	(470)
Realized gain from sales of securities available-for-sale	(957)	(332)
Realized loss from sales of premises and equipment	35	(1)
Realized loss from sales and write-downs of other real estate owned and repossessed assets	537	146
Origination of mortgage loans for sale	(7,853)	(5,237)
Realized gains from sales of loans	(175)	(288)
Proceeds from sales of mortgage loans	7,955	5,291
Penalty for prepayment of long-term debt	251	—
Compensation expense related to stock options	4	13
Compensation expense related to restricted stock	68	—
Changes in:		
Accrued income receivable	(1,208)	(1,103)
Other assets	1,494	(1,789)
Other liabilities	(1,025)	776
TOTAL ADJUSTMENTS	2,103	100
NET CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES	10,931	8,690
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sales of investment securities available-for-sale	62,252	54,955
Proceeds from maturities and calls of investment securities:		
Available-for-sale	41,157	19,658
Held-to-maturity	5,306	1,574
Purchases of investment securities:		
Available-for-sale	(67,139)	(89,961)
Held-to-maturity	(24,710)	(3,413)
Proceeds from sale of impaired loans	—	4,559
Net increase in loans	(40,908)	(34,281)
Purchase of bank owned life insurance	(4,000)	—
Proceeds from sale of other real estate owned and repossessed assets	253	114
Additions to other real estate owned	(182)	(20)
Purchases of premises and equipment	(5,234)	(444)
Proceeds from sale of premises and equipment	61	22
Net cash acquired from acquisition	—	8,993
NET CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES	(33,144)	(38,244)
CASH FLOWS FROM FINANCING ACTIVITIES:		

Net increase in deposits	71,761	58,175
Net decrease in short-term borrowings	(20,398)	(1,714)
Principal payments on long-term debt	(5,285)	(5,341)
Penalty for prepayment of long-term debt	(251)	—
Proceeds from issuance of common stock	38	46
Repurchase of stock warrants	(1,545)	—
Proceeds and excess tax benefit from exercise of stock options	650	165
Cash dividends paid on common stock	(4,531)	(4,411)
NET CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES	40,439	46,920
NET CHANGE IN CASH AND CASH EQUIVALENTS	18,226	17,366
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	14,987	15,845
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$33,213	33,211
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$2,680	2,490
Income taxes paid	3,330	3,470
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:		
Transfer from loans to other real estate owned and repossessed assets	32	79

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

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

Note 1 - Basis of Presentation

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

The unaudited interim consolidated condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations. In the opinion of management, the unaudited interim consolidated financial statements include all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation of financial position, results of operations, and cash flows for the interim periods, as required by Regulation S-X, Rule 10-01.

The consolidated condensed balance sheet as of December 31, 2015 has been derived from the audited consolidated balance sheet as of that day.

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

LCNB adopted ASU No. 2015-07, "Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)" during the first quarter of 2016. ASU No. 2015-07 applies to entities that measure an investment's fair value using the net asset value per share, or an equivalent, as a practical expedient. It eliminates the requirement to classify such investments within the fair value hierarchy. The amendments are to be applied retrospectively to all periods presented. LCNB measures the fair value of certain mutual fund investments using the net asset value per share practical expedient and disclosures concerning these investments in Note 15 - Fair Value Measurements have been changed to comply with the new guidance. Adoption did not have an impact on LCNB's results of operations or financial position.

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, 2016 are not necessarily indicative of the results to be expected for the full year ending December 31, 2016. 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 2015 Annual Report on Form 10-K filed with the SEC.

Note 2 – Acquisitions

On December 29, 2014, LCNB and BNB Bancorp, Inc. (“BNB”) entered into an Agreement and Plan of Merger (“Merger Agreement”) pursuant to which BNB was acquired by LCNB on April 30, 2015. Immediately following the merger of BNB into LCNB, Brookville National Bank ("Brookville"), a wholly-owned subsidiary of BNB, was merged into LCNB National Bank. Brookville operated a main office and a branch office, both in Brookville, Ohio. These offices became branches of the Bank after the merger.

Under the terms of the Merger Agreement, the shareholders of BNB common stock received, for each share of BNB common stock, (i) $15.75 in cash and (ii) 2.005 LCNB common shares.

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

Note 2 – Acquisitions (continued)

The merger with BNB 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	$ 9,063
Cash paid to shareholders	4,403
Total consideration paid	13,466
Identifiable Assets Acquired:	
Cash and cash equivalents	13,396
Investment securities	58,239
Federal Reserve Bank stock	130
Loans	34,661
Premises and equipment	2,311
Core deposit intangible	1,418
Other assets	532
Total identifiable assets acquired	110,687
Liabilities Assumed:	
Deposits	99,133
Deferred income taxes	576
Other liabilities	57
Total liabilities assumed	99,766
Total Identifiable Net Assets Acquired	10,921
Goodwill resulting from merger	$ 2,545

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 represent the excess purchase price over the estimated fair value of the net assets acquired. The goodwill will not be amortizable on LCNB's financial records, but is deductible for tax purposes. The core deposit intangible is being amortized over nine years using the straight-line method.

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

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Note 3 - Investment Securities

The amortized cost and estimated fair value of investment securities at September 30, 2016 and December 31, 2015 are summarized as follows (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2016				
Available-for-Sale:				
U.S. Treasury notes	$ 44,892	1,019	—	45,911
U.S. Agency notes	107,819	1,174	30	108,963
U.S. Agency mortgage-backed securities	49,753	606	37	50,322
Municipal securities:				
Non-taxable	115,493	2,227	44	117,676
Taxable	19,673	599	2	20,270
Mutual funds	2,517	2	11	2,508
Trust preferred securities	49	—	—	49
Equity securities	632	67	7	692
	$ 340,828	$ 5,694	131	346,391
Held-to-Maturity:				
Municipal securities:				
Non-taxable	31,965	821	23	32,763
Taxable	10,072	44	—	10,116
	$ 42,037	865	23	42,879
December 31, 2015				
Available-for-Sale:				
U.S. Treasury notes	$ 72,672	309	135	72,846
U.S. Agency notes	140,876	164	1,151	139,889
U.S. Agency mortgage-backed securities	29,608	174	404	29,378
Certificates of deposit	248	1	—	249
Municipal securities:				
Non-taxable	103,900	1,713	134	105,479
Taxable	26,738	337	134	26,941
Mutual funds	2,517	—	51	2,466
Trust preferred securities	49	1	—	50
Equity securities	659	40	19	680
	$ 377,267	2,739	2,028	377,978
Held-to-Maturity:				
Municipal securities:				
Non-taxable	22,233	95	97	22,231

Taxable	400	—	1	399
	$ 22,633	95	98	22,630

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

Note 3 - Investment Securities (continued)

Information concerning investment securities with gross unrealized losses at September 30, 2016 and December 31, 2015, aggregated by length of time that individual securities have been in a continuous loss position, is as follows (dollars in thousands):

	Less than Twelve Months		Twelve Months or Greater	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2016				
Available-for-Sale:				
U.S. Treasury notes	$4,008	—	$—	—
U.S. Agency notes	11,891	30	—	—
U.S. Agency mortgage-backed securities	5,164	11	3,761	26
Municipal securities:				
Non-taxable	6,926	41	1,602	3
Taxable	501	—	450	2
Mutual funds	—	—	272	11
Trust preferred securities	49	—	—	—
Equity securities	81	7	—	—
	$28,620	89	$6,085	42
Held-to-Maturity:				
Municipal securities:				
Non-taxable	$—	—	2,641	23
Taxable	—	—	—	—
	$—	—	$2,641	23
December 31, 2015				
Available-for-Sale:				
U.S. Treasury notes	$32,854	75	$4,846	60
U.S. Agency notes	104,053	1,000	9,869	151
U.S. Agency mortgage-backed securities	19,190	256	4,068	148
Municipal securities:				
Non-taxable	13,124	74	7,037	60
Taxable	15,601	114	880	20
Mutual funds	1,215	17	268	34
Trust preferred securities	—	—	—	—
Equity securities	248	12	73	7
	$186,285	1,548	$27,041	480
Held-to-Maturity:				
Municipal securities:				
Non-taxable	$832	3	$3,426	94

Taxable	399	1	—	—
	$1,231	4	$3,426	94

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

Note 3 - Investment Securities (continued)

Management has determined that the unrealized losses at September 30, 2016 are primarily due to fluctuations in market interest rates and do not reflect credit quality deterioration of the securities. Because LCNB does not have the intent to sell the investments and it is more likely than not that LCNB will not be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, LCNB does not consider these investments to be other-than-temporarily impaired.

Contractual maturities of investment securities at September 30, 2016 were as follows (in thousands). Actual maturities may differ from contractual maturities when issuers have the right to call or prepay obligations.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	$27,119	27,161	3,640	3,643
Due from one to five years	120,742	122,761	4,154	4,159
Due from five to ten years	135,686	138,587	11,073	11,297
Due after ten years	4,330	4,311	23,170	23,780
	287,877	292,820	42,037	42,879
U.S. Agency mortgage-backed securities	49,753	50,322	—	—
Mutual funds	2,517	2,508	—	—
Trust preferred securities	49	49	—	—
Equity securities	632	692	—	—
	$340,828	346,391	42,037	42,879

Investment securities with a market value of $195,448,000 and $215,952,000 at September 30, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for other purposes required as permitted by law.

Certain information concerning the sale of investment securities available-for-sale for the three and nine months ended September 30, 2016 and 2015 was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Proceeds from sales	$ 25,723	—	$62,252	54,955
Gross realized gains	307	—	978	345
Gross realized losses	—	—	21	13

Realized gains or losses from the sale of securities are computed using the specific identification method.

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LCNB CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)
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Note 4 - Loans

Major classifications of loans at September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016	December 31, 2015
Commercial and industrial	$ 40,097	45,275
Commercial, secured by real estate	467,512	419,633
Residential real estate	268,574	273,139
Consumer	18,752	18,510
Agricultural	15,872	13,479
Other loans, including deposit overdrafts	619	665
	811,426	770,701
Deferred net origination costs (fees)	236	237
	811,662	770,938
Less allowance for loan losses	3,798	3,129
Loans, net	$ 807,864	767,809

All advances from the Federal Home Loan Bank ("FHLB") of Cincinnati are secured by a blanket pledge of LCNB's 1-4 family first lien mortgage loans in the amount of approximately $228 million and $231 million at September 30, 2016 and December 31, 2015, respectively. Additionally, LCNB is required to hold minimum levels of FHLB stock, based on the outstanding borrowings.

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

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

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Note 4 – Loans (continued)

Non-accrual, past-due, and accruing restructured loans as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016	December 31, 2015
Non-accrual loans:		
Commercial and industrial	$ 182	—
Commercial, secured by real estate	2,744	876
Residential real estate	1,309	799
Consumer	—	—
Agricultural	384	48
Total non-accrual loans	4,619	1,723
Past-due 90 days or more and still accruing	20	559
Total non-accrual and past-due 90 days or more and still accruing	4,639	2,282
Accruing restructured loans	13,598	13,723
Total	$ 18,237	16,005

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Note 4 – Loans (continued)

The allowance for loan losses for the three and nine months ended September 30, 2016 and 2015 are as follows (in thousands):

	Commercial & Industrial	Commercial, Secured by Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
Three Months Ended September 30, 2016							
Allowance for loan losses:							
Balance, beginning of period	$ 273	2,071	885	80	62	2	3,373
Provision charged to expenses	162	193	(46)	36	6	21	372
Losses charged off	—	(19)	(21)	(30)	—	(33)	(103)
Recoveries	12	80	43	9	—	12	156
Balance, end of period	$ 447	2,325	861	95	68	2	3,798
Nine Months Ended September 30, 2016							
Allowance for loan losses:							
Balance, beginning of year	$ 244	1,908	854	54	66	3	3,129
Provision charged to expenses	236	478	19	85	2	38	858
Losses charged off	(49)	(159)	(63)	(83)	—	(75)	(429)
Recoveries	16	98	51	39	—	36	240
Balance, end of period	$ 447	2,325	861	95	68	2	3,798
Three Months Ended September 30, 2015							
Allowance for loan losses:							
Balance, beginning of period	$ 162	1,655	914	62	83	3	2,879
Provision charged to expenses	167	97	(60)	14	9	13	240
Losses charged off	(89)	(29)	(46)	(20)	—	(26)	(210)
Recoveries	3	—	23	12	—	11	49
Balance, end of period	$ 243	1,723	831	68	92	1	2,958
Nine Months Ended September 30, 2015							
Allowance for loan losses:							
Balance, beginning of year	$ 129	1,990	926	63	11	2	3,121
Provision charged to expenses	209	612	57	1	81	26	986
Losses charged off	(100)	(975)	(243)	(49)	(67)	(52)	(1,486)
Recoveries	5	96	91	53	67	25	337
Balance, end of period	$ 243	1,723	831	68	92	1	2,958

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Note 4 – Loans (continued)

A breakdown of the allowance for loan losses and the loan portfolio by loan segment at September 30, 2016 and December 31, 2015 are as follows (in thousands):

	Commercial & Industrial	Commercial, Secured by Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
September 30, 2016							
Allowance for loan losses:							
Individually evaluated for impairment	$ 171	183	96	14	—	—	464
Collectively evaluated for impairment	276	1,846	765	81	68	2	3,038
Acquired credit impaired loans	—	296	—	—	—	—	296
Balance, end of period	$ 447	2,325	861	95	68	2	3,798
Loans:							
Individually evaluated for impairment	$ 527	12,736	1,675	57	384	—	15,379
Collectively evaluated for impairment	38,260	448,252	264,726	18,767	15,495	130	785,630
Acquired credit impaired loans	1,325	6,181	2,640	18	—	489	10,653
Balance, end of period	$ 40,112	467,169	269,041	18,842	15,879	619	811,662
December 31, 2015							
Allowance for loan losses:							
Individually evaluated for impairment	$ 9	306	48	—	—	—	363
Collectively evaluated for impairment	235	1,602	806	54	66	3	2,766
Acquired credit impaired loans	—	—	—	—	—	—	—
Balance, end of period	$ 244	1,908	854	54	66	3	3,129
Loans:							
Individually evaluated for impairment	$ 370	12,351	1,541	56	—	—	14,318
Collectively evaluated for impairment	43,726	399,092	269,001	18,516	13,438	179	743,952
Acquired credit impaired loans	1,191	7,877	3,039	27	48	486	12,668
Balance, end of period	$ 45,287	419,320	273,581	18,599	13,486	665	770,938

Note 4 – Loans (continued)

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

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

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

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

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

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

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

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

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

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

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Note 4 – Loans (continued)

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

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

A breakdown of the loan portfolio by credit quality indicators at September 30, 2016 and December 31, 2015 is as follows (in thousands):

	Pass	OAEM	Substandard	Doubtful	Total
September 30, 2016					
Commercial & industrial	$39,237	318	557	—	40,112
Commercial, secured by real estate	438,732	1,400	27,037	—	467,169
Residential real estate	263,583	518	4,940	—	269,041
Consumer	18,779	—	63	—	18,842
Agricultural	14,331	—	1,548	—	15,879
Other	619	—	—	—	619
Total	$775,281	2,236	34,145	—	811,662
December 31, 2015					
Commercial & industrial	$44,596	—	691	—	45,287
Commercial, secured by real estate	397,938	9,316	12,066	—	419,320
Residential real estate	267,567	1,935	4,079	—	273,581
Consumer	18,528	—	71	—	18,599
Agricultural	12,246	850	390	—	13,486
Other	665	—	—	—	665
Total	$741,540	12,101	17,297	—	770,938

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Note 4 – Loans (continued)

A loan portfolio aging analysis at September 30, 2016 and December 31, 2015 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
September 30, 2016							
Commercial & industrial	$—	—	—	—	40,112	40,112	—
Commercial, secured by real estate	266	1,217	278	1,761	465,408	467,169	—
Residential real estate	587	109	1,086	1,782	267,259	269,041	19
Consumer	50	4	1	55	18,787	18,842	1
Agricultural	—	—	—	—	15,879	15,879	—
Other	65	—	—	65	554	619	—
Total	$968	1,330	1,365	3,663	807,999	811,662	20
December 31, 2015							
Commercial & industrial	$—	—	—	—	45,287	45,287	—
Commercial, secured by real estate	73	81	876	1,030	418,290	419,320	—
Residential real estate	777	198	1,124	2,099	271,482	273,581	516
Consumer	62	7	43	112	18,487	18,599	43
Agricultural	—	—	—	—	13,486	13,486	—
Other	109	—	—	109	556	665	—
Total	$1,021	286	2,043	3,350	767,588	770,938	559

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Note 4 – Loans (continued)

Impaired loans, including acquired credit impaired loans, at September 30, 2016 and December 31, 2015 are as follows (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2016			
With no related allowance recorded:			
Commercial & industrial	$ 1,337	1,599	—
Commercial, secured by real estate	15,289	16,629	—
Residential real estate	3,624	4,784	—
Consumer	28	36	—
Agricultural	384	384	—
Other	489	665	—
Total	$ 21,151	24,097	—
With an allowance recorded:			
Commercial & industrial	$ 515	515	171
Commercial, secured by real estate	3,628	3,999	479
Residential real estate	691	762	96
Consumer	47	47	14
Agricultural	—	—	—
Other	—	—	—
Total	$ 4,881	5,323	760
Total:			
Commercial & industrial	$ 1,852	2,114	171
Commercial, secured by real estate	18,917	20,628	479
Residential real estate	4,315	5,546	96
Consumer	75	83	14
Agricultural	384	384	—
Other	489	665	—
Total	$ 26,032	29,420	760
December 31, 2015			
With no related allowance recorded:			
Commercial & industrial	$ 1,205	1,500	—
Commercial, secured by real estate	16,345	18,335	—
Residential real estate	3,734	5,055	—
Consumer	81	109	—
Agricultural	48	151	—
Other	486	701	—
Total	$ 21,899	25,851	—

With an allowance recorded:			
Commercial & industrial	$ 356	356	9
Commercial, secured by real estate	3,883	4,014	306
Residential real estate	846	958	48
Consumer	2	1	—
Agricultural	—	—	—
Other	—	—	—
Total	$ 5,087	5,329	363
Total:			
Commercial & industrial	$ 1,561	1,856	9
Commercial, secured by real estate	20,228	22,349	306
Residential real estate	4,580	6,013	48
Consumer	83	110	—
Agricultural	48	151	—
Other	486	701	—
Total	$ 26,986	31,180	363

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Note 4 – Loans (continued)

The following presents information related to the average recorded investment and interest income recognized on impaired loans, including acquired credit impaired loans, for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	2016		2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three Months Ended September 30,				
With no related allowance recorded:				
Commercial & industrial	$1,356	34	1,609	34
Commercial, secured by real estate	15,594	236	18,841	270
Residential real estate	3,769	113	4,164	124
Consumer	29	7	110	7
Agricultural	384	—	110	11
Other	480	18	516	19
Total	$21,612	408	25,350	465
With an allowance recorded:				
Commercial & industrial	$476	5	382	6
Commercial, secured by real estate	3,383	41	3,994	29
Residential real estate	695	8	808	10
Consumer	45	1	—	—
Agricultural	—	—	—	—
Other	—	—	—	—
Total	$4,599	55	5,184	45
Total:				
Commercial & industrial	$1,832	39	1,991	40
Commercial, secured by real estate	18,977	277	22,835	299
Residential real estate	4,464	121	4,972	134
Consumer	74	8	110	7
Agricultural	384	—	110	11
Other	480	18	516	19
Total	$26,211	463	30,534	510
Nine Months Ended September 30,				
With no related allowance recorded:				
Commercial & industrial	$1,167	89	1,437	175
Commercial, secured by real estate	16,654	897	19,941	1,901
Residential real estate	3,809	306	4,295	364
Consumer	41	22	119	15
Agricultural	403	135	107	479

Other	488	58	515	58
Total	$22,562	1,507	26,414	2,992
With an allowance recorded:				
Commercial & industrial	$400	15	389	17
Commercial, secured by real estate	2,960	82	3,977	85
Residential real estate	680	24	825	29
Consumer	43	2	—	—
Agricultural	—	—	—	—
Other	—	—	—	—
Total	$4,083	123	5,191	131
Total:				
Commercial & industrial	$1,567	104	1,826	192
Commercial, secured by real estate	19,614	979	23,918	1,986
Residential real estate	4,489	330	5,120	393
Consumer	84	24	119	15
Agricultural	403	135	107	479
Other	488	58	515	58
Total	$26,645	1,630	31,605	3,123

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Note 4 – Loans (continued)

Of the interest income recognized on impaired loans during the nine months ended September 30, 2016 and 2015, approximately $48,000 and $96,000, respectively, were recognized on a cash basis.

Loan modifications that were classified as troubled debt restructurings during the three and nine months ended September 30, 2016 and 2015 are as follows (dollars in thousands):

	2016			2015		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Three Months Ended September 30,						
Commercial & industrial	—	$ —	—	—	$ —	—
Commercial, secured by real estate	1	304	304	—	—	—
Residential real estate	1	27	27	—	—	—
Consumer	1	11	11	1	2	2
Total	3	$ 342	342	1	$ 2	2
Nine Months Ended September 30,						
Commercial & industrial	—	$ —	—	1	$ 72	74
Commercial, secured by real estate	2	$ 603	676	—	—	—
Residential real estate	3	72	72	4	137	137
Consumer	3	38	38	1	2	2
Total	8	$ 713	786	6	$ 211	213

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

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

There were no troubled debt restructurings that subsequently defaulted within twelve months of the restructuring date for the nine months ended September 30, 2016 and 2015 and that remained in default at period end.

Note 5 - Acquired Credit Impaired Loans

The following table provides at September 30, 2016 and December 31, 2015 the major classifications of acquired credit impaired loans that are accounted for in accordance with FASB ASC 310-30 (in thousands):

	September 30, 2016	December 31, 2015
Commercial & industrial	$ 1,325	1,191
Commercial, secured by real estate	6,181	7,877
Residential real estate	2,640	3,039
Consumer	18	27
Agricultural	—	48
Other loans, including deposit overdrafts	489	486
	10,653	12,668
Less allowance for loan losses	296	—
Loans, net	$ 10,357	12,668

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

	September 30, 2016	December 31, 2015
Outstanding balance	$ 13,851	16,507
Carrying amount	10,357	12,668

Activity during the nine months ended September 30, 2016 and 2015 for the accretable discount related to acquired credit impaired loans is as follows (in thousands):

	2016	2015
Accretable discount at beginning of year	$ 1,503	2,674
Accretable discount acquired during period	—	413
Reclass from nonaccretable discount to accretable discount	338	957
Less disposals	(3)	(850)
Less accretion	(579)	(1,540)
Accretable discount at end of period	$ 1,259	1,654

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Note 6 – Other Real Estate Owned

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

	Nine Months Ended September 30, 2016	2015
Balance, beginning of year	$846	1,370
Additions	214	99
Reductions due to sales	(214)	(105)
Reductions due to valuation write downs	(576)	(156)
Balance, end of period	$270	1,208

Other real estate owned at September 30, 2016 and December 31, 2015 consisted of (dollars in thousands):

	September 30, 2016	December 31, 2015
Commercial real estate	$ 270	$ 846
Residential real estate	—	—
	$ 270	$ 846

The total recorded investment in residential consumer mortgage loans secured by residential real estate that was in the process of foreclosure at September 30, 2016 was $509,000.

Note 7 - Affordable Housing Tax Credit Limited Partnership

LCNB is a limited partner in a limited partnership that sponsors affordable housing projects utilizing the Low Income Housing Tax Credit (LIHTC) pursuant to Section 42 of the Internal Revenue Code. The purpose of this investment is to achieve a satisfactory return on capital, to facilitate the sale of additional affordable housing product offerings, and to assist in achieving goals associated with the Community Reinvestment Act. The primary activities of the limited partnership include the identification, development, and operation of multi-family housing that is leased to qualifying residential tenants.

The following table presents the balances of LCNB's affordable housing tax credit investment and related unfunded commitment at September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Affordable housing tax credit investment	$ 1,000	1,000
Less amortization	74	12

Net affordable housing tax credit investment	$	926	988
Unfunded commitment	$	838	907

LCNB expects to fund the unfunded commitment over 9.25 years.

LCNB CORP. AND SUBSIDIARIES
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Note 7 – Affordable Housing Tax Credit Limited Partnership (continued)

The following table presents other information relating to LCNB's affordable housing tax credit investment for the periods indicated (in thousands):

	Nine Months ended September 30,	
	2016	2015
Tax credits and other tax benefits recognized	$ 83	—
Tax credit amortization expense included in provision for income taxes	62	—

Note 8 – Short-Term Borrowings

Short-term borrowings at September 30, 2016 and December 31, 2015 are as follows (dollars in thousands):

	September 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
Line of credit	$—	— %	$13,187	1.00%
FHLB short-term advance	—	— %	10,000	0.35%
Repurchase agreements	16,989	0.10%	14,200	0.10%
	$16,989	0.10%	$37,387	0.48%

Repurchase agreements are an option customers may use in managing their cash positions and mature the next business day after issuance. Repurchase agreements at September 30, 2016 and December 31, 2015 were fully secured by U.S. Agency notes and such collateral securities were held by the Federal Reserve Bank.

Note 9 – Income Taxes

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Statutory tax rate	34.2 %	34.0 %	34.2 %	34.0 %
Increase (decrease) resulting from:				
Tax exempt interest	(7.0)%	(6.8)%	(6.6)%	(5.9)%
Tax exempt income on bank owned life insurance	(1.7)%	(1.5)%	(1.6)%	(1.4)%
Other, net	0.1 %	0.2 %	— %	0.5 %
Effective tax rate	25.6 %	25.9 %	26.0 %	27.2 %

Note 10 - Commitments and Contingent Liabilities

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

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Note 10 – Commitments and Contingent Liabilities (continued)

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

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

Financial instruments whose contract amounts represent off-balance-sheet credit risk at September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016	December 31, 2015
Commitments to extend credit:		
Commercial loans	$ 9,344	8,160
Other loans		
Fixed rate	8,126	2,293
Adjustable rate	1,908	1,362
Unused lines of credit:		
Fixed rate	6,430	6,378
Adjustable rate	89,843	90,153
Unused overdraft protection amounts on demand and NOW accounts	17,372	10,057
Standby letters of credit	357	457
	$ 133,380	118,860

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

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

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

Capital expenditures include the construction or acquisition of new office buildings, improvements to LCNB's offices, purchases of furniture and equipment, and additions or improvements to LCNB's information technology system. Commitments outstanding for capital expenditures as of September 30, 2016 totaled approximately $7,390,000, which includes estimated remaining costs for construction of a new Operations Center in Lebanon, Ohio.

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

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Note 11 – Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income for the nine months ended September 30, 2016 and 2015 are as follows (in thousands):

	Unrealized Gains and Losses on Available-for-Sale Securities	Changes in Pension Plan Assets and Benefit Obligations	Total
September 30, 2016			
Balance at beginning of period	$ 469	(233)	236
Before reclassifications	3,835	83	3,918
Reclassifications	(632)	—	(632)
Balance at end of period	$ 3,672	(150)	3,522
September 30, 2015			
Balance at beginning of period	$ 1,126	(341)	785
Before reclassifications	1,823	86	1,909
Reclassifications	(219)	—	(219)
Balance at end of period	$ 2,730	(255)	2,475

Reclassifications out of accumulated other comprehensive income during the three and nine months ended September 30, 2016 and 2015 and the affected line items in the consolidated condensed statements of income are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Affected Line Item in the Consolidated Condensed Statements of Income
	2016	2015	2016	2015	
Realized gain on sale of securities	$ 307	—	$ 957	332	Net gain on sales of securities
Less provision for income taxes	104	—	325	113	Provision for income taxes
Reclassification adjustment, net of taxes	$ 203	—	$ 632	219	

Note 12 – Retirement Plans

LCNB participates in a noncontributory defined benefit multi-employer retirement plan that covers substantially all regular full-time employees hired before January 1, 2009. Employees hired before this date who received a benefit reduction under certain amendments to the defined benefit retirement plan receive an automatic contribution of 5% or

7% of their annual compensation, depending on the sum of an employee's age and vesting service, into their defined contribution plans (401(k) plans), regardless of the contributions made by the employees. These contributions are made annually and these employees do not receive any employer matches to their 401(k) contributions.

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.

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Note 12 – Retirement Plans (continued)

Funding and administrative costs of the qualified noncontributory defined benefit retirement plan and 401(k) plan charged to pension and other employee benefits in the consolidated condensed statements of income for the three and nine-month periods ended September 30, 2016 and 2015 are as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Qualified noncontributory defined benefit retirement plan	$ 272	220	$ 712	763
401(k) plan	81	86	241	263

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

The components of net periodic pension cost of the nonqualified defined benefit retirement plan for the three and nine months ended September 30, 2016 and 2015 are summarized as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Service cost	$ 10	10	$ 30	29
Interest cost	20	17	58	51
Amortization of unrecognized net loss	42	43	126	128
Net periodic pension cost	$ 72	70	$ 214	208

Amounts recognized in accumulated other comprehensive income, net of tax, at September 30, 2016 and December 31, 2015 for the nonqualified defined benefit retirement plan consists of (in thousands):

	September 30, 2016	December 31, 2015
Net actuarial loss	$ 150	233

Note 13 - Stock Based Compensation

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

The 2015 Ownership Incentive Plan (the "2015 Plan") was ratified by LCNB's shareholders at the annual meeting on April 28, 2015 and allows for stock-based awards to eligible employees, as determined by the Compensation Committee of the Board of Directors. Awards may be made in the form of stock options, appreciation rights, restricted shares, and/or restricted share units. The 2015 Plan provides for the issuance of up to 450,000 shares. The 2015 Plan will terminate on April 28, 2025 and is subject to earlier termination by the Compensation Committee.

Stock-based awards may be in the form of treasury shares or new shares.

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Note 13 – Stock Based Compensation (continued)

LCNB has not granted stock option awards since 2012. Options granted to date under the 2002 Plan vest ratably over a five-year period and expire ten years after the date of grant. Stock options outstanding at September 30, 2016 were as follows:

	Outstanding Stock Options			Exercisable Stock Options		
Exercise Price Range	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
$9.00 - $10.99	4,356	$ 9.00	2.3	4,356	$ 9.00	2.3
$11.00 - $12.99	17,797	12.13	4.1	16,052	12.08	3.9
$17.00 - $18.99	2,516	17.88	0.3	2,516	17.88	0.3
	24,669	12.17	3.4	22,924	12.13	3.2

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

	2016		2015	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding, January 1,	83,861	$ 12.39	99,810	$ 12.16
Granted	—	—	—	—
Exercised	(51,390)	11.53	(13,449)	11.31
Expired	(7,802)	18.76	(2,500)	9.00
Outstanding, September 30,	24,669	12.17	83,861	12.39
Exercisable, September 30,	22,924	12.13	75,072	12.40

The aggregate intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) for options outstanding at September 30, 2016 that were "in the money" (market price greater than exercise price) was $149,000. The aggregate intrinsic value at that date for only the options that were exercisable was $140,000. The aggregate intrinsic value for options outstanding at September 30, 2015 that were in the money was $348,000 and the aggregate intrinsic value at that date for only the options that were exercisable was $313,000. The intrinsic value changes based upon fluctuations in the market value of LCNB's common stock.

Total expense related to options included in salaries and employee benefits for the three and nine months ended September 30, 2016 was $2,000 and $4,000, respectively. The related tax benefit for the three and nine months ended September 30, 2016 was $0 and $1,000, respectively. Total expense related to options included in salaries and employee benefits for the three and nine months ended September 30, 2015 was $3,000 and $13,000, respectively. The related tax benefit for the three and nine months ended September 30, 2015 was $1,000 and $4,000, respectively. Unrecognized compensation cost related to option awards to be recognized through the first quarter of 2017 is approximately $2,000.

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Note 13 – Stock Based Compensation (continued)

Restricted stock awards granted under the 2015 Plan were as follows:

	2016		2015	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding, January 1,	16,038	$ 15.47	—	$ —
Granted	—	—	—	—
Vested	(5,255)	15.47	—	—
Forfeited	—	—	—	—
Outstanding, September 30,	10,783	$ 15.47	—	$ —

Total expense related to restricted stock awards included in salaries and wages in the consolidated condensed statements of income for the three and nine months ended September 30, 2016 was $23,000 and $68,000, respectively. The related tax benefit for the three and nine months end September 30, 2016 was $8,000 and $23,000, respectively. Unrecognized compensation expense for restricted stock awards was $90,000 at September 30, 2016 and is expected to be recognized over a period of 4.25 years.

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, warrants, and restricted stock. The diluted average number of common shares outstanding has been increased for the assumed exercise of stock options and warrants with proceeds used to purchase treasury shares at the average market price for the period. The computations are as follows for the three and nine months ended September 30, 2016 and 2015 (dollars in thousands, except share and per share data):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$2,896	2,633	$8,828	8,590
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	9,962,571	9,898,233	9,930,182	9,637,344
Add dilutive effect of:				
Stock options	10,052	16,219	15,360	17,199
Stock warrants	—	91,336	22,093	88,296
Restricted shares	4,969	—	6,684	—
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share	9,977,592	10,005,788	9,974,319	9,742,839
Earnings per common share:				

Basic	$0.29	0.26	$0.89	0.89
Diluted	0.29	0.26	0.88	0.88

Options to purchase 2,516 and 12,962 shares of common stock at a weighted average price of $17.88 and $18.41 per share were outstanding at September 30, 2016 and 2015, respectively, but were not included in the computation of diluted earnings per common share because the exercise prices of the options were greater than the average market price of the common shares.

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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 from the sale of an asset in an orderly transaction between market participants at the measurement date.

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

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

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

LCNB utilizes a pricing service for determining the fair values of most of its investment securities. Fair value for U.S. Treasury notes are determined based on market quotations (level 1). Fair value for most of the other investment securities is calculated using the discounted cash flow method for each security. The discount rates for these cash flows are estimated by the pricing service using rates observed in the market (level 2). Cash flow streams are dependent on estimated prepayment speeds and the overall structure of the securities given existing market conditions. In addition, LCNB has invested in trust preferred securities, equity securities, and three mutual funds that are not priced by the pricing service. Market quotations (level 1) are used to determine fair values for the trust preferred securities, equity securities, and a publicly traded mutual fund. Investments in two mutual funds that are measured at fair value using net asset values ("NAV") per share as a practical expedient are not required to be classified in the fair value hierarchy. These funds can be redeemed at any time at their current NAVs. An investment in a mutual fund that is not traded in an active market is considered to have level 2 inputs because an investor can have its interest in the fund redeemed for the balance of its capital account at any quarter-end assuming the fund is given a 60 day notice. The investment in this fund is carried at fair value, which approximates cost.

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. 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.

These inputs are also considered to be level 3.

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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 September 30, 2016 and December 31, 2015 (in thousands):

		Fair Value Measurements at the End of the Reporting Period Using		
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2016				
Recurring fair value measurements:				
Investment securities available-for-sale:				
U.S. Treasury notes	$ 45,911	45,911	—	—
U.S. Agency notes	108,963	—	108,963	—
U.S. Agency mortgage-backed securities	50,322	—	50,322	—
Certificates of deposit with other banks	—	—	—	—
Municipal securities:				
Non-taxable	117,676	—	117,676	—
Taxable	20,270	—	20,270	—
Mutual funds	1,000	—	1,000	—
Mutual funds measured at net asset value (a)	1,508			
Trust preferred securities	49	49	—	—
Equity securities	692	692	—	—
Total recurring fair value measurements	$ 346,391	46,652	298,231	—
Nonrecurring fair value measurements:				
Impaired loans	$ 4,121	—	—	4,121
Other real estate owned and repossessed assets	270	—	—	270
Total nonrecurring fair value measurements	$ 4,391	—	—	4,391
December 31, 2015				
Recurring fair value measurements:				
Investment securities available-for-sale:				
U.S. Treasury notes	$ 72,846	72,846	—	—
U.S. Agency notes	139,889	—	139,889	—
U.S. Agency mortgage-backed securities	29,378	—	29,378	—
Certificates of deposit with other banks	249	—	249	—

Municipal securities:				
Non-taxable	105,479	—	105,479	—
Taxable	26,941	—	26,941	—
Mutual funds	1,018	18	1,000	—
Mutual funds measured at net asset value (a)	1,448			
Trust preferred securities	50	50	—	—
Equity securities	680	680	—	—
Total recurring fair value measurements	$ 377,978	73,594	302,936	—
Nonrecurring fair value measurements:				
Impaired loans	$ 4,722	—	—	4,722
Other real estate owned and repossessed assets	846	—	—	846
Total nonrecurring fair value measurements	$ 5,568	—	—	5,568

(a) In accordance with Subtopic 820-10, certain investments that are measured at fair value using the net asset value per share practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the Consolidated Condensed Balance Sheets.

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Note 15 - Fair Value Measurements (continued)

The following table presents quantitative information about unobservable inputs used in nonrecurring level 3 fair value measurements at September 30, 2016 and December 31, 2015 (dollars in thousands):

	Fair Value	Valuation Technique	Unobservable Inputs	Range High	Range Low	Weighted Average
September 30, 2016						
Impaired loans	$4,121	Estimated sales price	Adjustments for comparable properties, discounts to reflect current market conditions	Not applicable		
		Discounted cash flows	Discount rate	8.25 %	4.45 %	5.48 %
Other real estate owned	270	Estimated sales price	Adjustments for comparable properties, discounts to reflect current market conditions	Not applicable		
December 31, 2015						
Impaired loans	$4,722	Estimated sales price	Adjustments for comparable properties, discounts to reflect current market conditions	Not applicable		
		Discounted cash flows	Discount rate	11.00 %	4.00 %	5.27 %
Other real estate owned	846	Estimated sales price	Adjustments for comparable properties, discounts to reflect current market conditions	Not applicable		

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Note 15 - Fair Value Measurements (continued)

Carrying amounts and estimated fair values of financial instruments as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

			Fair Value Measurements at the End of the Reporting Period Using		
	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2016					
FINANCIAL ASSETS:					
Cash and cash equivalents	$33,213	33,213	33,213	—	—
Investment securities, held-to-maturity	42,037	42,879	—	—	42,879
Federal Reserve Bank stock	2,732	2,732	2,732	—	—
Federal Home Loan Bank stock	3,638	3,638	3,638	—	—
Loans, net	807,864	800,499	—	—	800,499
Accrued interest receivable	4,449	4,449	—	4,449	—
FINANCIAL LIABILITIES:					
Deposits	1,158,921	1,161,419	940,294	221,125	—
Short-term borrowings	16,989	16,989	16,989	—	—
Long-term debt	662	681	—	681	—
Accrued interest payable	282	282	—	282	—
December 31, 2015					
FINANCIAL ASSETS:					
Cash and cash equivalents	$14,987	14,987	14,987	—	—
Investment securities, held-to-maturity	22,633	22,630	—	—	22,630
Federal Reserve Bank stock	2,732	2,732	2,732	—	—
Federal Home Loan Bank stock	3,638	3,638	3,638	—	—
Loans, net	767,809	761,388	—	—	761,388
Accrued interest receivable	3,380	3,380	—	3,380	—
FINANCIAL LIABILITIES:					
Deposits	1,087,160	1,087,914	869,940	217,974	—
Short-term borrowings	37,387	37,387	37,387	—	—
Long-term debt	5,947	6,290	—	6,290	—

Accrued interest payable	345	345	—	345	—

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Note 15 - Fair Value Measurements (continued)

The fair values of off-balance-sheet financial instruments such as loan commitments and letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements. The fair values of such instruments were not material at September 30, 2016 and December 31, 2015.

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, held-to-maturity
Fair values for investment securities, held-to-maturity are based on quoted market prices for similar securities and/or discounted cash flow analysis or other methods.

Federal Home Loan Bank stock and Federal Reserve Bank stock
The carrying value of Federal Home Loan Bank and Federal Reserve Bank stock approximates fair value based on the respective redemptive provisions.

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

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

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

Accrued interest receivable and Accrued interest payable
Carrying amount approximates fair value.

Note 16 – Recent Accounting Pronouncements

From time to time the FASB issues an Accounting Standards Update ("ASU") to communicate changes to Generally Accepted Accounting Principles. The following information provides brief summaries of newly issued but not yet effective ASUs that could have an effect on LCNB’s financial position or results of operations:

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Note 16 – Recent Accounting Pronouncements (continued)

ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)"
ASU No. 2014-09 was issued in May 2014 and supersedes most current revenue recognition guidance for contracts to transfer goods or services or other nonfinancial assets. Lease contracts, insurance contracts, and most financial instruments are not included in the scope of this update. ASU No. 2014-09 provides that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance enumerates five steps that entities should follow in achieving this core principle. Additional disclosures providing information about contracts with customers are required.

Guidance in ASU No. 2014-09 has been clarified by the following ASUs:
- ASU No. 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)"
- ASU No. 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing"
- ASU No. 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow Scope Improvements and Practical Expedients"

As extended by ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date," ASU No. 2014-09 and the clarifying ASUs are effective for public companies for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Transitional guidance is included in the updates. Earlier adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. Since LCNB's products are substantially financial in nature, adoption of ASU No. 2014-09 and the clarifying ASUs are not expected to have a material impact on LCNB's results of operations or financial position.

ASU No. 2014-15, "Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern"
ASU No. 2014-15 was issued in August 2014 and requires management to evaluate for each annual and interim reporting period whether it is probable that the entity will not be able to meet its obligations as they become due within one year after the date that financial statements are issued (or are available to be issued, where applicable). Certain disclosures, as described in the update, are required if management identifies substantial doubt about the entity's ability to continue as a going concern. ASU No. 2014-15 will take effect in the annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016. Early application is permitted. Adoption of ASU No. 2014-15 is not expected to have a material impact on LCNB's results of operations or financial position.

ASU No. 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities"
ASU No. 2016-01 was issued in January 2016 and applies to all entities that hold financial assets or owe financial liabilities. It makes targeted changes to generally accepted accounting principles for public companies as follows:
1. Requires most equity investments to be measured at fair value with changes in fair value recognized in net income.
2. Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an

entity is required to measure the investment at fair value.

3. Eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.
4. Requires use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
5. Requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
6. Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.
7. Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

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Note 16 – Recent Accounting Pronouncements (continued)

For public business entities, the new guidance is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2017. Adoption of ASU No. 2016-01 is not expected to have a material impact on LCNB's results of operations or financial position.

ASU No. 2016-02, "Leases (Topic 842)"
ASU No. 2016-02 was issued in February 2016 and requires a lessee to recognize in the statement of financial position a liability to make lease payments ("the lease liability") and a right-of-use asset representing its right to use the underlying asset for the lease term, initially measured at the present value of the lease payments. When measuring assets and liabilities arising from a lease, the lessee should include payments to be made in optional periods only if the lessee is reasonably certain, as defined, to exercise an option to the lease or not to exercise an option to terminate the lease. Optional payments to purchase the underlying asset should be included if the lessee is reasonably certain it will exercise the purchase option. Most variable lease payments should be excluded except for those that depend on an index or a rate or are in substance fixed payments.

A lessee shall classify a lease as a finance lease if it meets any of five listed criteria:
1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
3. The lease term is for the major part of the remaining economic life of the underlying asset.
4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.
5. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

For finance leases, a lessee shall recognize in the statement of comprehensive income interest on the lease liability separately from amortization of the right-of-use asset. Amortization of the right-of-use asset shall be on a straight-line basis, unless another basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset’s future economic benefits. If the lease does not meet any of the five criteria, the lessee shall classify it as an operating lease and shall recognize a single lease cost on a straight-line basis over the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

The amendments in this update are to be applied using a modified retrospective approach, as defined, and are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018. Early application is permitted. LCNB management is currently evaluating the financial statement impact of adopting the new guidance.

ASU No. 2016-05, "Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (a consensus of the Emerging Issues Task Force)"
ASU No. 2016-05 was issued in March 2016 and applies to reporting entities for which there is a change in a counterparty to a derivative instrument that has been designated a hedging instrument under Topic 815, "Derivatives and Hedging." The amendments in this update clarify that a change in a counterparty to such a derivative instrument

does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria under applicable guidance continue to be met. The amendments in ASU No. 2016-05 are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. LCNB does not currently have any investments in derivative instruments that have been designated as hedging instruments and adoption of ASU No. 2016-05 is not expected to have an impact on LCNB's results of operations or financial position.

Note 16 – Recent Accounting Pronouncements (continued)

ASU No. 2016-06 , "Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments (a consensus of the Emerging Issues Task Force)"
ASU No. 2016-06 was issued in March 2016 and clarifies what steps are required when assessing whether the economic characteristics and risks of call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to the economic characteristics and risks of their debt hosts, which is one of the criteria for bifurcating an embedded derivative. An entity performing the assessment under the amendments in this update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The four-step decision sequence requires an entity to consider whether (1) the payoff is adjusted based on changes in an index, (2) the payoff is indexed to an underlying other than interest rates or credit risk, (3) the debt involves a substantial premium or discount, and (4) the call (put) option is contingently exercisable. The amendments in ASU No. 2016-06 are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. LCNB does not currently have any investments in debt instruments containing such call (put) options and adoption of ASU No. 2016-06 is not expected to have an impact on LCNB's results of operations or financial position.

ASU No. 2016-09, "Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting"
ASU No. 2016-09 was issued in March 2016 and affects all entities that issue share-based payment awards to their employees. The new guidance involves several aspects of the accounting for share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Under ASU No. 2016-09, any excess tax benefits or tax deficiencies should be recognized as income tax expense or benefit in the income statement. Excess tax benefits are to be classified as an operating activity in the statement of cash flows. In accruing compensation cost, an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest, as required under current guidance, or account for forfeitures when they occur. For an award to qualify for equity classification, an entity cannot partially settle the award in excess of the employer's maximum statutory withholding requirements. Such cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity in the statement of cash flows. The amendments in ASU No. 2016-09 are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. Adoption of ASU No. 2016-07 is not expected to have a material impact on LCNB's results of operations or financial position.

ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments"
ASU No. 2016-13 was issued in June 2016 and, once effective, will significantly change current guidance for recognizing impairment of financial instruments. Current guidance requires an "incurred loss" methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. ASU No. 2016-13 replaces the incurred loss impairment methodology with a new methodology that reflects expected credit losses over the lives of the loans and requires consideration of a broader range of information to inform credit loss estimates. The ASU requires an organization to estimate all expected credit losses for financial assets measured at amortized cost, including loans and held-to-maturity debt securities, based on historical experience, current conditions, and reasonable and supportable forecasts. Additional disclosures are required.

ASU No. 2016-13 also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. Under the new guidance, entities will determine whether all or a portion of the unrealized loss on an available-for-sale debt security is a credit loss. Any credit loss will be recognized as an allowance for credit losses on available-for-sale debt securities rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. As a result, entities will recognize improvements to estimated credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time, as currently required.

ASU No. 2016-13 eliminates the current accounting model for purchased credit impaired loans and debt securities. Instead, purchased financial assets with credit deterioration will be recorded gross of estimated credit losses as of the date of acquisition and the estimated credit losses amounts will be added to the allowance for credit losses. Thereafter, entities will account for additional impairment of such purchased assets using the models listed above.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)
(Continued)

Note 16 – Recent Accounting Pronouncements (continued)

ASU No. 2016-13 will take effect for U.S. Securities and Exchange Commission (SEC) filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. LCNB management is currently evaluating the financial statement impact of adopting the new guidance.

ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Paymnents"
ASU No. 2016-15 was issued in August 2016 and applies to all entities required to present a statement of cash flows in their financial reports. The guidance in this ASU addresses eight cash flow classification issues that have been creating diversity in practice. One of the issues is the classification of cash payments for debt prepayment or debt extinguishment costs, which are to be classified as cash outflows from financing activities under the new guidance. LCNB incurred a prepayment penalty during January 2016 upon the early payment in full of a FHLB advance and classified such penalty as a cash outflow from operating activities in its consolidated condensed statements of cash flows. Management early adopted ASU No. 2016-15 during the third quarter 2016 and reclassified the penalty as a cash outflow from financing activities.

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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 statements made in this document regarding LCNB's financial condition, results of operations, plans, objectives, future performance and business, are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. These forward-looking statements are identified by the fact they are not historical facts and include words such as "anticipate", "could", "may", "feel", "expect", "believe", "plan", and similar express

These forward-looking statements reflect management's current expectations based on all information available to management and its knowledge of LCNB's business and operations. Additionally, LCNB's financial condition, results of operations, plans, objectives, future performance and business are subject to risks and uncertainties that may cause actual results to differ materially. These factors include, but are not limited to:

1. the success, impact, and timing of the implementation of LCNB's business strategies;
2. LCNB may incur increased charge-offs in the future;
3. LCNB may face competitive loss of customers;
4. changes in the interest rate environment may have results on LCNB's operations materially different from those anticipated by LCNB's market risk management functions;
5. changes in general economic conditions and increased competition could adversely affect LCNB's operating results;
6. changes in other regulations and government policies affecting bank holding companies and their subsidiaries, including changes in monetary policies, could negatively impact LCNB's operating results;
7. LCNB may experience difficulties growing loan and deposit balances;
8. the current economic environment poses significant challenges for us and could adversely affect our financial condition and results of operations;
9. deterioration in the financial condition of the U.S. banking system may impact the valuations of investments LCNB has made in the securities of other financial institutions resulting in either actual losses or other than temporary impairments on such investments; and
10. the effects of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the regulations promulgated and to be promulgated thereunder, which may subject LCNB and its subsidiaries to a variety of new and more stringent legal and regulatory requirements which adversely affect their respective businesses.

Forward-looking statements made herein reflect management's expectations as of the date such statements are made. Such information is provided to assist shareholders and potential investors in understanding current and anticipated financial operations of LCNB and is included pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. LCNB undertakes no obligation to update any forward-looking statement to reflect events or circumstances that arise after the date such statements are made.

Critical Accounting Policies

Allowance for Loan Losses. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collection of the principal is unlikely. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb inherent losses in the loan portfolio, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

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

The allowance consists of specific and general components. The specific component relates to loans that are classified as doubtful, substandard, or special mention. For such loans an allowance is established when the discounted cash flows or collateral value is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors, which include trends in underperforming loans, trends in the volume and terms of loans, economic trends and conditions, concentrations of credit, trends in the quality of loans, and borrower financial statement exceptions.

Based on its evaluations, management believes that the allowance for loan losses will be adequate to absorb estimated losses inherent in the current loan portfolio.

Acquired Credit Impaired Loans. LCNB accounts for acquisitions using the acquisition method of accounting, which requires that assets acquired and liabilities assumed be measured at their fair values at the acquisition date. Acquired loans are reviewed to determine if there is evidence of deterioration in credit quality since inception and if it is probable that LCNB will be unable to collect all amounts due under the contractual loan agreements. The analysis includes expected prepayments and estimated cash flows including principal and interest payments at the date of acquisition. The amount in excess of the estimated future cash flows is not accreted into earnings. The amount in excess of the estimated future cash flows over the book value of the loan is accreted into interest income over the remaining life of the loan (accretable yield). LCNB records these loans on the acquisition date at their net realizable value. Thus, an allowance for estimated future losses is not established on the acquisition date. Subsequent to the date of acquisition, expected future cash flows on loans acquired are updated and any losses or reductions in estimated cash flows which arise subsequent to the date of acquisition are reflected as a charge through the provision for loan losses. An increase in the expected cash flows adjusts the level of the accretable yield recognized on a prospective basis over the remaining life of the loan. Due to the number, size, and complexity of loans within the acquired loan portfolio, there is always a possibility of inherent undetected losses.

Accounting for Intangibles. LCNB's intangible assets at September 30, 2016 are composed primarily of goodwill and core deposit intangibles related to acquisitions of other financial institutions. It also includes mortgage servicing rights recorded from sales of mortgage loans to the Federal Home Loan Mortgage Corporation and mortgage servicing rights acquired through the acquisition of Eaton National Bank & Trust Co. Goodwill is not subject to amortization, but is reviewed annually for impairment. Core deposit intangibles are being amortized on a straight line basis over their respective estimated weighted average lives. Mortgage servicing rights are capitalized by allocating the total cost of loans between mortgage servicing rights and the loans based on their estimated fair values. Capitalized mortgage servicing rights are amortized to loan servicing income in proportion to and over the period of estimated servicing income, subject to periodic review for impairment.

Results of Operations

Net income for the three and nine months ended September 30, 2016 was $2,896,000 (total basic and diluted earnings per share of $0.29) and $8,828,000 (total basic and diluted earnings per share of $0.89 and $0.88), respectively. This compares to net income of $2,633,000 (total basic and diluted earnings per share of $0.26) and $8,590,000 (total basic and diluted earnings per share of $0.89 and $0.88, respectively) for the same three- and nine-month periods in 2015. Results for the first nine months of 2016 were significantly affected by the acquisition of BNB Bancorp, Inc. ("BNB") on April 30, 2015. In addition, LCNB sold impaired loans with a carrying value of approximately $4.5 million during the second quarter of 2015, resulting in a net gain from sale of loans of $181,000.

Net income for the nine months ended September 30, 2016 included several one-time charges. The first of which was a $251,000 penalty incurred during the first quarter for the early payoff of a now high-rate Federal Home Loan Bank ("FHLB") borrowing, which will decrease future interest expense. The second was write-downs totaling $576,000 recognized during the second and third quarters for a commercial other real estate owned property.

Organic loan growth during the nine-month period in 2016 was $40.7 million, which significantly contributed to increases in net interest income of $513,000 and $482,000 for the three and nine months ended September 30, 2016, respectively, as compared to the same periods in 2015.

The provision for loan losses for the three months ended September 30, 2016 was $132,000 greater than the comparable period in 2015. The provision for the nine-month period of 2016 was $128,000 less than the comparable period in 2015. Net loan charge-offs for the nine months ended September 30, 2016 and 2015 totaled $189,000 and $1,149,000, respectively. The 2015 balance includes charge-offs recognized as a result of the impaired loan sale mentioned above.

Non-accrual loans and loans past due 90 days or more and still accruing interest increased $2,357,000, from $2,282,000 or 0.30% of total loans at December 31, 2015, to $4,639,000 or 0.57% of total loans at September 30, 2016, primarily due to two loans to the same borrower totaling $1,307,000 that were newly classified as non-accrual during the first quarter 2016 and two loans to the same borrower totaling $1,217,000 that were newly classified as non-accrual during the third quarter 2016. These four loans were classified as impaired at September 30, 2016 and reviewed to determine if specific allowance for loan loss allocations were needed.

Loans with a credit quality indicator of substandard increased $16,848,000, from $17,297,000 at December 31, 2015 to $34,145,000 at September 30, 2016. Commercial, secured by real estate loans classified as substandard at September 30, 2016 included seven loans totaling $12,276,000 that were not classified as substandard at December 31, 2015.

Other real estate owned (which includes property acquired through foreclosure or deed-in-lieu of foreclosure) decreased from $846,000 at December 31, 2015 to $270,000 at September 30, 2016 due to write-downs totaling $576,000 recognized on commercial property.

Non-interest income for the three and nine months ended September 30, 2016 was $460,000 and $715,000 greater than the comparable periods in 2015, respectively, primarily due to increases in gains from sales of investment securities, reflecting a higher volume of securities sales.

Non-interest expense for the three and nine months ended September 30, 2016 was $505,000 and $1,190,000 greater than the comparable periods in 2015, respectively. The increase for the quarter was largely due to increases in salaries and employee benefits. The increase for the nine-month period was primarily due to increases in salaries and employee benefits, increases in other real estate owned expenses, and a $251,000 penalty for the early payoff of a $5 million FHLB advance recognized during the first quarter 2016. The FHLB advance had an interest rate of 5.25% and was paid off to reduce interest expense on long-term debt. Salaries and employee benefits increased primarily due to salary and wage increases, employees retained from the BNB acquisition, and an increase in the number of employees in addition to the acquisition. Other real estate owned expenses increased primarily due to the $576,000 of write-downs recognized during the second and third quarters of 2016 as discussed previously. These increases were partially offset by the absence of merger-related expenses during the 2016 period.

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LCNB CORP. AND SUBSIDIARIES

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

Net Interest Income

Three Months Ended September 30, 2016 vs. 2015

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, 2016 and 2015, 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,					
	2016			2015		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
			(Dollars in thousands)			
Loans (1)	$800,729	8,876	4.41%	$760,159	8,540	4.46 %
Federal funds sold	—	—	— %	—	—	— %
Interest-bearing demand deposits	14,883	18	0.48%	15,257	7	0.18 %
Federal Reserve Bank stock	2,732	—	— %	2,476	—	— %
Federal Home Loan Bank stock	3,638	36	3.94%	3,638	36	3.93 %
Investment securities:						
Taxable	245,863	1,152	1.86%	259,090	1,094	1.68 %
Non-taxable (2)	144,387	1,236	3.41%	120,149	1,109	3.66 %
Total earnings assets	1,212,232	11,318	3.71%	1,160,769	10,786	3.69 %
Non-earning assets	114,682			109,287		
Allowance for loan losses	(3,382)			(2,885)		
Total assets	$1,323,532			$1,267,171		
Savings deposits	$668,007	167	0.10%	$637,331	143	0.09 %
IRA and time certificates	217,125	705	1.29%	225,506	691	1.22 %
Short-term borrowings	16,328	8	0.19%	13,450	5	0.15 %
Long-term debt	684	5	2.91%	6,040	73	4.80 %
Total interest-bearing liabilities	902,144	885	0.39%	882,327	912	0.41 %
Demand deposits	262,849			236,893		
Other liabilities	11,168			8,919		
Capital	147,371			139,032		
Total liabilities and capital	$1,323,532			$1,267,171		
Net interest rate spread (3)			3.32%			3.28 %
Net interest income and net interest margin on a taxable-equivalent basis (4)		10,433	3.42%		9,874	3.37 %
Ratio of interest-earning assets to interest-bearing liabilities	134.37 %			131.56 %		

(1)Includes non-accrual loans, if any.

(2)Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax rate of 34.2% for 2016 and 34.0% for 2015.

(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, 2016 as compared to the same period in 2015. 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, 2016 vs. 2015 Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning Assets:			
Loans	$451	(115)	336
Federal funds sold	—	—	—
Interest-bearing demand deposits	—	11	11
Federal Reserve Bank stock	—	—	—
Federal Home Loan Bank stock	—	—	—
Investment securities:			
Taxable	(58)	116	58
Non-taxable	212	(85)	127
Total interest income	605	(73)	532
Interest-bearing Liabilities:			
Savings deposits	7	17	24
IRA and time certificates	(26)	40	14
Short-term borrowings	1	2	3
Long-term debt	(47)	(21)	(68)
Total interest expense	(65)	38	(27)
Net interest income	$670	(111)	559

Net interest income on a fully tax-equivalent basis for the three months ended September 30, 2016 totaled $10,433,000, an increase of $559,000 over the comparable period in 2015. Total interest income increased $532,000 and total interest expense decreased $27,000.

The increase in total interest income was due primarily to a $51.5 million increase in average total earning assets. Average loans increased $40.6 million and average non-taxable investment securities increased $24.2 million, partially offset by a $13.2 million decrease in taxable investment securities. Slightly offsetting this net increase was a 5 basis point (a basis point equals 0.01%) decrease in the average rate earned on loans and a 25 basis point decrease in the average rate earned on non-taxable investment securities, partially offset by an 18 basis point increase in the average rate earned on taxable investment securities.

The decrease in total interest expense was due primarily to a $5.4 million decrease in average long-term debt and a 189 basis point decrease in the average rate paid on average long-term debt. Both decreases were due to the early payment in full during January 2016 of a $5.0 million FHLB advance bearing an interest rate of 5.25%. The advance was paid off to reduce future interest expense. These decreases were partially offset by increases in the average rates paid on savings deposits and IRA and time certificates.

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Nine months ended September 30, 2016 vs. 2015

The following table presents, for the nine months ended September 30, 2016 and 2015, 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.

	Nine Months Ended September 30,					
	2016			2015		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
			(Dollars in thousands)			
Loans (1)	$785,807	26,395	4.49%	$732,600	26,572	4.85 %
Federal funds sold	—	—	— %	604	1	0.22 %
Interest-bearing demand deposits	12,632	45	0.48%	12,756	21	0.22 %
Federal Reserve Bank stock	2,732	82	4.01%	2,421	74	4.09 %
Federal Home Loan Bank stock	3,638	109	4.00%	3,638	109	4.01 %
Investment securities:						
Taxable	250,354	3,528	1.88%	236,412	2,983	1.69 %
Non-taxable (2)	137,417	3,594	3.49%	110,920	3,162	3.81 %
Total earnings assets	1,192,580	33,753	3.78%	1,099,351	32,922	4.00 %
Non-earning assets	112,246			108,431		
Allowance for loan losses	(3,206)			(2,873)		
Total assets	$1,301,620			$1,204,909		
Savings deposits	$655,999	499	0.10%	$599,371	397	0.09 %
IRA and time certificates	217,329	2,066	1.27%	219,720	1,790	1.09 %
Short-term borrowings	17,128	30	0.23%	13,358	13	0.13 %
Long-term debt	895	22	3.28%	6,247	222	4.75 %
Total interest-bearing liabilities	891,351	2,617	0.39%	838,696	2,422	0.39 %
Demand deposits	255,314			223,788		
Other liabilities	10,277			8,169		
Capital	144,678			134,256		
Total liabilities and capital	$1,301,620			$1,204,909		
Net interest rate spread (3)			3.39%			3.61 %
Net interest income and net interest margin on a taxable-equivalent basis (4)		31,136	3.49%		30,500	3.71 %
Ratio of interest-earning assets to interest-bearing liabilities	133.79 %			131.08 %		

(1)Includes non-accrual loans, if any.

(2)Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax of 34.2% for 2016 and 34.0% for

2015.

(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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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, 2016 as compared to the same period in 2015. 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.

	Nine Months Ended September 30, 2016 vs. 2015 Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
Interest-earning Assets:			
Loans	$1,859	(2,036)	(177)
Federal funds sold	(1)	—	(1)
Interest-bearing demand deposits	—	24	24
Federal Reserve Bank stock	9	(1)	8
Federal Home Loan Bank stock	—	—	—
Investment securities:			
Taxable	183	362	545
Non-taxable	709	(277)	432
Total interest income	2,759	(1,928)	831
Interest-bearing Liabilities:			
Savings deposits	40	62	102
IRA and time certificates	(20)	296	276
Short-term borrowings	4	13	17
Long-term debt	(147)	(53)	(200)
Total interest expense	(123)	318	195
Net interest income	$2,882	(2,246)	636

Net interest income on a fully tax-equivalent basis for the nine months ended September 30, 2016 totaled $31,136,000, an increase of $636,000 over the comparable period in 2015. Total interest income increased $831,000, partially offset by an increase in total interest expense of $195,000.

The increase in total interest income was due primarily to a $93.2 million increase in average total earning assets, partially offset by a 22 basis point decrease in the average rate earned on earning assets. Included in the average rate for 2015 was non-accrual interest recognized as a result of the impaired loan sale. The increase in average total earning assets was due to a $53.2 million increase in average loans and to a $40.4 million increase in average total investment securities. The increase in average loans was partially due to the acquisition of BNB and partially due to organic loan growth.

The increase in total interest expense was primarily due to an 18 basis point increase in the average rate paid on IRA and time certificates, partially offset by a combination of a 147 basis point decrease in the average rate paid on long-term debt and a $5.4 million decrease in average long-term debt. Average long-term debt and the rate associated with that debt decreased due to the payment in full during January 2016 of a $5.0 million advance from the FHLB of Cincinnati that had an interest rate of 5.25%.

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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 and nine months ended September 30, 2016 were $372,000 and $858,000, respectively, as compared to $240,000 and $986,000 for the same periods in 2015. Net recoveries for the three months ended September 30, 2016 was $53,000 and net charge-offs for the nine months ended September 30, 2016 was $189,000. This compares to net charge-offs of $161,000 and $1,149,000 for the three and nine months ended September 30, 2015, respectively. Net charge-offs and the provision for loan losses had elevated balances during the nine-month period in 2015 due to the sale of impaired loans during the second quarter of that year.

Non-Interest Income

Three Months Ended September 30, 2016 vs. 2015

Total non-interest income for the third quarter of 2016 was $460,000 greater than for the third quarter of 2015 primarily due to $307,000 in net gains from sales of securities (no securities were sold during the third quarter of 2015) and to a $117,000 increase in trust income reflecting an increase in the volume of brokerage sales during the third quarter of 2016.

Nine Months Ended September 30, 2016 vs. 2015

Total non-interest income for the first nine months of 2016 was $715,000 greater than for the first nine months of 2015 primarily due to a $625,000 increase in net gains from sales of securities, partially offset by a $113,000 decrease in gains from sales of loans. Net gains from sales of securities increased due to a greater volume of sales during 2016. The decrease in gains from sales of loans reflects the absence during 2016 of net gains totaling $181,000 recognized on impaired loans sold during the second quarter of 2015.

Non-Interest Expense

Three Months Ended September 30, 2016 vs. 2015

Non-interest expense for the third quarter of 2016 was $505,000 greater than for the third quarter of 2015 primarily due to a $302,000 increase in salaries and employee benefits and a $237,000 increase in other non-interest expense. Salaries and employee benefits increased primarily due to salary and wage increases and an increase in the number of employees. The increase in other non-interest expense includes a $98,000 increase in fraudulent check and checkcard losses, and a $110,000 increase in fees paid for contracted services.

Nine Months Ended September 30, 2016 vs. 2015

Non-interest expense for the first nine months of 2016 was $1,190,000 greater than for the first nine months of 2015 primarily due to a $726,000 increase in salaries and employee benefits, a $364,000 increase in other real estate owned expense, and a $759,000 increase in other non-interest expense. Salaries and employee benefits increased primarily due to salary and wage increases, employees retained from the BNB acquisition, and an increase in the number of employees outside of the acquisition. The increase in other real estate owned expense was primarily due to writedowns during 2016 totaling $576,000 on a commercial other real estate owned property. The increase in other non-interest expense included a $251,000 penalty incurred on the early payoff during the first quarter of 2016 of the FHLB advance mentioned earlier, a $161,000 increase in fraudulent check and checkcard losses, and a $122,000 increase in fees paid for contracted services.

Income Taxes
LCNB's effective tax rates for the nine months ended September 30, 2016 and 2015 were 26.0% and 27.2%, respectively. The difference between the statutory rate of 34.0% and the effective tax rate is primarily due to tax-exempt interest income from municipal securities and tax-exempt earnings from bank owned life insurance.

Financial Condition
Interest-bearing demand deposits, a component of total cash and cash equivalents in the asset section of the balance sheet, was $15.3 million greater at September 30, 2016 than at December 31, 2015 because of a $38.3 million increase in public fund deposits. Public fund deposits can be relatively volatile due to seasonal tax collections and the financial needs of the local entities. Historically, public fund deposits tend to be at their lowest balances at year-ends. Not including public fund deposits, the remaining increase was predominately in short-term noninterest-bearing deposits and savings deposits products.
Available-for-sale investment securities at September 30, 2016 were $31.6 million less than at December 31, 2015 and held-to-maturity investment securities were $19.4 million greater at September 30, 2016 than at December 31, 2015. Investment securities in the held-to-maturity category increased due to municipal securities purchased from various governmental entities within LCNB's marketing area. Investment securities in the available-for-sale category decreased because a portion of the cash received from sales, maturities, and calls was used to fund loan growth and the purchase of the local held-to-maturity municipal securities.

Net loans at September 30, 2016 were $40.1 million greater than at December 31, 2015. Commercial real estate loans increased by $47.9 million and agricultural loans increased by $2.4 million, partially offset by a $4.6 million decrease in residential real estate loans and a $5.2 million decrease in commercial and industrial loans.

Net premises and equipment at September 30, 2016 was $4.2 million greater than at December 31, 2015 primarily due to land and construction costs paid during the first nine months of 2016 for the new Operations Center.

Bank owned life insurance at September 30, 2016 was $4.6 million greater than at December 31, 2015 primarily due to the purchase of $4.0 million of new policies during the first quarter of 2016.

Total deposits at September 30, 2016 were $71.8 million greater than at December 31, 2015. Included in this increase was a $38.3 million increase in public fund deposits by local government entities.

The increase in public fund deposits contributed to the $15.3 million increase in interest-bearing demand deposits, a component of total cash and cash equivalents in the asset section of the balance sheet, between December 31, 2015 and September 30, 2016 and the $20.4 million decrease in short-term borrowings between the same two dates.

Long-term debt at September 30, 2016 was $5.3 million less than at December 31, 2015 primarily due to the early payment in full of a $5.0 million advance from the FHLB during January 2016. The advance had an interest rate of 5.25% and its payment will reduce future interest expense.

Shareholders' equity at September 30, 2016 was $6.8 million greater than at December 31, 2015, primarily due to earnings retained and an increase in accumulated other comprehensive income, net of taxes, resulting from market driven increases in the market value of investments securities. Partially offsetting these increases was a $1.3 million decrease in common shares primarily resulting from the repurchase and cancellation of all outstanding warrants.

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). Common Equity Tier 1 Capital is the sum of common stock, related surplus, and retained earnings net of treasury stock, accumulated other comprehensive income, and other adjustments. These three 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 standby letters of credit. The leverage ratio supplements the risk-based capital guidelines.

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

	Minimum Requirement		To Be Considered Well-Capitalized	
Ratio of Common Equity Tier 1 Capital to risk-weighted assets	4.5	%	6.5	%
Ratio of Tier 1 Capital to risk-weighted assets	6.0	%	8.0	%
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)	4.0	%	5.0	%

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LCNB CORP. AND SUBSIDIARIES

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

A new rule requiring a Capital Conservation Buffer began phase-in on January 1, 2016. Under the fully-implemented rule, a financial institution will need to maintain a Capital Conservation Buffer composed of Common Equity Tier 1 Capital of at least 2.5% above its minimum risk-weighted capital requirements to avoid limitations on its ability to make capital distributions, including dividend payments to shareholders and certain discretionary bonus payments to executive officers. A financial institution with a buffer below 2.5% will be subject to increasingly stringent limitations on capital distributions as the buffer approaches zero.

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

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

	September 30, 2016	December 31, 2015
Regulatory Capital:		
Shareholders' equity	$146,906	140,108
Goodwill and other intangibles	(32,790)	(32,146)
Accumulated other comprehensive (income) loss	(3,522)	(256)
Tier 1 risk-based capital	110,594	107,706
Eligible allowance for loan losses	3,798	3,129
Total risk-based capital	$114,392	110,835
Capital ratios:		
Common Equity Tier 1 Capital to risk-weighted assets	12.92 %	13.46 %
Tier 1 Capital to risk-weighted assets	12.92 %	13.46 %
Total Capital to risk-weighted assets	13.36 %	13.85 %
Leverage	8.61 %	8.62 %

Liquidity

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

Liquidity is the ability to have funds available at all times to meet the commitments of LCNB. Asset liquidity is provided by cash and assets which are readily marketable or pledgeable or which will mature in the near future. Liquid assets include cash and cash equivalents and securities available for sale. At September 30, 2016, LCNB's liquid assets amounted to $379.6 million or 28.5% of total assets. This compares to liquid assets totaling $393.0 million, or 30.7% of total assets, at December 31, 2015.

Liquidity is also provided by access to core funding sources, primarily core depositors in LCNB's market area. Approximately 81.5% of total deposits at September 30, 2016 were "core" deposits, compared to 84.3% of deposits at December 31, 2015. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit greater than $100,000. The percentage of core deposits to total deposits decreased because of the growth in public fund deposits discussed above in relation to total growth in deposits.

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LCNB CORP. AND SUBSIDIARIES

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

Secondary sources of liquidity include LCNB's ability to sell loan participations, borrow funds from the FHLB, 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 ("NII") 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 September 30, 2016 IRSA indicates that an increase in interest rates will 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	% Change in NII
	(Dollars in thousands)		
Up 300	$44,287	3,257	7.94 %
Up 200	43,134	2,104	5.13 %
Up 100	42,039	1,009	2.46 %
Base	41,030	—	— %

IRSA shows the effect on NII during a one-year period only. A more long-range model is the EVE analysis, which shows the estimated present value of future cash inflows from interest-earning assets less the present value of future cash outflows for interest-bearing liabilities for the same rate shocks. As shown below, the September 30, 2016 EVE analysis indicates that an increase in interest rates will have a negative effect on the EVE. The changes in EVE for all rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in Basis Points	Amount	$ Change in EVE	% Change in EVE
	(Dollars in thousands)		
Up 300	$145,353	(3,864)	(2.59)%
Up 200	146,149	(3,068)	(2.06)%
Up 100	146,831	(2,386)	(1.60)%
Base	149,217	—	— %

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.

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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 and that such information is accumulated and communicated to LCNB's management, including its principal executive officer and principal financial officer, as appropriate, in order to allow timely decisions to be made regarding required disclosures. Based upon this evaluation, these officers have concluded that, as of September 30, 2016, LCNB's disclosure controls and procedures were effective.

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

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PART II. OTHER INFORMATION

LCNB CORP. AND SUBSIDIARIES

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

No material changes

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

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

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

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

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LCNB CORP. AND SUBSIDIARIES
Item 6. Exhibits

Exhibit No.	Exhibit Description
2.1	Agreement and Plan of Merger dated as of December 29, 2014 by and between LCNB Corp. and BNB Bancorp, Inc. - incorporated by reference to the Registrant's Current Report on Form 8-K filed on January 2, 2015, 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	LCNB Corp. 2015 Ownership Incentive Plan - incorporated by reference to Registrant's Form DEF 14A Proxy Statement pursuant to Section 14(a), dated March 13, 2015, Exhibit A (001-35292)
10.3	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.
10.4	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.
10.5	Form of Restricted Share Grant Agreement under the LCNB Corp. 2015 Ownership Incentive Plan - incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 2015, Exhibit 10.7
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 Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from LCNB Corp.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 is formatted in Extensible Business Reporting Language: (i) the Consolidated Condensed Balance Sheets, (ii) the Consolidated Condensed Statements of Income, (iii) the Consolidated Condensed Statements of Comprehensive Income, (iv) the Consolidated Condensed Statements of Shareholders' Equity, (v) the Consolidated Condensed Statements of Cash Flows, and (vi) the Notes to Consolidated Condensed Financial Statements.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	LCNB Corp.
November 8, 2016	/s/ Steve P. Foster Steve P. Foster Chief Executive Officer and President
November 8, 2016	/s/ Robert C. Haines, II Robert C. Haines, II Executive Vice President and Chief Financial Officer