

LCNB CORP  
Form 10-Q  
July 31, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

( X )

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

For the quarterly period ended June 30, 2006

( )

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

For the transition period from

to

Commission File Number 000-26121

**LCNB Corp.**

(Exact name of registrant as specified in its charter)

**Ohio**

**31-1626393**

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

**2 North Broadway, Lebanon, Ohio 45036**

(Address of principal executive offices, including Zip Code)

**(513) 932-1414**

(Registrant's telephone number, including area code)

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

Yes       No

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

Large accelerated filer       Accelerated filer       Non-accelerated filer

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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 July 28, 2006 was 3,238,408 shares.

**LCNB Corp.**

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**LCNB CORP. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

June 30,

December 31,

2006

2005

(Unaudited)

**ASSETS:**

Cash and due from banks

\$  
15,794



	13,415
Federal funds sold and interest-bearing demand deposits	
	12,407
	1,909
Total cash and cash equivalents	
	28,201
	15,324
Securities available for sale, at market value	
	112,049
	133,505
Federal Reserve Bank stock and Federal Home	
Loan Bank stock, at cost	
	3,254

	3,181
Loans, net	
	371,452
	357,651
Premises and equipment, net	
	12,210
	12,571
Intangibles, net	
	1,777
	1,575
Bank owned life insurance	
	10,746
	10,515

Other assets

6,392

5,179

**TOTAL ASSETS**

\$

546,081

539,501

**LIABILITIES:**

Deposits

Noninterest-bearing

\$

79,467

82,030

Interest-bearing

411,443

	399,445
Total deposits	
	490,910
	481,475
Long-term debt	
	40
	2,073
Accrued interest and other liabilities	
	3,215
	3,931
<b>TOTAL LIABILITIES</b>	
	494,165
	487,479

**SHAREHOLDERS EQUITY:**

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

none outstanding

-

-

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

issued and outstanding 3,551,884 shares

10,560

10,560

Surplus

10,569

10,562

Retained earnings

	40,874
	39,612
Treasury shares at cost, 298,276 and 274,676 shares at	
June 30, 2006 and December 31, 2005, respectively	
	(8,907)
	(8,011)
Accumulated other comprehensive income (loss), net of taxes	
	(1,180)
	(701)
<b>TOTAL SHAREHOLDERS EQUITY</b>	
	51,916
	52,022
<b>TOTAL LIABILITIES AND</b>	

**SHAREHOLDERS EQUITY**

\$  
546,081  
  
539,501

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

**LCNB CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands)

(Unaudited)

Three Months Ended

Six Months Ended

June 30,

June 30,

2006

2005

2006

2005

**INTEREST INCOME:**



Interest and fees on loans

\$

6,159

5,479

12,135

10,814

Dividends on Federal Reserve Bank

and Federal Home Loan Bank stock

56

49

92

76

Interest on investment securities

Taxable

649

646

1,346

1,259

Non-taxable

486

495

1,027

989

Other short-term investments

121

168

18

	195
	247
<b>TOTAL INTEREST INCOME</b>	
	7,471
	6,837
	14,795
	13,385
<b>INTEREST EXPENSE:</b>	
Interest on deposits	
	2,898
	2,176
	5,567
	4,118
	19

Interest on borrowings

11

33

71

66

TOTAL INTEREST EXPENSE

2,909

2,209

5,638

4,184

NET INTEREST INCOME

4,562

4,628

20

	9,157
	9,201
PROVISION FOR LOAN LOSSES	
	146
	118
	34
	216
NET INTEREST INCOME AFTER	
PROVISION FOR LOAN LOSSES	
	4,416
	4,510
	9,123
	8,985
	21

**NON-INTEREST INCOME:**

Trust income

450

421

943

745

Service charges and fees

1,084

1,014

2,004

1,940

Net gain (loss) on sales of securities

-

	-
	(12)
	-
Insurance agency income	
	466
	409
	848
	720
Bank-owned life insurance income	
	116
	116
	230
	234
	23

Other operating income

62

76

126

122

**TOTAL NON-INTEREST INCOME**

2,178

2,036

4,139

3,761

**NON-INTEREST EXPENSE:**

Salaries and wages

1,988

24



	1,877
	3,903
	3,706
Pension and other employee benefits	
	481
	479
	1,016
	981
Equipment expenses	
	266
	261
	521
	533
	25

Occupancy expense, net

317

292

651

642

State franchise tax

153

150

313

302

Marketing

103

123

26

	195
	243
Intangible amortization	
	151
	147
	297
	293
Other non-interest expense	
	971
	965
	2,066
	1,929
TOTAL NON-INTEREST EXPENSE	

4,430

4,294

8,962

8,629

**INCOME BEFORE INCOME TAXES**

2,164

2,252

4,300

4,117

**PROVISION FOR INCOME TAXES**

555

560

1,082

1,019

28

**NET INCOME**

\$

1,609

1,692

3,218

3,098

Dividends declared per common share

\$

0.30

0.29

0.60

0.58

Earnings per common share:

Basic

\$

0.49

29

	0.51
	0.99
	0.93
Diluted	
	0.49
	0.51
	0.99
	0.93
Average shares outstanding:	
Basic	
	3,256,132
	3,312,498
	3,261,945
	30

	3,319,482
Diluted	
	3,257,405
	3,313,803
	3,263,194
	3,320,823

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

**LCNB CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(In thousands)

(Unaudited)

Three Months Ended

Six Months Ended

June 30,

June 30,

2006

2005

2006

2005

Net Income



\$

1,609

1,692

3,218

3,098

Other comprehensive income (loss):

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

securities (net of taxes of \$161 and \$69 for the three months ended June 30, 2006 and 2005, respectively, and net of taxes of \$251 and \$333 for the six months ended June 30, 2006 and 2005, respectively)

(311)

134

(487)

(647)

Reclassification adjustment for net realized

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

included in net income (net of taxes \$4 for the six months ended June 30, 2006, respectively)

-

34

	-
	8
	-
<b>TOTAL COMPREHENSIVE INCOME</b>	\$
	1,298
	1,826
	2,739
	35

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

**LCNB CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

(In thousands)

(Unaudited)

Accumulated

Other

Total

Common

Retained

Treasury

Comprehensive

Shareholders

Shares

Surplus

Earnings

Shares

Income (Loss)

Equity

Balance January 1, 2006

\$

10,560

10,562

39,612

(8,011)

(701)

52,022

Net income

3,218

3,218

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

		(479)
		(479)
Compensation expense relating to stock options		
		7
	7	
Treasury shares purchased		
		(896)
		(896)
Cash dividends declared, \$0.60 per share		

	(1,956)
	(1,956)
Balance June 30, 2006	
	\$
	10,560
	10,569
	40,874
	(8,907)
	(1,180)
	51,916
Balance January 1, 2005	
	\$
	10,560
	10,553
	36,735
	(6,078)
	40



	526
	52,296
Net income	
	3,098
	3,098
Change in estimated fair value of securities available-for-sale, net of tax and reclassification adjustment	
	(647)
	(647)
Compensation expense relating to stock options	

Treasury shares purchased

(862)

(862)

Cash dividends declared, \$0.58 per share

(1,923)

(1,923)

Balance June 30, 2005

\$

10,560

10,557

37,910

(6,940)

(121)

51,966

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

**LCNB CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(unaudited)

Six Months Ended

June 30,

2006

2005

**CASH FLOWS FROM OPERATING ACTIVITIES:**

Net income

\$

3,218

3,098

Adjustments to reconcile net income to net cash flows from

operating activities

Depreciation, amortization, and accretion

1,114

1,317

Provision for loan losses

34

216

Federal Home Loan Bank stock dividends

(73)

(57)

Bank owned life insurance income

(230)

(234)

Realized loss on sales of securities available for sale

45

12

		-
Mortgage loans originated for sale		(2,125)
		(2,796)
Realized gains from sales of mortgage loans		(35)
		(47)
Proceeds from sales of mortgage loans	2,137	2,812
Compensation expense related to stock options		

7

4

(Increase) decrease in income receivable

145

(333)

(Increase) decrease in other assets

(444)

(387)

Increase (decrease) in other liabilities

64

196

TOTAL ADJUSTMENTS

606

691

47

NET CASH FLOWS FROM OPERATING ACTIVITIES

3,824

3,789

CASH FLOWS FROM INVESTING ACTIVITIES:

Proceeds from sales of securities available for sale

8,204

-

Proceeds from maturities of securities available for sale

20,270

17,695

Purchases of securities available for sale

(7,848)

(46,638)



Net decrease (increase) in loans		(14,739)
		(12,224)
Net cash paid for acquisition		(514)
	-	
Proceeds from sale of other real estate acquired through foreclosure		
	84	
	-	
Purchases of premises and equipment		(174)
		(1,359)
Proceeds from sales of premises and equipment		

-

9

**NET CASH FLOWS FROM INVESTING ACTIVITIES**

5,283

(42,517)

**CASH FLOWS FROM FINANCING ACTIVITIES:**

Net change in deposits

9,435

21,630

Net change in short-term borrowings

(780)

(540)

Principal payments on long-term debt

50

	(2,033)
	(32)
Cash dividends paid	
	(1,956)
	(1,923)
Purchases of treasury shares	
	(896)
	(862)
NET CASH FLOWS FROM FINANCING ACTIVITIES	
	3,770
	18,273
NET CHANGE IN CASH AND CASH EQUIVALENTS	
	12,877

(20,455)

**CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD**

15,324

43,115

**CASH AND CASH EQUIVALENTS AT END OF PERIOD**

\$

28,201

22,660

**SUPPLEMENTAL CASH FLOW INFORMATION:**

**CASH PAID DURING THE YEAR FOR:**

Interest

\$

5,605

4,179

Income taxes

1,031

996

**SUPPLEMENTAL DISCLOSURES OF  
NON-CASH INVESTING ACTIVITY:**

Transfer from loans to real estate acquired through foreclosure

752

32

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

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**Note 1 - Basis of Presentation**

Substantially all of the assets, liabilities and operations of LCNB Corp. ("LCNB") are attributable to its wholly owned subsidiaries, Lebanon Citizens National Bank ("Lebanon Citizens") and Dakin Insurance Agency, Inc. ("Dakin"). The accompanying unaudited consolidated financial statements include the accounts of LCNB, Lebanon Citizens, and Dakin.

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

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

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

Results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year ending December 31, 2006. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements, accounting policies, and financial notes thereto included in LCNB's 2005 Form 10-K filed with the SEC.

**Note 2 - Acquisition**

On May 31, 2006, Dakin purchased the existing book of business of Altemeier Oliver & Company Agency, Inc. ( AOC ), an independent insurance agency located in Blue Ash, Ohio. The acquisition of AOC will be accounted for using the purchase accounting method and the results of operations of AOC have been included in the consolidated financial statements of LCNB since the acquisition date. LCNB and Dakin are in the process of finalizing the allocation of the purchase price to the acquired assets, which consist solely of intangible assets, including a customer list and covenants not to compete. LCNB anticipates the amortization period of the collective intangible assets will approximate ten years.

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

(Unaudited)

(Continued)

**Note 3 - Earnings Per Share**

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	\$ 1,609	1,692	3,218	3,098
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	3,256,132	3,312,498	3,261,945	3,319,482
Add dilutive effect of stock options	1,273	1,305	1,249	1,341
Adjusted weighted average number of shares outstanding used in the calculation of diluted				



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earnings per common share

	3,257,405	3,313,803	3,263,194	3,320,823
Basic earnings per common share	\$ 0.49	0.51	0.99	0.93
Diluted earnings per common share	\$ 0.49	0.51	0.99	0.93

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**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 4 - Investment Securities**

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

	Amortized Cost	June 30, 2006		Market Value
		Unrealized Gains	Unrealized Losses	
U.S. Treasury notes	\$ 4,192	-	51	4,141
U.S. Agency notes	36,993	-	531	36,462
U.S. Agency mortgage-backed securities	18,966	1	959	18,008
Municipal securities:				
Non-taxable	47,004	325	436	46,893
Taxable	6,683	1	139	6,545
	\$ 113,838	327	2,116	112,049

	Amortized Cost	December 31, 2005		Market Value
		Unrealized Gains	Unrealized Losses	

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

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

		<u>Less than Twelve Months</u>		<u>Twelve Months or More</u>	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury notes	\$	-	-	4,141	51
U.S. Agency notes		10,663	54	25,799	477
U.S. Agency mortgage-backed securities		2,065	53	15,764	906
Municipal securities:					
Non-taxable		13,656	180	13,082	256
Taxable		2,261	5	4,029	134
	\$	28,645	292	62,815	1,824

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 4 - Investment Securities (continued)**

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

**Note 5 - Loans**

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

	June 30, 2006	December 31, 2005
Commercial and industrial	\$ 32,370	34,607
Commercial, secured by real estate	136,533	124,823
Residential real estate	162,386	161,656
Consumer	38,813	35,879
Agricultural	2,452	1,978
Other loans	137	152
Lease financing	16	37
	372,707	359,132

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Deferred net origination costs	796	669
	373,503	359,801
Less allowance for loan losses	2,051	2,150
Loans, net	\$ 371,452	357,651

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

	Six Months Ended June 30,	
	2006	2005
Balances, beginning of year	\$ 2,150	2,150
Provision for loan losses	34	216
Charge-offs	(324)	(403)
Recoveries	191	191
Balances, end of period	\$ 2,051	2,154

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 5 - Loans (continued)**

Charge-offs for the six months ended June 30, 2006 consisted of residential and commercial real estate loans, consumer loans, and checking and NOW account overdrafts. Charge-offs for the six months ended June 30, 2005 consisted primarily of consumer loans and checking and NOW account overdrafts.

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

	June 30, 2006	December 31, 2005
Non-accrual loans	\$ 360	785
Past-due 90 days or more and still accruing	142	61
Restructured loans	3,610	1,717
Total	\$ 4,112	2,563

Non-accrual loans at June 30, 2006 consisted of one real estate mortgage loan and one loan secured by farmland. Non-accrual loans at December 31, 2005 consisted of two real estate mortgage loans. Loans past-due 90 days or more and still accruing interest at June 30, 2006 consisted of one real estate mortgage loan and consumer loans. Loans past-due 90 days or more at December 31, 2005 consisted primarily of consumer loans.

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

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

Mortgage loans sold to and serviced for the Federal Home Loan Mortgage Corporation ("FHLMC") are not included in the accompanying balance sheets. The unpaid principal balances of those loans at June 30, 2006 and December 31, 2005 were \$44,819,000 and \$46,244,000, respectively. Loans sold to the FHLMC during the three and six months ended June 30, 2006 totaled \$902,000 and \$2,125,000, respectively, and \$2,068,000 and \$2,796,000 during the three and six months ended June 30, 2005, respectively.

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 6 Long-Term Debt and Other Borrowings**

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

At June 30, 2006 and December 31, 2005, accrued interest and other liabilities included U.S. Treasury demand note borrowings of approximately \$251,000 and \$1,031,000, respectively. The interest rate on these borrowings is variable and was 4.94% and 4.00% at June 30, 2006 and December 31, 2005, respectively.

**Note 7 Regulatory Capital**

Lebanon Citizens and LCNB are required by regulators to meet certain minimum levels of capital adequacy. These are expressed in the form of certain ratios. Capital is separated into Tier 1 capital (essentially shareholders' equity less goodwill and other intangibles) and Tier 2 capital (essentially the allowance for loan losses limited to 1.25% of risk-weighted assets). The first two ratios, which are based on the degree of credit risk in LCNB's assets, provide for weighting assets based on assigned risk factors and include off-balance sheet items such as loan commitments and stand-by letters of credit. The ratio of Tier 1 capital to risk-weighted assets must be at least 4.0% and the ratio of Total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8.0%. The capital leverage ratio supplements the risk-based capital guidelines. Banks are required to maintain a minimum ratio of Tier 1 capital to adjusted quarterly average total assets of 3.0%.



For various regulatory purposes, financial institutions are classified into categories based upon capital adequacy. The highest "well-capitalized" category requires capital ratios of at least 10% for total risk-based, 6% for Tier 1 risk-based, and 5% for leverage. As of the most recent notification from their regulators, Lebanon Citizens and LCNB were categorized as "well-capitalized" under the regulatory framework for prompt corrective action. Management believes that no conditions or events have occurred since the last notification that would change the Lebanon Citizens' or LCNB's category. A summary of the regulatory capital and capital ratios of LCNB follows:



**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 7 Regulatory Capital (continued)**

	At June 30, 2006	At December 31, 2005
	(Dollars in thousands)	
Regulatory Capital:		
Shareholders' equity	\$ 51,916	52,022
Goodwill and other intangibles	(1,563)	(1,348)
Net unrealized securities losses (gains)	1,180	701
Tier 1 risk-based capital	51,533	51,375
Eligible allowance for loan losses	2,051	2,150
Total risk-based capital	\$ 53,584	53,525
Capital ratios:		
Total risk-based (required 8.00%)	14.45%	14.94%
Tier 1 risk-based (required 4.00%)	13.90%	14.34%
Leverage (required 3.00%)	9.54%	9.55%

**Note 8 - Commitments and Contingent Liabilities**

LCNB is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments included commitments to extend credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets.

Exposure to credit loss in the event of nonperformance by the other parties to financial instruments for commitments to extend credit is represented by the contract amount of those instruments.

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

	June 30, 2006	December 31, 2005
Commitments to extend credit	\$ 89,642	74,753
Standby letters of credit	5,761	5,946

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**LCNB Corp. and Subsidiaries****Notes to the Consolidated Financial Statements**

(Unaudited)

(Continued)

**Note 8 Commitments and Contingent Liabilities (continued)**

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. They include amounts not drawn on line of credit loans, commitments to make new loans, and unused overdraft protection amounts on demand and NOW accounts. Commitments generally have fixed expiration dates or other termination clauses. At June 30, 2006, \$17,580,000 of such commitments were for fixed rate products and unused overdraft protection amounts and \$72,062,000 were for adjustable rate products.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. At June 30, 2006 and December 31, 2005, outstanding guarantees of \$1,707,000 and \$1,892,000, respectively, were issued to developers and contractors. These guarantees generally are fully secured and have varying maturities. In addition, LCNB has a participation in a letter of credit securing payment of principal and interest on a bond issue.

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

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

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

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

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

(Unaudited)

(Continued)

**Note 9 - Stock Options**

Under the Ownership Incentive Plan (the "Plan") LCNB may grant stock-based awards to eligible employees. The awards may be in the form of stock options, share awards, and/or appreciation rights. The Plan provides for the issuance of up to 100,000 shares. As of June 30, 2006, only stock options have been granted under the Plan. Options granted to date vest ratably over a five year period and expire ten years after the date of grant. Stock options outstanding at June 30, 2006 were as follows (thousands):

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

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

	<u>2006</u>
Risk-free interest rate	4.64%
Average dividend yield	3.04%
Volatility factor of the expected market price of the Company's common stock	22.70%
Average life	8.5 years

Compensation expense recognized in the consolidated statements of income for all stock options granted prior to January 1, 2005 is determined using the modified prospective approach as allowed by SFAS No. 123 (revised). Total expense related to options included in salaries and wages in the consolidated statements of income for the three and six months ended June 30, 2006 were \$4,000 and \$7,000, respectively and \$2,000 and \$4,000 for the three and six months ended June 30, 2005, respectively.

**LCNB Corp. and Subsidiaries**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**(Continued)**

**Note 10 Employee Benefits**

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

	For the Three Months		For the Six Months	
	Ended June 30,		Ended June 30,	
	2006	2005	2006	2005
Service cost	\$ 161	157	322	312
Interest cost	83	74	165	147
Expected return on plan assets	(91)	(81)	(181)	(161)
Amortization on net (gain) loss	1	-	1	1
Net periodic pension cost	154	150	307	299

LCNB previously disclosed in its consolidated financial statements for the year ended December 31, 2005, that it expected to contribute \$875,000 to its pension plan in 2006. As of June 30, 2006, no contributions have been made.

**Note 11 Recent Accounting Pronouncements**



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

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

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

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

LCNB Corp. and subsidiaries

Lebanon, Ohio

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

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

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

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We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of LCNB Corp. and subsidiaries as of December 31, 2005 (presented herein), and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated February 16, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2005, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

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

Cincinnati, Ohio

July 27, 2006

## **LCNB Corp. and Subsidiaries**

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

#### **Forward Looking Statements**

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

#### **Acquisition**

On May 31, 2006, Dakin purchased the existing book of business of Altemeier Oliver & Company Agency, Inc. ( AOC ), an independent insurance agency located in Blue Ash, Ohio. The acquisition of AOC will be accounted for using the purchase accounting method and the results of operations of AOC have been included in the consolidated financial statements of LCNB since the acquisition date. LCNB and Dakin are in the process of finalizing the allocation of the purchase price to the acquired assets, which consist solely of intangible assets, including a customer list and covenants not to compete. LCNB anticipates the amortization period of the collective intangible assets will approximate ten years.

**Results of Operations**

LCNB earned \$1,609,000 or \$0.49 per share for the three months ended June 30, 2006, compared to \$1,692,000 or \$0.51 per share for the three months ended June 30, 2005. The return on average assets (ROAA) for the second quarter, 2006 was 1.19% and the return on average equity (ROAE) was 12.35%, compared with an ROAA of 1.26% and an ROAE of 13.01% for the second quarter of 2005. The decrease in net income for the second quarter, 2006 is primarily attributable to a decrease in net interest income, an increase in the provision for loan losses, and an increase in non-interest expense. These items were partially offset by an increase in non-interest income.

LCNB earned \$3,218,000 or \$0.99 per share during the first six months of 2006 compared to \$3,098,000 or \$0.93 per share for the first six months of 2005. The ROAA and ROAE for the first six months of 2006 were 1.20% and 12.41%, respectively. The comparable ratios for the first six months of 2005 were 1.18% and 11.92%, respectively. The provision for loan losses for the 2006 period was less than the provision recorded during the 2005 period and non-interest income for the first six months of 2006 was greater than the amount for the comparable 2005 period. These positive effects on net income were partially offset by a decrease in net interest income and an increase in non-interest expense.

**LCNB Corp. and Subsidiaries**

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

**Net Interest Income**

**Three Months Ended June 30, 2006 vs. 2005.**

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

	Three Months Ended June 30,					
	2006			2005		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Loans (1)	\$ 368,541	\$ 6,160	6.70%	\$ 344,787	\$ 5,479	6.37%
Federal funds sold and interest-bearing demand deposits	9,903	121	4.90%	21,905	168	3.08%
Federal Reserve Bank stock	647	19	11.78%	647	19	11.78%
Federal Home Loan Bank stock	2,571	37	5.77%	2,438	30	4.94%
Investment securities:						

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Taxable	66,080	649	3.94%	74,346	646	3.49%
Non-taxable (2)	50,658	736	5.83%	53,014	750	5.67%
Total earnings assets	498,400	7,722	6.21%	497,137	7,092	5.72%
Non-earning assets	43,860			44,306		
Allowance for loan losses	(2,052)			(2,154)		
Total assets	\$ 540,208			\$ 539,289		
Interest-bearing deposits	\$ 404,434	2,898	2.87%	\$ 405,538	2,176	2.15%
Short-term debt	854	10	4.70%	648	4	2.48%
Long-term debt	48	1	8.36%	2,113	29	5.50%
Total interest-bearing liabilities	405,336	2,909	2.88%	408,299	2,209	2.17%
Demand deposits	79,779			76,455		
Other liabilities	2,813			2,369		
Capital	52,280			52,166		
Total liabilities and capital	\$ 540,208			\$ 539,289		
Net interest rate spread (3)			3.33%			3.55%
Net interest income and net interest margin on a taxable-equivalent basis (4)		\$ 4,813	3.87%		\$ 4,883	3.94%
Ratio of interest-earning assets to interest-bearing liabilities		122.96%			121.76%	

(1)

Includes nonaccrual loans, if any. Income from tax-exempt loans is included in interest income on a tax-equivalent basis, using an incremental rate of 34%.

(2)

Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax rate of 34%.

(3)

The net interest spread is the difference between the average rate on total interest-earning assets and interest-bearing liabilities.

(4)

The net interest margin is the taxable-equivalent net interest income divided by average interest-earning assets.

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**LCNB Corp. and Subsidiaries**

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

The following table presents the changes in taxable-equivalent basis interest income and expense for each major category of interest-earning assets and interest-bearing liabilities and the amount of change attributable to volume and rate changes for the three months ended June 30, 2006 as compared to the same period in 2005. Changes not solely attributable to rate or volume have been allocated to volume and rate changes in proportion to the relationship of absolute dollar amounts of the changes in each.

	Three Months Ended June 30, 2006 vs. 2005		
	Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
<b>Interest-earning Assets:</b>			
Loans	\$ 389	292	681
Federal funds sold and interest-bearing			
demand deposits	(118)	71	(47)
Federal Home Loan Bank stock	2	5	7
Investment securities:			
Taxable	(76)	79	3
Nontaxable	(34)	20	(14)
Total interest income	163	467	630
<b>Interest-bearing Liabilities:</b>			
Deposits	(6)	728	722
Short-term borrowings	2	4	6

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Long-term debt	(38)	10	(28)
Total interest expense	(42)	742	700
Net interest income	\$ 205	(275)	(70)

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**LCNB Corp. and Subsidiaries**

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

**Operations (continued)**

Net interest income on a fully tax-equivalent basis for the three months ended June 30, 2006 totaled \$4,813,000, a decrease of \$70,000 from the comparable period in 2005. Total interest expense increased \$700,000, which was partially offset by an increase in total interest income of \$630,000.

The increase in total interest income was primarily due to a 49 basis point (one basis point equals 0.01%) increase in the average rate earned on earning assets and secondarily to a \$1.3 million increase in average interest earning assets, from \$497.1 million for the three months ended June 30, 2005 to \$498.4 million for the same period in 2006. The increase in interest earning assets was primarily from loan growth, which increased by \$23.8 million on an average basis. The increase in the average rate earned on earning assets was primarily due to general increases in market interest rates.

The increase in total interest expense was primarily due to a 71 basis point increase in the average rate paid, slightly offset by a \$3.0 million decrease in average interest-bearing liabilities. The increase in the average rate paid on interest-bearing liabilities was primarily due to general increases in market interest rates.

The net interest margin narrowed 7 basis points in the second quarter, 2006 compared to the second quarter, 2005. The tighter margin reflects highly competitive market pricing conditions for both loans and deposits and a relatively flat yield curve between short-term and long-term interest rates. As a result, average deposit rates increased faster than average loan rates.

Six Months Ended June 30, 2006 vs. 2005.

The following table presents, for the six months ended June 30, 2006 and 2005, average balances for interest-earning assets and interest-bearing liabilities, the income or expense related to each item, and the resultant average yields earned or rates paid.

**LCNB Corp. and Subsidiaries**

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

	Six Months Ended June 30,					
	2006			2005		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Loans (1)	\$ 365,520	\$ 12,136	6.70%	\$ 341,660	\$ 10,814	6.38%
Federal funds sold and interest-						
bearing demand deposits	8,273	195	4.75%	18,367	247	2.71%
Federal Reserve Bank stock	647	19	5.92%	647	19	5.92%
Federal Home Loan Bank stock	2,553	73	5.77%	2,425	57	4.74%
Investment securities:						
Taxable	68,401	1,346	3.97%	72,799	1,259	3.49%
Non-taxable (2)	52,862	1,556	5.94%	52,703	1,498	5.73%
Total earnings assets	498,256	15,325	6.20%	488,601	13,894	5.73%
Non-earning assets	44,289			43,779		
Allowance for loan losses	(2,106)			(2,156)		
Total assets	\$ 540,439			\$ 530,224		
Interest-bearing deposits	\$ 402,796	5,567	2.79%	\$ 397,168	4,118	2.09%
Short-term debt	1,823	42	4.65%	572	7	2.47%
Long-term debt	1,040	29	5.62%	2,121	59	5.61%
Total	405,659	5,638	2.80%	399,861	4,184	2.11%

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interest-bearing liabilities				
Demand deposits	79,698		75,571	
Other liabilities	2,766		2,388	
Capital	52,316		52,404	
Total liabilities and capital	\$ 540,439		\$ 530,224	
Net interest rate spread (3)		3.40%		3.62%
Net interest income and net interest margin on a taxable-equivalent basis (4)	\$ 9,687	3.92%	\$ 9,710	4.01%
Ratio of interest-earning assets to interest-bearing liabilities	122.83%		122.19%	

(1)

Includes nonaccrual loans, if any. Income from tax-exempt loans is included in interest income on a tax-equivalent basis, using an incremental rate of 34%.

(2)

Income from tax-exempt securities is included in interest income on a taxable-equivalent basis. Interest income has been divided by a factor comprised of the complement of the incremental tax rate of 34%.

(3)

The net interest spread is the difference between the average rate on total interest-earning assets and interest-bearing liabilities.

(4)

The net interest margin is the taxable-equivalent net interest income divided by average interest-earning assets.



**LCNB Corp. and Subsidiaries**

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

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

	Six Months Ended June 30, 2006 vs. 2005		
	Increase (decrease) due to:		
	Volume	Rate	Total
	(In thousands)		
<b>Interest-earning Assets:</b>			
Loans	\$ 777	545	1,322
Federal funds sold and interest-bearing			
demand deposits	(179)	127	(52)
Federal Home Loan Bank stock	3	13	16
<b>Investment securities:</b>			
Taxable	(79)	166	87
Nontaxable	5	53	58
Total interest income	527	904	1,431
<b>Interest-bearing Liabilities:</b>			
Deposits	59	1,390	1,449
Short-term borrowings	25	10	35
Long-term debt	(30)	-	(30)



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Total interest expense	54	1,400	1,454
Net interest income	\$ 473	(496)	(23)

Net interest income on a fully tax-equivalent basis for the first half of 2006 totaled \$9,687,000, a \$23,000 decrease from the first half of 2005. Total interest expense increased \$1,454,000 and was partially offset by an increase in total interest income of \$1,431,000.

The increase in total interest income was due primarily to a 47 basis point increase in the average rate earned on earning assets, from 5.73% for the first half of 2005 to 6.20% for the first half of 2006, and secondarily to a \$9.7 million increase in average total earning assets. The increase in average earning assets was due to a \$23.9 million increase in average loans, largely offset by a \$10.1 decrease in federal funds sold and interest-bearing demand deposits and a \$4.2 million decrease in investment securities.

**LCNB Corp. and Subsidiaries**

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

**Operations (continued)**

The increase in total interest expense was due primarily to a 69 basis point increase in the average rate paid on interest-bearing liabilities. The net interest margin narrowed 9 basis points in the first half of 2006 compared to the first half of 2005 for substantially the same reasons previously discussed.

**Provision and Allowance For Loan Losses**

The total provision for loan losses is determined based upon management's evaluation as to the amount needed to maintain the allowance for credit losses at a level considered appropriate in relation to the risk of losses inherent in the portfolio. The total loan loss provision and the other changes in the allowance for loan losses are shown below.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(In thousands)			
Balance, beginning of period	\$ 2,050	2,150	2,150	2,150
Charge-offs	(223)	(207)	(324)	(403)
Recoveries	78	93	191	191
Net charge-offs	(145)	(114)	(133)	(212)
Provision for loan losses	146	118	34	216
Balance, end of period	\$ 2,051	2,154	2,051	2,154

Charge-offs for the six months ended June 30, 2006 consisted of residential and commercial real estate loans, consumer loans, and checking and NOW account overdrafts. Charge-offs for the six months ended June 30, 2005 consisted primarily of consumer loans and checking and NOW account overdrafts.

**LCNB Corp. and Subsidiaries**

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

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

	June 30, 2006	December 31, 2005
	(In thousands)	
Non-accrual loans	\$ 360	785
Past-due 90 days or more and still accruing	142	61
Restructured loans	3,610	1,717
Total	\$ 4,112	2,563

Non-accrual loans at June 30, 2006 consisted of one real estate mortgage loan and one loan secured by farmland. Non-accrual loans at December 31, 2005 consisted of two real estate mortgage loans. Loans past-due 90 days or more and still accruing interest at June 30, 2006 consisted of one real estate mortgage loan and consumer loans. Loans past-due 90 days or more at December 31, 2005 consisted primarily of consumer loans.

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

**Non -Interest Income**

Three Months Ended June 30, 2006 vs. 2005.

Non-interest income of \$2,178,000 for the second quarter of 2006 was \$142,000, or 7.0%, greater than for the same period in 2005 primarily due to a \$29,000 increase in trust income, a \$57,000 increase in insurance agency income, and a \$70,000 increase in service charges and fees. Trust income increased primarily due to an increase in brokerage fees, resulting from new business. Insurance agency income increased primarily due to new business. Service charges and fees increased primarily due to an increase in check card income and an increase in the number of non-sufficient fund charges. Check card income grew because a greater number of cards were outstanding and because of the increasing popularity of check cards as a retail payment method.

**LCNB Corp. and Subsidiaries**

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

Six Months Ended June 30, 2006 vs. 2005.

Non-interest income of \$4,139,000 for the first half of 2006 was \$378,000, or 10.1%, greater than for the same period in 2005 primarily due to a \$198,000 increase in trust income, a \$128,000 increase in insurance agency income, and a \$64,000 increase in service charges and fees. The increase in trust income was primarily due to an increase in brokerage income resulting from new business and from trust fee modifications. Insurance agency income increased due to an increase in contingency income recognized during the first quarter and due to new business. Service charges and fees increased primarily due to an increase in check card income.

Non-Interest Expense

Three Months Ended June 30, 2006 vs. 2005.

Total non-interest expense increased \$136,000, or 3.2%, during the second quarter, 2006 compared to the second quarter, 2005, primarily due to increases in salaries and wages. Salaries and wages increased \$111,000, or 5.9%, primarily due to additional employees and routine salary and wage increases.

Six Months Ended June 30, 2006 vs. 2005.

Total non-interest expense increased \$333,000, or 3.9%, during the first half, 2006 compared to the first half of 2005 primarily due to a \$197,000 increase in salaries and wages and a \$112,000 increase in ATM expense, which is included in other non-interest expense. Salaries and wages increased for substantially the same reasons discussed above. The increase in ATM expense is primarily due to fee adjustments from the vendor related to prior periods that were recognized during the first quarter, 2006.

**Income Taxes**

LCNB's effective tax rates for the six months ended June 30, 2006 and 2005 were 25.2% and 24.8%, respectively. The difference between the statutory rate of 34.0% and the effective tax rate is primarily due to tax-exempt interest income from municipal securities and tax-exempt earnings from bank owned life insurance.

**LCNB Corp. and Subsidiaries**

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

**Operations (continued)**

**Financial Condition**

Federal funds sold and interest bearing demand deposits totaled \$12.4 million at June 30, 2006, or \$10.5 more than at December 31, 2005. The increase reflects management's decision to build cash and cash equivalents to fund increased loan demand and to service higher levels of public fund deposits.

Securities available for sale had a market value of \$112.0 million at June 30, 2006, approximately \$21.5 million less than at December 31, 2005. Increases in unrealized losses during the first half of 2006 comprise only \$0.6 million of the decline. The balance of the decrease primarily reflects management's decision to invest most of the funds received from investment maturities and calls in federal funds sold and interest bearing demand deposits, thus building cash and cash equivalents, and in new loans.

Gross loans, before the allowance for loan losses, at June 30, 2006 were \$373.5 million, approximately \$13.7 million greater than at December 31, 2005. Commercial loans secured by real estate comprised \$11.7 million of the increase and consumer loans comprised another \$2.9 million of the increase.

Interest-bearing deposits at June 30, 2006 totaled \$411.4 million, approximately \$12.0 million greater than at December 31, 2005. NOW accounts increased \$29.1 million, partially offset by declines in money market deposit accounts, regular savings, and time deposits. The increase in the NOW account classification was primarily due to a \$26.1 million increase in public fund NOW account deposits. Public fund deposits represent deposits by local and state governmental entities, and balances maintained are highly volatile.

Long-term debt at June 30, 2006 was \$40,000, which was a \$2.0 million decrease from the balance at December 31, 2005. The decrease is due to the maturation and payment in full of a \$2.0 Federal Home Loan Bank note on March



31, 2006.

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

<b>CONDENSED QUARTERLY AVERAGE</b>			
<b>BALANCE SHEETS</b>			
	June 30, 2006	March 31, 2006	December 31, 2005
(In thousands)			
<b>ASSETS</b>			
Interest earning:			
Federal funds sold and			
interest-bearing demand deposits	\$ 9,903	6,625	8,615
Investment securities	119,956	129,020	134,262
Loans	368,541	362,465	353,744
Total interest-earning assets	498,400	498,110	496,621
Noninterest-earning:			
Cash and due from banks	13,949	15,269	14,660
All other assets	29,911	29,422	29,457
Allowance for credit losses	(2,052)	(2,160)	(2,154)
TOTAL ASSETS	\$ 540,208	540,641	538,584
<b>LIABILITIES</b>			
Interest-bearing:			

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Interest-bearing deposits	\$ 404,434	401,141	397,556
Short-term borrowings	854	2,803	693
Long-term debt	48	2,043	2,081
Total interest-bearing liabilities	405,336	405,987	400,330
Noninterest-bearing:			
Noninterest-bearing deposits	79,779	79,546	83,261
All other liabilities	2,813	2,756	2,704
TOTAL LIABILITIES	487,928	488,289	486,295
SHAREHOLDERS' EQUITY	52,280	52,352	52,289
TOTAL LIABILITIES AND			
SHAREHOLDERS' EQUITY	\$ 540,208	540,641	538,584

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## LCNB Corp. and Subsidiaries

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

#### Operations (continued)

Average total interest-earning assets increased approximately \$0.3 million during the second quarter, 2006 compared to the first quarter, 2006. Federal funds sold and interest-bearing demand deposits increased \$3.3 million, investment securities decreased \$9.1 million, and loans increased \$6.1 million for substantially the same reasons discussed above.

Average total interest-bearing liabilities decreased approximately \$0.7 million during the second quarter, 2006, compared to the first quarter, 2006. Interest-bearing deposits grew \$3.3 million and long-term debt decreased \$2.0 million for substantially the same reasons discussed above. Average short-term borrowings decreased \$2.0 million because, with higher balances in cash and cash equivalents during the second quarter, overnight borrowings decreased.

#### Liquidity

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

Liquidity is the ability to have funds available at all times to meet the commitments of LCNB. Asset liquidity is provided by cash and assets which are readily marketable or pledgeable or which will mature in the near future. Liquid assets include cash and cash equivalents and securities available for sale. At June 30, 2006, LCNB's liquid assets

amounted to \$140.2 million or 25.7% of total gross assets, a decrease from \$148.8 million or 27.6% at December 31, 2005. Liquid assets decreased, despite a \$12.9 million increase in cash and cash equivalents, due to the \$21.5 million decrease in securities available for sale. The decrease in liquidity was used primarily to fund new lending activity.

Liquidity is also provided by access to core funding sources, primarily core depositors in the bank's trade area. Approximately 76.5% of total deposits at June 30, 2006 were core deposits, a decrease from 80.7% at December 31, 2005. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit greater than \$100,000. Core deposits decreased because of the previously discussed increase in public fund deposits and decreases in money market deposit accounts, regular savings, and time deposit accounts.

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

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

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## **LCNB Corp. and Subsidiaries**

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

#### **Recent Accounting Pronouncements**

Statement of Financial Accounting Standards (SFAS) No. 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140*, was issued in February, 2006. It amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement is effective for all financial

instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. LCNB has not made any transactions covered by SFAS No. 155 and is not affected by the pronouncement.

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

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

### LCNB Corp. and Subsidiaries

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

The Bank's Asset and Liability Management Committee ("ALCO") primarily uses a combination of Interest Rate Sensitivity Analysis (IRSA) and Economic Value of Equity (EVE) analysis for measuring and managing interest rate risk. The IRSA model is used to estimate the effect on net interest income during a one-year period of instantaneous and sustained movements in interest rates, also called interest rate shocks, of 100, 200, and 300 basis points. The base projection uses a current interest rate scenario. As shown below, the June 30, 2006 IRSA indicates that an increase in interest rates would have a positive effect on net interest income, and a decrease in rates would have a negative effect on net interest income. The changes in net interest income for the up and down 100, 200, and 300 basis point rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in <u>Basis Points</u>	Amount	\$ Change in Net Interest	% Change in Net Interest
	<u>(In thousands)</u>	<u>Income</u>	<u>Income</u>
Up 300	\$ 18,935	149	0.80%
Up 200	18,891	105	0.56%
Up 100	18,843	57	0.31%
Base	18,786	-	-%
Down 100	18,683	(103)	-0.55%
Down 200	18,504	(282)	-1.50%
Down 300	18,274	(512)	-2.72%

IRSA shows the affect on net interest income during a one-year period only. A more long-range model is the EVE analysis, which shows the estimated present value of future cash inflows from interest-earning assets less the present value of future cash outflows for interest-bearing liabilities for the same rate shocks. The EVE analysis at June 30, 2006 is shown below. The changes in the economic value of equity for these rate assumptions are within LCNB's acceptable ranges.

Rate Shock Scenario in <u>Basis Points</u>	Amount	\$ Change in	% Change in
	<u>(In thousands)</u>	<u>EVE</u>	<u>EVE</u>
Up 300	\$ 93,166	(10,355)	-10.00%
Up 200	97,300	(6,221)	-6.01%
Up 100	100,919	(2,602)	-2.51%
Base	103,521	-	-%
Down 100	103,555	34	0.03%
Down 200	101,035	(2,486)	-2.40%
Down300	96,806	(6,715)	-6.49%

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



**LCNB Corp. and Subsidiaries**

**Item 4. Controls and Procedures**

a) **Disclosure controls and procedures.** The Chief Executive Officer and the Chief Financial Officer have carried out an evaluation of the effectiveness of LCNB's disclosure controls and procedures that ensure that information relating to LCNB required to be disclosed by LCNB in the reports that it files or submits under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Based upon this evaluation, these officers have concluded, that as of June 30, 2006, LCNB's disclosure controls and procedures were effective.

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

**PART II. OTHER INFORMATION**

**LCNB Corp. and Subsidiaries**

**Item 1. Legal Proceedings - Not Applicable**

**Item 1A. Risk Factors No material changes**

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

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

Under the "Market Repurchase Program" LCNB was originally authorized to purchase up to 100,000 shares of its stock through market transactions with a selected stockbroker. On November 14, 2005, the Board of Directors extended the Market Repurchase Program by increasing the shares authorized for repurchase to 200,000 total shares. Through June 30, 2006, 119,022 shares had been purchased under this program. The following table shows information relating to the repurchase of shares under the Market Repurchase Program during the three months ended June 30, 2006:

Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
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	Total Number of Shares Purchased	Average Price Paid Per Share		
April 1-30, 2006	-	\$ -	-	86,378
May 1-31, 2006	5,400	38.00	5,400	80,978
June 1-30, 2006	-	-	-	80,978
Total	5,400	38.00	5,400	80,978

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

## PART II. OTHER INFORMATION

### LCNB Corp. and Subsidiaries

#### Item 3. Defaults Upon Senior Securities - Not Applicable

#### Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of the shareholders of LCNB Corp. was held on April 11, 2006.

One item was voted on by the shareholders of LCNB: Election of three Class I directors to serve until the 2009 Annual Meeting.

The following nominees were elected as Class I directors by the votes indicated:

<u>Director</u>	<u>For</u>	<u>Withheld</u>
David S. Beckett	2,772,823	27,410
Spencer S. Cropper	2,793,926	6,307
Stephen P. Wilson	2,772,823	27,410

The following Class II and III members of the Board of Directors have terms expiring in 2007 and 2008, respectively:

Class II: Joseph W. Schwarz and Kathleen Porter Stolle

Class III: Rick L. Blossom, Steve P. Foster, William H. Kaufman, George L. Leasure

**Item 5. Other Information - Not Applicable**

## PART II. OTHER INFORMATION

### LCNB Corp. and Subsidiaries

#### Item 6. Exhibits

<u>Exhibit No.</u>	<u>Title</u>
3(i)	Articles of Incorporation incorporated by reference to Form 10-Q for the quarterly period ended March 31, 2005, Exhibit 3(i).
3(ii)	Regulations incorporated by reference to Form 10-Q for the quarterly period ended March 31, 2005, Exhibit 3(ii).
10.1	LCNB Corp. Ownership Incentive Plan incorporated by reference to Registrant's Form DEF 14A Proxy Statement pursuant to Section 14(a), Dated March 15, 2002, Exhibit A.
10.2	Form of Option Grant Agreement under the LCNB Corp. Ownership Incentive Plan incorporated by reference to Form 10-K for the fiscal year Ended December 31, 2005, Exhibit 10.2.
15	Letter regarding unaudited interim financial information.
31.1	Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Chief Financial Officer and Chief Financial Officer

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under Section 906 of the Sarbanes-Oxley Act of 2002.

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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.

July 31, 2006

/s/ Stephen P. Wilson

Stephen P. Wilson, President, CEO &

Chairman of the Board of Directors

July 31, 2006

/s/Steve P. Foster

Steve P. Foster, Executive Vice President



and Chief Financial Officer

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