UTSTARCOM INC
Form S-3/A
February 19, 2002

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON FEBRUARY 15, 2002

REGISTRATION NO. 333-82458

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

AMENDMENT NO. 1

TO

FORM S-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

UTSTARCOM, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	52-1782500
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

1275 HARBOR BAY PARKWAY
ALAMEDA, CALIFORNIA 94502
(510) 864-8800
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

HONG L. LU
PRESIDENT AND CHIEF EXECUTIVE OFFICER
UTSTARCOM, INC.
1275 HARBOR BAY PARKWAY
ALAMEDA, CALIFORNIA 94502
(510) 864-8800
(NAME, ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF AGENT FOR SERVICE)

COPIES TO:

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PROFESSIONAL CORPORATION	MENLO PARK, CA 94025
650 PAGE MILL ROAD	(650) 752-2000
PALO ALTO, CA 94304	
(650) 493-9300	

APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC: As soon

as practicable after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. [_]

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. [_]

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [_] ________

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [_] ________

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. [_]

CALCULATION OF REGISTRATION FEE

TITLE OF SECURITIES TO BE REGISTERED	AMOUNT TO BE REGISTERED	PROPOSED MAXIMUM OFFERING PRICE PER SHARE(1)	PROPOSED MAXIMUM AGGREGATE OFFERING PRICE	AMOUNT OF REGISTRATION FEE
Common stock, $0.00125 par value....	11,500,000	$22.775	$261,912,500	$24,095.95(2)

(1) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act, and is based upon the average of the high and low prices of the Registrant's common stock as reported on the Nasdaq National Market on February 11, 2002.

(2) $20,102.85 of this fee has been previously paid.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION ACTING PURSUANT TO SAID SECTION 8(A) MAY DETERMINE.

THE INFORMATION IN THIS PROSPECTUS IS NOT COMPLETE AND MAY BE CHANGED. WE MAY NOT SELL THESE SECURITIES UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL THESE SECURITIES AND IT IS NOT SOLICITING AN OFFER TO BUY THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

SUBJECT TO COMPLETION

PRELIMINARY PROSPECTUS DATED FEBRUARY 15, 2002

PROSPECTUS

10,000,000 SHARES

[LOGO] LOGO OF UT STARCOM

COMMON STOCK

SOFTBANK America Inc. is selling 10,000,000 shares.

The shares are quoted on The Nasdaq National Market under the symbol "UTSI." On February 14, 2002, the last sale price of the shares as reported on The Nasdaq National Market was $23.34 per share.

INVESTING IN THE COMMON STOCK INVOLVES RISKS THAT ARE DESCRIBED IN THE "RISK FACTORS" SECTION BEGINNING ON PAGE 5 OF THIS PROSPECTUS.

	PER SHARE	TOTAL
Public offering price....................................	$	$
Underwriting discount....................................	$	$
Proceeds, before expenses, to SOFTBANK America Inc.........	$	$

The underwriters may also purchase up to an additional 1,500,000 shares from us at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus to cover overallotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The shares will be ready for delivery on or about , 2002.

JOINT BOOK-RUNNING MANAGERS

MERRILL LYNCH & CO. CREDIT SUISSE FIRST BOSTON

SALOMON SMITH BARNEY
BANC OF AMERICA SECURITIES LLC
U.S. BANCORP PIPER JAFFRAY
HSBC

The date of this prospectus is , 2002.

Carrier's Backbone Network		UTStarcom Network Solutions	Application
PSTN		[Graphic of AN-2000] Broadband AN-2000	[Graphic of computer] Broadband [Graphic of telephone] Telephony
QoSIP		[Graphic of PAS] Wireless PAS	[Graphic of house, telephone and computer] Fixed Wireless
Internet	[Graphic of mSwitch] Softswitch mSwitch	[Graphic of 3G] 3G	[Graphic of cell phone] Mobility [Graphic of laptop computer] Multimedia

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You should rely only on the information contained or incorporated by reference in this prospectus. We have not, and the underwriters have not, authorized any person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. Information contained on our Web site is not part of this prospectus. SOFTBANK America Inc., we and the underwriters are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate as of the date on the front cover of this prospectus only. Our business, financial condition, results of operations and prospects may have changed since that date.

UTStarcom is registered as a trademark in the United States. UTStarcom and PAS are registered as trademarks in China. We have applied to register the mSwitch and Netman trademarks in China. This prospectus also includes product names, trade names and trademarks of other companies. All other product names, trade names and trademarks appearing in this prospectus are the property of their respective holders.

In this prospectus, references to and statements regarding China refer to mainland China, references to "U.S. dollars," or "$" are to United States Dollars, and references to "Renminbi" are to Renminbi, the legal currency of China.

Unless specifically stated, information in this prospectus assumes:

- an exchange rate of 8.3 Renminbi for one U.S. dollar, the exchange rate in effect as of December 31, 2001; and

- the underwriters will not exercise their overallotment option and no other person will exercise any other outstanding options or warrants.

PROSPECTUS SUMMARY

THIS SUMMARY HIGHLIGHTS SELECTED INFORMATION CONTAINED ELSEWHERE IN, OR INCORPORATED BY REFERENCE INTO, THIS PROSPECTUS. YOU SHOULD READ THE ENTIRE PROSPECTUS CAREFULLY, INCLUDING "RISK FACTORS" AND THE INFORMATION INCORPORATED BY REFERENCE, INCLUDING THE CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES, BEFORE MAKING AN INVESTMENT DECISION.

UTSTARCOM, INC.

We design, manufacture and market wireline and wireless broadband access and switching equipment that enables migration to next generation IP-based networks. Historically, substantially all of our sales have been to service providers in China, however we are currently expanding to include other growing communications markets outside of China. Our integrated suite of products provides migration to next generation networks and allows service providers to offer efficient and expandable voice, data and Internet access services. Because our systems are based on widely adopted international communications standards, service providers can easily integrate our systems into their existing networks and deploy our systems in new broadband, Internet Protocol and wireless network rollouts. Internet Protocol, or IP, refers to a set of rules developed for communicating information over the Internet.

China has one of the fastest growing communications markets in the world. Growth in China's communications equipment and services markets is being driven by the government of China's commitment to developing a communications infrastructure, strong demand for communications services and robust economic growth. While growth in China's communications market is currently driven predominantly by voice services, the increasing demand for data services also presents a growing opportunity both in China and in other international markets. The Gartner Group estimates that Internet users in China will grow from 20.0 million in 2001 to 51.0 million in 2004, representing a compound annual growth rate of 36.6%. China's ability to invest heavily in its communications infrastructure is fueled by the country's strong economic activity. According to the Economist Intelligence Unit, China's gross domestic product, or GDP, grew 7.3% in 2001. The Economist Intelligence Unit also estimates that China's GDP will grow at a compound annual growth rate of 7.5% from 2001 to 2005.

Voice and data service providers require network solutions that address all of their access needs and offer easy migration to next generation networks. These service providers require products that enable them to quickly, and with minimal incremental investment, address the changing demands of their subscribers for expanded or more advanced services. Given the rapid growth in emerging communications markets such as China, network solutions must be scalable so that the same architecture can provide an affordable entry level solution to initially serve a few hundred subscribers, yet economically scale to serve several hundred thousand subscribers over time. In addition, service providers require products that provide an integrated product solution and an economical migration path to next generation networks.

We believe our key competitive advantages are:

MIGRATION TO NEXT GENERATION IP NETWORKS. Our products are designed with the flexibility to allow service providers to deliver voice and data services over today's circuit-based networks and offer the ability to migrate to next generation broadband wireline and wireless networks based on IP and open standards. As a result, service providers can preserve their investment in existing networks and generate significant incremental revenue from their investment in our products, while migrating to next generation networks over time. Our products enable service providers to effectively time their network equipment expenditures, expand voice and data capacity and rapidly introduce

new services as demand warrants.

COST-EFFECTIVE SOLUTIONS. Our products are designed to provide operators with a high return on their investment. By reducing network complexity, integrating high performance capabilities and providing a flexible

migration path to next generation networks, our products cost less to deploy and maintain than most alternative technologies.

CONVERGENCE OF VOICE AND DATA SERVICES. We have designed our systems to offer a high degree of flexibility in terms of subscriber capacity and types of traffic delivered. Our equipment can be flexibly configured to offer a variety of services in response to subscriber demand. This flexibility is particularly important in China, as the communications services market is undergoing rapid change and growth. As Internet usage achieves greater penetration in China, we believe service providers will desire systems that are designed to deliver high-speed data capability. Our access systems allow service providers to quickly and cost-effectively implement upgrades for new services, including high-speed data capability, compared to alternative solutions which may require the purchase of an entirely new system to provide these services.

WIRELESS ACCESS NETWORKS. Our wireless access solutions are ideally suited for the requirements of service providers in emerging communications markets. Service providers can deploy our products quickly to cost-effectively meet customer demand. Our systems allow service providers to rapidly add new subscribers and to scale network capacity in response to demand. Our IP-based wireless access solutions also provide a platform for service providers to migrate to third generation, or 3G, mobile networks.

LOCAL PRESENCE. We have established a strong local presence in China that allows us to be responsive to the needs of service providers and their subscribers. We manufacture our products primarily at our facility in Hangzhou in Zhejiang province. By using local facilities in China, we have helped create new jobs within the provinces and have strengthened our relationships with the Telecommunications Administrations in some of China's most modern and rapidly growing provinces. We also maintain 15 sales and customer support sites in China that allow us to deploy a customer support representative onsite anywhere in China within 24 hours. Our sales force develops direct relationships with decision makers at both the provincial and local levels through pre-sales design and consulting services. Additionally, through our relationships at the national, provincial and local levels we receive a flow of information regarding market changes and insight into unique service provider needs and related opportunities. As part of this strategy to develop a local presence in markets that we serve, we also have sales, support and engineering personnel in Taiwan and India.

Our objective is to be a leading provider of wireline and wireless broadband access and switching equipment. The principal elements of our strategy are as follows:

- capitalize on the emerging IP-based switching market;
- leverage our installed base to capitalize on demand for wireless and wireline broadband services;
- expand our presence in China; and
- penetrate other growing communications markets worldwide.

As of December 31, 2001, we had sold approximately 6.6 million lines of PAS equipment servicing approximately 3.0 million subscribers in 210 cities in China. Based on our knowledge of China's communications market, we believe that PAS is the most widely deployed wireless local access system in China. In the Taiwan market, there were approximately 160,000 subscribers using our PAS systems as of December 31, 2001. For wireline networks, we provide a broadband-ready access platform called AN-2000. As of December 31, 2001, approximately 3.2 million lines of our wireline AN-2000 access platform have been deployed in China, including deployments in the six largest regional communications markets. Another 800,000 lines of our AN-2000 access platform have been deployed in markets outside of China.

We were incorporated in Delaware as Unitech Industries Inc. in 1991. In 1994, we changed our name to Unitech Telecom, Inc. In 1995, we acquired StarCom Network Systems, Inc. and changed our name to UTStarcom, Inc. Our principal executive offices are located at 1275 Harbor Bay Parkway, Alameda, California 94502 and our telephone number is (510) 864-8800.

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THE OFFERING

Common stock offered by SOFTBANK America Inc.......	10,000,000 shares
Shares outstanding after the offering..................	109,302,816 shares
Use of proceeds.............	We will not receive any proceeds from the sale of shares by SOFTBANK America Inc.
Risk factors................	See "Risk Factors" and other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of the common stock.
Nasdaq National Market symbol	UTSI

The number of shares that will be outstanding after the offering is based on the number of shares outstanding as of December 31, 2001 and excludes:

- options to purchase 12,578,417 shares of common stock outstanding under our stock option plans at a weighted average exercise price of $12.22 per share, and 2,450,501 additional shares available for grant under our stock option plans as of December 31, 2001;

- 3,716,294 shares of common stock available for purchase under our 2000 Employee Stock Purchase Plan as of December 31, 2001; and

- 32,000 shares of common stock reserved for issuance upon the exercise

of warrants outstanding as of December 31, 2001 at a weighted average exercise price of $2.50 per share.

The number of shares outstanding after the offering assumes that the underwriters' overallotment option is not exercised. If the overallotment option is exercised in full, the number of shares outstanding after the offering will be 110,802,816.

SUMMARY CONSOLIDATED FINANCIAL DATA

The summary consolidated financial data below should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and the related notes incorporated by reference into this prospectus.

	YEARS ENDED DECEMBER			
	1997	1998	1999	2
	(IN THOUSANDS, EXCEPT PER SH			
CONSOLIDATED STATEMENT OF OPERATIONS DATA:				
Net sales	$75,597	$105,167	$187,516	$36
Gross profit	26,802	41,025	74,813	12
Operating income (loss)	(3,390)	3,013	16,719	3
Income (loss) from continuing operations	(1,383)	593	13,119	2
Net income (loss) available to common stockholders	30	(300)	(18,514)	2
Earnings (loss) per share--income from continuing operations:				
Basic	$ (0.19)	$ 0.08	$ (1.94)	$
Diluted	$ (0.19)	$ 0.01	$ (1.94)	$
Earnings (loss) per share--net income:				
Basic	$ --	$ (0.04)	$ (2.13)	$
Diluted	$ --	$ --	$ (2.13)	$
Shares used in per share calculations:				
Basic	7,320	7,582	8,678	7
Diluted	7,320	77,050	8,678	10

	DECEMBER 31, 2001
	(IN THOUSANDS)
CONSOLIDATED BALANCE SHEET DATA:	
Cash and cash equivalents(1)	$ 321,136
Working capital	591,103
Total assets	1,005,880
Total short-term debt	58,434
Total long-term debt	12,048
Total stockholders' equity	681,887

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(1) Includes restricted cash of $5.2 million as of December 31, 2001.

RISK FACTORS

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING A DECISION TO BUY OUR COMMON STOCK. THE RISKS AND UNCERTAINTIES DESCRIBED BELOW ARE NOT THE ONLY ONES FACING OUR COMPANY. IF ANY OF THE FOLLOWING RISKS ACTUALLY OCCUR, OUR BUSINESS COULD BE HARMED, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED IN OR INCORPORATED BY REFERENCE INTO THIS PROSPECTUS, INCLUDING THE FINANCIAL STATEMENTS AND RELATED NOTES INCORPORATED HEREIN.

RISKS RELATING TO OUR COMPANY

OUR FUTURE PRODUCT SALES ARE UNPREDICTABLE, OUR OPERATING RESULTS ARE LIKELY TO FLUCTUATE FROM QUARTER TO QUARTER, AND IF WE FAIL TO MEET THE EXPECTATIONS OF SECURITIES ANALYSTS OR INVESTORS, OUR STOCK PRICE COULD DECLINE SIGNIFICANTLY

Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate in the future due to a variety of factors, some of which are outside of our control. As a result, period-to-period comparisons of our operating results are not necessarily meaningful or indicative of future performance. Furthermore, it is likely that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could decline.

Factors that may affect our future operating results include:

- the timing, number and size of orders for our products, as well as the relative mix of orders for each of our products, particularly the volume of lower margin handsets;
- cancellation, deferment or delay in implementation of large contracts;
- the evolving and unpredictable nature of the economic, regulatory, competitive and political environments in China and other countries in which we market or plan to market our products;
- price reductions by our competitors;
- changes in our customers' subscriber growth rate;
- currency fluctuations;
- market acceptance of our products and product enhancements;
- the lengthy and unpredictable sales cycles associated with sales of our products combined with the impact of this variability on our suppliers' ability to provide us with components on a timely basis;
- longer collection periods of accounts receivable in China and other countries; and
- the decline in business activity we typically experience during the Lunar New Year, which leads to decreased sales during our first fiscal quarter.

The limited performance history of some of our products, our limited forecasting experience and processes and the emerging nature of our target markets make forecasting our future sales and operating results difficult. Our expense levels are based, in part, on our expectations regarding future sales, and these expenses are largely fixed, particularly in the short term. In addition, to enable us to promptly fill orders, we maintain inventories of finished goods, components and raw materials. As a result, we commit to considerable costs in advance of anticipated sales. In the past, a substantial portion of our sales in each quarter resulted from orders received and shipped in that quarter, and we have operated with a limited backlog of unfilled orders. Accordingly, we may not be able to reduce our costs in a timely manner to compensate for any unexpected

shortfall between forecasted and actual sales. Any significant shortfall of sales may require us to maintain higher levels of inventories of finished goods, components and raw materials than we require, thereby increasing our risk of inventory obsolescence and corresponding inventory write-downs and write-offs.

COMPETITION IN OUR MARKETS MAY LEAD TO REDUCED PRICES, REVENUES AND MARKET SHARE

We are increasingly facing intense competition in our target markets, especially from domestic companies in China. We believe that our strongest competition in the future may come from these companies, many of which operate under lower cost structures and more favorable governmental policies and have much larger sales forces than we do. Furthermore, other companies not presently offering competing products may also enter our target markets, particularly with the reduction of trade restrictions as a result of China's admission to the World Trade Organization, or WTO. Many of our competitors have significantly greater financial, technical, product development, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies and changes in service provider requirements. Our competitors may also be able to devote greater resources than we can to the development, promotion and sale of new products. These competitors may also be able to offer significant financing arrangements to service providers, in some cases facilitated by government policies, which is a competitive advantage in selling systems to service providers with limited financial and currency resources. Increased competition is likely to result in price reductions, reduced gross profit as a percentage of net sales and loss of market share, any one of which could materially harm our business, financial condition and results of operations.

Moreover, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties, including Telecommunications Administrations, Telecommunications Bureaus and other local organizations, to increase the ability of their products to address the needs of prospective customers in our target markets. Accordingly, alliances among competitors or between competitors and third parties may emerge and rapidly acquire significant market share. To remain competitive, we believe that we must continue to partner with Telecommunications Administrations and other local organizations, maintain a high level of investment in research and development and in sales and marketing, and manufacture and deliver products to service providers on a timely basis and without significant defects. If we fail to meet any of these objectives, our business, financial condition and results of operations could be harmed.

The introduction of inexpensive wireless telephone service or other competitive services in China may also have an adverse impact on sales of our

PAS systems and handsets in China. We may not be able to compete successfully against current or future competitors, and competitive pressures in the future may materially adversely affect our business, financial condition and results of operations.

BECAUSE CONTRACTS AND PURCHASE ORDERS ARE GENERALLY SUBJECT TO CANCELLATION OR DELAY BY CUSTOMERS WITH LIMITED OR NO PENALTY, OUR BACKLOG IS NOT NECESSARILY INDICATIVE OF FUTURE REVENUES OR EARNINGS

As of December 31, 2001, our backlog totaled approximately $360.7 million, compared to approximately $191.2 million as of December 31, 2000. We include in our backlog contracts and purchase orders for which we anticipate delivery to occur within 12 months and products delivered but for which final acceptance has not yet been received. Because contracts and purchase orders are generally subject to cancellation or delay by customers with limited or no penalty, our backlog is not necessarily indicative of future revenues or earnings. In addition, we have a number of large contracts under which realization of our backlog is dependent on the successful implementation of our products by our customers and in some cases, the successful development of regional infrastructures.

OUR BUSINESS MAY SUFFER IF WE ARE UNABLE TO COLLECT PAYMENTS FROM OUR CUSTOMERS ON A TIMELY BASIS

Our customers often must make a significant commitment of capital to purchase our products. As a result, any downturn in a customer's business that affects the customer's ability to pay us could harm our

financial condition. Moreover, accounts receivable collection cycles historically tend to be much longer in China than in other markets. The failure of any of our customers to make timely payments could require us to write-off accounts receivable or increase our accounts receivable reserves, either of which could adversely affect our financial condition.

OUR MARKET IS SUBJECT TO RAPID TECHNOLOGICAL CHANGE, AND TO COMPETE EFFECTIVELY, WE MUST CONTINUALLY INTRODUCE NEW PRODUCTS THAT ACHIEVE MARKET ACCEPTANCE

The emerging market for communications equipment in developing countries is characterized by rapid technological developments, frequent new product introductions and evolving industry and regulatory standards. Our success will depend in large part on our ability to enhance our network access and switching technologies and develop and introduce new products and product enhancements that anticipate changing service provider requirements and technological developments. We may need to make substantial capital expenditures and incur significant research and development costs to develop and introduce new products and enhancements. If we fail to timely develop and introduce new products or enhancements to existing products that effectively respond to technological change, our business, financial condition and results of operations could be materially adversely affected.

From time to time, our competitors or we may announce new products or product enhancements, technologies or services that have the potential to replace or shorten the life cycles of our products and that may cause customers to defer purchasing our existing products, including the possible adoption and implementation of third generation, or 3G systems, resulting in inventory obsolescence. Future technological advances in the communications industry may diminish or inhibit market acceptance of our existing or future products or

render our products obsolete.

Even if we are able to develop and introduce new products, they may not gain market acceptance. Market acceptance of our products will depend on various factors including:

- our ability to obtain necessary approvals from regulatory organizations;
- the perceived advantages of the new products over competing products;
- our ability to attract customers who have existing relationships with our competitors;
- product cost relative to performance; and
- the level of customer service available to support new products.

Specifically, sales of PAS, our wireless access system, will depend in part upon consumer acceptance of the mobility limitations of this service relative to other wireless service systems, such as GSM or CDMA. If our existing or new products fail to achieve market acceptance for any reason, our business could be seriously harmed.

OUR BUSINESS WILL SUFFER IF WE ARE UNABLE TO DELIVER QUALITY PRODUCTS ON A TIMELY AND COST EFFECTIVE BASIS

Our operating results depend on our ability to manufacture products on a timely and cost effective basis. In the past, we have experienced reductions in yields as a result of various factors, including defects in components and human error in assembly. If we experience deterioration in manufacturing performance or a delay in production of any of our products, we could experience delays in shipments and cancellations of orders. Moreover, networking products frequently contain undetected software or hardware defects when first introduced or as new versions are released. In addition, our products are often embedded in or deployed in conjunction with service providers' products, which incorporate a variety of components produced by third parties. As a result, when a problem occurs, it may be difficult to identify the source of the problem. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product

development efforts and cause significant customer relation problems or loss of customers, any one of which could harm our business.

We contract with third parties in China to undertake high volume manufacturing and assembly of our handsets. In addition, we sometimes use third parties for high volume assembly of circuit boards. We do not have any long term contracts with these third party manufacturers, and in the event that these manufacturers are unable or unwilling to continue to manufacture our products, we may be unable to secure alternative manufacturers or could experience delays in qualifying new manufacturers. We currently manufacture internally only a very limited quantity of our handsets. However, if future demand for our handsets requires additional manufacturing capacity, we may invest in and build additional manufacturing facilities, most likely in China. However, new manufacturing facilities may not attain the same quality or level of efficiencies as those of our existing third party manufacturers.

WE DEPEND ON SOME SOLE SOURCE AND OTHER KEY SUPPLIERS FOR HANDSETS, COMPONENTS

AND MATERIALS USED IN OUR PRODUCTS, AND IF THESE SUPPLIERS FAIL TO PROVIDE US WITH ADEQUATE SUPPLIES OF HIGH QUALITY PRODUCTS AT COMPETITIVE PRICES, OUR COMPETITIVE POSITION, REPUTATION AND BUSINESS COULD BE HARMED

Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers. If any supplier is unwilling or unable to provide us with high quality components and materials in the quantities required and at the costs specified by us, we may not be able to find alternative sources on favorable terms, in a timely manner, or at all. Our inability to obtain or to develop alternative sources if and as required could result in delays or reductions in manufacturing or product shipments. Moreover, these suppliers may delay product shipments or supply us with inferior quality products. If any of these events occur, our competitive position, reputation and business could suffer.

Our ability to source a sufficient quantity of high quality components used in our products may be limited by China's import restrictions and duties. We require a significant number of imported components to manufacture our products in China. Imported electronic components and other imported goods used in the operation of our business are subject to a variety of permit requirements, approval procedures, import duties and registration requirements. Non-payment of required import duties could subject us to penalties and fines and could adversely affect our ability to manufacture and sell our products in China. In addition, import duties increase the cost of our products and may make them less competitive.

In particular, an integral component of our PAS system is the handset used by subscribers to make and receive mobile telephone calls. Our inability to obtain a sufficient number of high quality components and assemblies for handsets could severely harm our business. From time to time, there has been a worldwide shortage of handsets, and there currently exists a shortage of low-priced handsets, which we have found to be popular with many consumers in China. We have only used third parties to assemble and manufacture handsets in China for us for a limited period of time. These manufacturers may be unable to produce adequate quantities of high-quality handsets to meet the demand of our customers.

IF WE ARE UNABLE TO EXPAND OUR DIRECT SALES OPERATION IN CHINA AND INDIRECT DISTRIBUTION CHANNELS ELSEWHERE OR SUCCESSFULLY MANAGE OUR EXPANDED SALES ORGANIZATION, OUR OPERATING RESULTS MAY SUFFER

Our distribution strategy focuses primarily on developing and expanding our direct sales organization in China and our indirect distribution channels outside of China. We may not be able to successfully expand our direct sales organization in China and the cost of any expansion may exceed the revenue generated from these efforts. Even if we are successful in expanding our direct sales organization in China, we may not be able to compete successfully against the significantly larger and better-funded sales and marketing operations of current or potential competitors. In addition, if we fail to develop relationships with significant international resellers or manufacturers' representatives, or if these resellers or representatives are not successful in their sales or marketing efforts, we may be unsuccessful in our expansion efforts outside China.

WE EXPECT AVERAGE SELLING PRICES OF OUR PRODUCTS TO DECREASE WHICH MAY REDUCE OUR REVENUES, AND, AS A RESULT, WE MUST INTRODUCE NEW PRODUCTS AND REDUCE OUR COSTS IN ORDER TO MAINTAIN PROFITABILITY

The average selling prices for communications access and switching systems and subscriber terminal products, such as handsets, in China have been declining as a result of a number of factors, including:

- increased competition;
- aggressive price reductions by competitors; and
- rapid technological change.

We anticipate that average selling prices of our products will decrease in the future in response to product introductions by us or our competitors or other factors, including price pressures from customers. Therefore, we must continue to develop and introduce new products and enhancements to existing products that incorporate features that can be sold at higher average selling prices. Failure to do so could cause our revenues and gross profit, as a percentage of net sales, to decline.

Our cost reduction efforts may not allow us to keep pace with competitive pricing pressures or lead to improved gross profit, as a percentage of net sales. In order to be competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in these efforts or delivering our products to market in a timely manner. Any redesign may not result in sufficient cost reductions to allow us to reduce the prices of our products to remain competitive or to improve or maintain our gross profit, as a percentage of net sales.

SHIFTS IN OUR PRODUCT MIX MAY RESULT IN DECLINES IN GROSS PROFIT, AS A PERCENTAGE OF NET SALES

Our gross profit, as a percentage of net sales, varies among our product groups. Our gross profit, as a percentage of net sales, is generally higher on our access network system products and is significantly lower on our handsets. We also anticipate that the gross profit, as a percentage of net sales, may be lower for our newly developed products due to start-up costs and may improve as unit volumes increase and efficiencies can be realized. Our overall gross profit, as a percentage of net sales, has fluctuated from period to period as a result of shifts in product mix, the introduction of new products, decreases in average selling prices for older products and our ability to reduce manufacturing costs. As a result of a growth in sales of lower margin handsets we have experienced a decline in overall gross profit, as a percentage of net sales. We are likely to continue to experience downward pressure on our gross profit, as a percentage of net sales.

SERVICE PROVIDERS SOMETIMES EVALUATE OUR PRODUCTS FOR LONG AND UNPREDICTABLE PERIODS WHICH CAUSES THE TIMING OF PURCHASES AND OUR RESULTS OF OPERATIONS TO BE UNPREDICTABLE

The period of time between our initial contact with a service provider and the receipt of an actual purchase order may span a year or more. During this time, service providers may subject our products to an extensive and lengthy evaluation process before making a purchase. The length of these qualification processes may vary substantially by product and service provider, making our results of operations unpredictable. We may incur substantial sales and marketing expenses and expend significant management effort during this process, which ultimately may not result in a sale. These qualification processes often make it difficult to obtain new customers, as service providers are reluctant to expend the resources necessary to qualify a new supplier if they have one or more existing qualified sources.

OUR INABILITY TO EXERCISE COMPLETE CONTROL OVER A SUBSIDIARY MAY BE DETRIMENTAL TO OUR BUSINESS

A considerable portion of our operations is and will continue to be conducted through direct and indirect subsidiaries. For example, we currently own a 51.0% interest in a joint venture that operates the Guangdong

manufacturing facility. However, even though we own a majority interest in this joint venture, we do not have sole power to control all of the policies and decisions of this jointly-owned subsidiary. Under the law of China governing Sino-foreign joint ventures, equity holders exercise rights primarily through the board of directors, which constitutes the highest authority of the joint venture. Although we own a majority of the Guangdong joint venture, we are only entitled to appoint a minority of the directors to the joint venture's board of directors, which prevents us from controlling the actions of the board. China law requires unanimous approval of the board of directors for some significant corporate actions, including:

- amendment of the Articles of Association of the joint venture;
- liquidation or dissolution of the joint venture;
- any increase, decrease or transfer of equity interests of any party to the joint venture; and
- a merger of the joint venture with another economic entity.

Our operating results and cash flow depend on the operating results and cash flow of our subsidiaries and the payment of funds by those subsidiaries to us. These subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to pay dividends or otherwise provide financial benefits to us. Moreover, with respect to our Guangdong manufacturing joint venture, any payment of dividends to us must be agreed to by our joint venture partner, whose interests in receiving dividend distributions may not coincide with ours. In addition, applicable law in some countries including China limits the ability of a subsidiary to pay dividends for various reasons including the absence of sufficient distributable reserves. In the event of any insolvency, bankruptcy or similar proceedings, creditors of the subsidiaries would generally be entitled to priority over us with respect to assets of the affected subsidiary.

OUR MULTI-NATIONAL OPERATIONS SUBJECT US TO VARIOUS ECONOMIC, POLITICAL, REGULATORY AND LEGAL RISKS

We market and sell our products in China and other markets, including Taiwan and India. The expansion of our existing multi-national operations and entry into additional international markets will require significant management attention and financial resources. Multi-national operations are subject to inherent risks, including:

- difficulties in designing products that are compatible with varying international communications standards;
- longer accounts receivable collection periods and greater difficulty in accounts receivable collection;
- unexpected changes in regulatory requirements or the regulatory environment;
- changes in governmental control or influence over our customers;

- changes to import and export regulations, including quotas, tariffs and other trade barriers;
- delays or difficulties in obtaining export and import licenses;
- potential foreign exchange controls and repatriation controls on foreign earnings;
- exchange rate fluctuations and currency conversion restrictions;
- the burdens of complying with a variety of foreign laws and regulations;
- difficulties and costs of staffing and managing multi-national operations;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences; and
- political and economic instability.

Multi-national companies are required to establish intercompany pricing for transactions between their separate legal entities operating in different taxing jurisdictions. These intercompany transactions are subject to audit by taxing authorities in the jurisdictions in which multinational companies operate. An additional tax liability may be incurred if it is determined that intercompany pricing was not done at arm's length. We believe we have adequately estimated and recorded our liability arising from intercompany pricing, but an additional tax liability may result from audits of our intercompany pricing policies.

In markets outside of China, we rely on a number of original equipment manufacturers, or OEMs, and third-party distributors and agents to market and sell our network access products. If these OEMs, distributors or agents fail to provide the support and effort necessary to service developing markets effectively, our ability to maintain or expand our operations outside of China will be negatively impacted. We may not successfully compete in these markets, our products may not be accepted and we may not successfully overcome the risks associated with international operations.

WE ARE SUBJECT TO RISKS RELATING TO CURRENCY EXCHANGE RATE FLUCTUATIONS

We are exposed to foreign exchange rate risk because our sales to China are denominated in Renminbi and portions of our accounts payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been insignificant, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations.

OUR FAILURE TO MEET INTERNATIONAL AND GOVERNMENTAL PRODUCT STANDARDS COULD BE DETRIMENTAL TO OUR BUSINESS

Many of our products are required to comply with numerous government regulations and standards, which vary by market. As standards for products continue to evolve, we will need to modify our products or develop and support new versions of our products to meet emerging industry standards, comply with

government regulations and satisfy the requirements necessary to obtain approvals. Our inability to obtain regulatory approval and meet established standards could delay or prevent our entrance into or force our departure from particular markets.

OUR RECENT GROWTH HAS STRAINED OUR RESOURCES, AND IF WE ARE UNABLE TO MANAGE AND SUSTAIN OUR GROWTH, OUR OPERATING RESULTS WILL BE NEGATIVELY AFFECTED

We have recently experienced a period of rapid growth and anticipate that we must continue to expand our operations to address potential market opportunities. If we fail to implement or improve systems or controls or to manage any future growth and expansion effectively, our business could suffer.

Our expansion has placed and will continue to place a significant strain on our management, operational, financial and other resources. To manage our growth effectively, we will need to take various actions, including:

- enhancing management information systems and forecasting procedures;
- further developing our operating, administrative, financial and accounting systems and controls;
- maintaining close coordination among our engineering, accounting, finance, marketing, sales and operations organizations;
- expanding, training and managing our employee base; and
- expanding our finance, administrative and operations staff.

WE HAVE ONLY RECENTLY BECOME PROFITABLE AND MAY NOT BE ABLE TO SUSTAIN PROFITABILITY

We have only recently become profitable and may not be able to remain profitable in future periods. We anticipate continuing to incur significant sales and marketing, research and development and general and administrative expenses and, as a result, we will need to generate higher revenues to remain profitable. Numerous factors could negatively impact our results of operations, including a decrease in sales, price pressures and significant fixed costs. Our past results should not be relied on as an indication of our future performance.

OUR SUCCESS IS DEPENDENT ON CONTINUING TO HIRE AND RETAIN QUALIFIED PERSONNEL, AND IF WE ARE NOT SUCCESSFUL IN ATTRACTING AND RETAINING THESE PERSONNEL, OUR BUSINESS WOULD BE HARMED

The success of our business depends in significant part upon the continued contributions of key technical and senior management personnel, many of whom would be difficult to replace. In particular, our success depends in large part on the knowledge, expertise and services of Hong Liang Lu, our President and Chief Executive Officer, and Ying Wu, our Executive Vice President and Chief Executive Officer of China Operations. The loss of any key employee, the failure of any key employee to perform satisfactorily in his or her current position or our failure to attract and retain other key technical and senior management employees could have a significant negative impact on our operations.

To effectively manage our recent growth as well as any future growth, we will need to recruit, train, assimilate, motivate and retain qualified employees. Competition for qualified employees is intense, and the process of

recruiting personnel with the combination of skills and attributes required to execute our business strategy can be difficult, time-consuming and expensive. We are actively searching for research and development engineers and sales and marketing personnel, who are in short supply. Additionally, we have a need for and have experienced difficulty in finding qualified accounting personnel knowledgeable in U.S. and China accounting standards who are resident in China. If we fail to attract, hire, assimilate or retain qualified personnel, our business would be harmed.

Competitors and others have in the past and may in the future attempt to recruit our employees. In addition, companies in the communications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may be the subject of these types of claims in the future as we seek to hire qualified personnel. Some of these claims may result in material litigation and disruption to our operations. We could incur substantial costs in defending ourselves against these claims, regardless of their merit.

ANY ACQUISITIONS THAT WE UNDERTAKE COULD BE DIFFICULT TO INTEGRATE, DISRUPT OUR BUSINESS, DILUTE OUR STOCKHOLDERS AND HARM OUR OPERATING RESULTS

We may acquire complementary businesses, products and technologies. For example, in November 2001, we acquired Advanced Communication Devices Corporation, a system on chip semiconductor company. Any anticipated benefits of an acquisition may not be realized. We have in the past and will continue to evaluate acquisition prospects that would complement our existing product offerings, augment our market coverage, enhance our technological capabilities, or that may otherwise offer growth opportunities. Acquisitions of other companies may result in dilutive issuances of equity securities, the incurrence of debt and the amortization of expenses related to goodwill and other intangible assets. In addition, acquisitions involve numerous risks, including difficulties in the assimilation of operations, technologies, products and personnel of the acquired company, diversion of management's attention from other business concerns, risks of entering markets in which we have no direct or limited prior experience, and the potential loss of key employees of the acquired company.

WE MAY BE UNABLE TO ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY AND MAY BE SUBJECT TO CLAIMS THAT WE INFRINGE THE INTELLECTUAL PROPERTY OF OTHERS, EITHER OF WHICH COULD SUBSTANTIALLY HARM OUR BUSINESS

We rely on a combination of patents, copyrights, trademarks, trade secret laws and contractual obligations to protect our technology. We have applied for patents in the United States, three of which have been

issued. We have also filed patent applications in other countries. Additional patents may not be issued from our pending patent applications and our issued patents may not be upheld. In addition, we have, from time to time, chosen to abandon previously filed applications. Moreover, we have not yet obtained, and may not be able to obtain, patents in China on our products or the technology that we use to manufacture our products. Our subsidiaries and joint ventures in China rely upon our trademarks, technology and know-how to manufacture and sell our products. We cannot guarantee that these and other intellectual property protection measures will be sufficient to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to ours. In addition, the legal systems of many foreign countries, including China, do not protect intellectual property rights to the same extent as the legal system of the United States. If

we are unable to adequately protect our proprietary information and technology, our business, financial condition and results of operations could be materially adversely affected.

The increasing dependence of the communications industry on proprietary technology has resulted in frequent litigation based on allegations of the infringement of patents and other intellectual property. In the future we may be subject to litigation to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Future litigation also may be necessary to enforce and protect our trade secrets and other intellectual property rights. Any intellectual property litigation could be costly and could cause diversion of management's attention from the operation of our business. Adverse determinations in any litigation could result in the loss of our proprietary rights, subject us to significant liabilities or require us to seek licenses from third parties which may not be available on commercially reasonable terms, if at all. We could also be subject to court orders preventing us from manufacturing or selling our products.

BUSINESS INTERRUPTIONS COULD ADVERSELY AFFECT OUR BUSINESS

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster recovery plan. Our headquarters facility in the State of California is currently subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations at our headquarters. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business.

WE HAVE BEEN NAMED AS A DEFENDANT IN SECURITIES LITIGATION

On October 31, 2001, a putative stockholder class action lawsuit was filed against our company, some of our directors and officers and various underwriters for our initial public offering. The complaint alleges undisclosed improper underwriting practices concerning the allocation of IPO shares, in violation of the federal securities laws. Similar complaints have been filed concerning the IPOs of more than 300 companies, and the litigation has been coordinated in federal court for the Southern District of New York as IN RE INITIAL PUBLIC OFFERING SECURITIES LITIGATION, 21 MC 92. We believe we have meritorious defenses to the claims against us and intend to defend the litigation vigorously. However, as litigation is by its nature uncertain, an unfavorable resolution of the lawsuit could have a material adverse effect on our business, results of operations, or financial condition.

RISKS RELATING TO THE STRUCTURE AND REGULATION OF CHINA'S TELECOMMUNICATIONS INDUSTRY

CHINA'S TELECOMMUNICATIONS INDUSTRY IS SUBJECT TO EXTENSIVE GOVERNMENT REGULATION

China's telecommunications industry is heavily regulated by the Ministry of Information Industry. The Ministry of Information Industry has broad discretion and authority to regulate all aspects of the telecommunications and information technology industry in China, including managing spectrum bandwidths, setting network equipment specifications and standards and drafting laws and regulations related to the

electronics and telecommunications industries. Additionally, the Ministry of Information Industry can decide what types of equipment may be connected to the national telecommunications networks, the forms and types of services that may be offered to the public, the rates that are charged to subscribers for those services and the content of material available in China over the Internet. If the Ministry of Information Industry sets standards with which we are unable to comply or which render our products noncompetitive, our ability to sell products in China may be limited, resulting in substantial harm to our operations.

At the end of May 2000, we became aware of an internal notice, circulated within the Ministry of Information Industry, announcing a review of PHS-based telecommunications equipment for future installation into China's telecommunications infrastructure. The Ministry of Information Industry requested service providers to temporarily halt new deployments of PHS-based telecommunications equipment, including our PAS systems and handsets, pending conclusion of a review by the Ministry of Information Industry. Subsequently, at the end of June 2000, the Ministry of Information Industry issued a notice stating that it had concluded its review of PHS-based equipment and that the continued deployment of PHS-based systems, such as our PAS systems and handsets, in China's county-level cities and towns and villages would be permitted. In addition, the notice stated that deployments within large and medium-sized cities would only be allowed in very limited areas of dense population, such as campuses, commercial buildings and special development zones. The notice confirmed, however, that new citywide deployments of our PAS system in large and medium cities would not be permitted. Failure of the Ministry of Information Industry to permit the sale or deployment of our PAS systems and handsets, or the sale or deployment of our other products, or the imposition of additional limitations on their sale in the future could have a material adverse effect on our business and financial condition. The Ministry of Information Industry may conduct further reviews or evaluations of PHS-based telecommunications equipment or may change its position regarding PHS-based systems in the future.

CHINA'S TELECOMMUNICATIONS REGULATORY FRAMEWORK IS IN THE PROCESS OF BEING DEVELOPED, WHICH HAS LED TO UNCERTAINTIES REGARDING HOW TO CONDUCT OUR BUSINESS IN CHINA

China does not yet have a national telecommunications law. However, with China's recent admission into the WTO the Ministry of Information Industry, under the direction of the State Council, must shortly present the first draft of the Telecommunications Law of the People's Republic of China for ultimate submission to the National People's Congress for review and adoption. We do not know the nature and scope of regulation that the Telecommunications Law would create. Accordingly, we cannot predict whether it will have a positive or negative effect on us or on some or all aspects of our business.

China's telecommunications regulatory framework is in the process of being developed. In September 2000, the State Council issued the Telecommunications Regulations of the People's Republic of China, known as the Telecom Regulations. The Telecom Regulations cover telecommunications services and market regulations, pricing, interconnection and connection, as well as telecommunications construction and security issues. In May 2001, the Ministry of Information Industry issued the Administrative Measures of Network Access Licenses to implement the Telecom Regulations. Regulations in this area often require subjective interpretation and, given the relative infancy of the Telecom Regulations and the implementing regulations, we do not know how the regulations will be interpreted or enforced. As a result, our attempts to comply with these regulations may be deemed insufficient by the appropriate regulatory agencies, which could subject us to penalties that adversely affect our business.

OUR BUSINESS MAY SUFFER AS A RESULT OF THE RECENT RESTRUCTURING OF CHINA TELECOM

In February 1999, the State Council approved a restructuring plan for the China Telecom system, under which the telecommunications operations of the China Telecom system were separated along four business lines: fixed line, mobile, paging and satellite communications services. Following the announcement, we observed a reduction in orders from Telecommunications Bureaus, which we attributed to the uncertainties surrounding the restructuring and the ultimate impact the restructuring would have on the Telecommunications Bureaus.

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On December 11, 2001, the Chinese government announced that China Telecom would be further split into two entities by region, Northern and Southern. The 10 Northern provinces, municipalities and autonomous regions of China Telecom will be merged with China Netcom Co. Ltd. and China Jitong Network Communications Co. Ltd. to form a new company which we refer to as the New CNC. The remaining 21 provinces, municipalities and autonomous regions will constitute the Southern entity, which will keep the name of China Telecom. The New CNC will inherit 30% of the old China Telecom's national backbone network, with the rest going to the New China Telecom. As the announcement of this change is very recent and its implementation is ongoing, we cannot be certain what impact the restructuring will have on our business operations. However, we may experience another decline in orders and related revenues similar to that which we experienced following the 1999 restructuring, resulting from uncertainty among our Telecommunications Bureau customers associated with the restructuring. Moreover, following any restructuring, the New CNC, the New China Telecom or any other entity that may replace it as a result of any subsequent restructuring may restrict or prohibit the sales of our products, which could cause substantial harm to our business.

WE DO NOT HAVE SOME OF THE LICENSES WE ARE REQUIRED TO HAVE TO SELL OUR NETWORK ACCESS PRODUCTS IN CHINA

Under China's current regulatory structure, the communications products that we offer in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without the license, the equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and may not lower the quality or performance of other installed licensed products. The State Council's product quality supervision department, in concert with the Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. We have obtained the required network access licenses for our AN-2000 platform. We have applied for, but have not yet received, a network access license for our PAS systems and handsets. Based upon conversations with the Ministry of Information Industry, we understand that our PAS systems and handsets are considered to still be in the trial period and that sales of our PAS systems and handsets may continue to be made by us during this trial period, but a license will ultimately be required. Network access licenses will also be required for most additional products that we are selling or may sell in China, including our mSwitch

platform. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. Our counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our counsel in China, either of which could have a material adverse effect on our business and financial condition.

SOFTWARE INCORPORATED IN OUR PRODUCTS HAS NOT BEEN REGISTERED IN ACCORDANCE WITH RELEVANT CHINESE REGULATIONS, AND OUR ABILITY TO SELL THE PRODUCTS INCORPORATING THE SOFTWARE MAY BE AFFECTED

In October 2000, the Ministry of Information Industry issued regulations which prohibit the production and sale of software products, or products incorporating software, in China unless the software is registered with the government. We are in the process of applying for registration of our software. Based upon verbal advice received from the Ministry of Information Industry, we believe that we will be able to continue to sell products incorporating our software during the period in which the regulations are being implemented and our applications are pending. However, this implementation period may not last long enough for us to complete the registration of our software. Moreover, the Chinese government may interpret or apply the regulations in such a way as to prohibit sales of products incorporating our unregistered software prior to registration. If the government prohibits sales pending registration, or if we fail in our efforts to register our software, we could be prohibited

from making further sales of products incorporating our unregistered software in China, which could substantially harm our business and financial condition.

MOST OF OUR CUSTOMERS IN CHINA ARE PART OF THE CHINA TELECOM SYSTEM AND ARE SUBJECT TO ITS ULTIMATE CONTROL, AND, FOLLOWING THE RESTRUCTURING OF CHINA TELECOM, MOST WILL BE PART OF THE NEW CHINA TELECOM OR THE NEW CNC AND WILL BE SUBJECT TO THEIR ULTIMATE CONTROL

Our main customers in China are the local Telecommunications Bureaus, which operate under China Telecom, China's state-owned fixed line operator, and are subject to its ultimate control. The Telecommunications Bureaus will operate under the ultimate control of the New China Telecom or the New CNC after the restructuring of China Telecom. Policy statements may be issued, or decisions may be made by these entities, which govern the equipment purchasing decisions of most of our customers in China. For example, in late 1999 China Telecom prohibited all Telecommunications Bureaus from purchasing PHS systems, such as our PAS systems, for implementation in large cities, even before these sales were prohibited by the Ministry of Information Industry. As most of our sales are generated from our operations in China, any decisions by China Telecom and, thereafter, the New China Telecom or the New CNC, restricting or prohibiting the sales or deployment of our products could cause substantial harm to our business.

OUR ABILITY TO SELL OUR PAS WIRELESS SYSTEMS AND HANDSETS COULD BE SIGNIFICANTLY IMPAIRED IF CHINA TELECOM OR THE RESULTING ORGANIZATIONS FOLLOWING THE REORGANIZATION OF CHINA TELECOM ARE GRANTED OR OTHERWISE ACQUIRE MOBILE LICENSES, WHICH WILL ALLOW CHINA TELECOM OR SUCH RESULTING ENTITIES TO DELIVER CELLULAR SERVICES

China Telecom holds and operates and, after the restructuring, the New

China Telecom and the New CNC will hold and operate, the fixed line telephone and data communications assets in China and will be prohibited from offering cellular services. To offer wireless services to end users, the Telecommunications Bureaus must offer services that can be delivered over wireline networks, such as those delivered over our PAS wireless systems and handsets. China's media sources have widely reported that after the restructuring of China Telecom, the Ministry of Information Industry may grant a mobile license to either one or both of the New CNC and the New China Telecom. If the Ministry of Information Industry does grant a mobile license to the New China Telecom or the New CNC, or if such entities otherwise acquire mobile licenses, local Telecommunications Bureaus will be free to offer cellular services, such as GSM or CDMA, to their customers and they may therefore elect not to deploy our PAS systems and handsets. If this were to occur, we could lose current and potential customers for our PAS systems and handsets, and our financial condition and results of operations could be harmed.

CHANGES IN TELECOMMUNICATIONS RATES OR PRICING POLICIES MAY RESULT IN DECREASED DEMAND FOR OUR PRODUCTS

In November 2000, the Ministry of Information Industry announced significant changes in rates for telecommunications services in China. While long distance, international, leased line and Internet connection fees were cut by up to 70%, the rates for local telephone services, which include certain types of wireless access services such as those offered over our PAS systems and handsets, were increased, from approximately $0.01 per minute to approximately $0.02 per minute. The increase in rates may result in a reduced demand by end users for wireless services delivered over our PAS system and a corresponding decline in demand for our products. Additionally, the Ministry of Information Industry may implement future rate changes for wireline or wireless services in China or change telecommunications pricing policies, including allowing carriers to set prices based on market conditions, any of which may lead to reduced demand for our systems and products and result in a material adverse effect on our business or results of operations.

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RISKS RELATING TO CONDUCTING OPERATIONS IN CHINA

SALES IN CHINA HAVE ACCOUNTED FOR MOST OF OUR SALES, AND THEREFORE, OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS ARE TO A SIGNIFICANT DEGREE SUBJECT TO ECONOMIC, POLITICAL AND SOCIAL EVENTS IN CHINA

Approximately $565.9 million, or 90.3%, of our net sales in fiscal 2001, $364.0 million, or 98.8%, of our net sales in fiscal 2000, and $183.6 million, or 97.9%, of our net sales in fiscal 1999, occurred in China. Additionally, a substantial portion of our fixed assets are located in China. Of our total fixed assets, approximately 75.3% as of December 31, 2001, 75.0% as of December 31, 2000, and 53.7% as of December 31, 1999 were in China. We expect to make further investments in China in the future. Therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political and social events in China.

DEVALUATION IN THE VALUE OF THE RENMINBI AND FLUCTUATIONS IN EXCHANGE RATES COULD ADVERSELY AFFECT OUR FINANCIAL RESULTS

Exchange rate fluctuations could have a substantial negative impact on our financial condition and results of operations. We purchase substantially all of our materials in the United States and Japan and a significant portion of our cost of goods sold is incurred in U.S. dollars and Japanese yen. A significant portion of our operating expenses are incurred in U.S. dollars. At

the same time, most of our sales are denominated in Renminbi. The value of the Renminbi is fixed by China's national government and is subject to changes in China's governmental policies and to international economic and political developments. China may choose to devalue the Renminbi against the U.S. dollar. Additionally, China's government has considered from time to time whether to partially or fully abandon the official exchange rate for Renminbi to the U.S. dollar. The abandonment of this official exchange rate policy may lead to sharp depreciation of the Renminbi against the U.S. dollar and other foreign currencies and to significantly more volatility in the Renminbi exchange rate in the future, both of which would adversely affect our financial results and make our future results more subject to fluctuation.

In the past, financial markets in many Asian countries have experienced severe volatility and, as a result, some Asian currencies have experienced significant devaluation from time to time. The devaluation of some Asian currencies may have the effect of rendering exports from China more expensive and less competitive and therefore place pressure on China's government to devalue the Renminbi. Any devaluation of the Renminbi could result in an increase in volatility of Asian currency and capital markets. Future volatility of Asian financial markets could have an adverse impact on our ability to expand our product sales into Asian markets outside of China. Moreover, due to the limitations on the convertibility of Renminbi, we are limited in our ability to engage in currency hedging activities in China and do not currently engage in currency hedging activities with respect to international sales outside of China.

CURRENCY RESTRICTIONS IN CHINA MAY LIMIT THE ABILITY OF OUR SUBSIDIARIES AND JOINT VENTURES IN CHINA TO OBTAIN AND REMIT FOREIGN CURRENCY NECESSARY FOR THE PURCHASE OF IMPORTED COMPONENTS AND MAY LIMIT OUR ABILITY TO OBTAIN AND REMIT FOREIGN CURRENCY IN EXCHANGE FOR RENMINBI EARNINGS

China's government imposes controls on the convertibility of Renminbi into foreign currencies and, in certain cases, the remittance of currency out of China. Under the current foreign exchange control system, sufficient foreign currency may not be available to satisfy our currency needs. Shortages in the availability of foreign currency may restrict the ability of our Chinese subsidiaries to obtain and remit sufficient foreign currency to pay dividends to us, or otherwise satisfy their foreign currency denominated obligations, such as payments to us for components which we export to them and for technology licensing fees. We may also experience difficulties in completing the administrative procedures necessary to obtain and remit needed foreign currency.

Our business could be substantially harmed if we are unable to convert and remit our sales received in Renminbi into U.S. dollars. Under existing foreign exchange laws, Renminbi held by our China subsidiaries can

be converted into foreign currencies and remitted out of China to pay current account items such as payments to suppliers for imports, labor services, payment of interest on foreign exchange loans and distributions of dividends so long as the subsidiaries have adequate amounts of Renminbi to purchase the foreign currency. Expenses of a capital nature such as the repayment of bank loans denominated in foreign currencies, however, require approval from appropriate governmental authorities before Renminbi can be used to purchase foreign currency and then remitted out of China. This system could be changed at any time by executive decision of the State Council to impose limits on current account convertibility of the Renminbi or other similar restrictions. Moreover, even though the Renminbi is intended to be freely convertible under

the current account, the State Administration of Foreign Exchange, which is responsible for administering China's foreign currency market, has a significant degree of administrative discretion in implementing the laws. From time to time, the State Administration of Foreign Exchange has used this discretion in ways which effectively limit the convertibility of current account payments and restrict remittances out of China. Furthermore, in many circumstances the State Administration of Foreign Exchange must approve foreign currency conversions and remittances. Under the current foreign exchange control system, sufficient foreign currency may not be available at a given exchange rate to satisfy our currency demands.

CHINA SUBJECTS FOREIGN INVESTORS IN THE TELECOMMUNICATIONS INDUSTRY TO OWNERSHIP AND GEOGRAPHIC LIMITATIONS

China's government and its agencies, including the Ministry of Information Industry and the State Council, regulate foreign investment in the telecommunications industry through the promulgation of various laws and regulations and the issuance of various administrative orders and decisions. Currently, foreign investors may engage in such activities only in accordance with certain ownership and geographic limitations. China may promulgate new laws or regulations, or issue administrative or judicial decisions or interpretations, which would further restrict or bar foreigners from engaging in telecommunications-related activities. The promulgation of laws or regulations or the issuance of administrative orders or judicial decisions or interpretations restricting or prohibiting telecommunications activities by foreigners could have a substantial impact on our ongoing operations.

GOVERNMENTAL POLICIES IN CHINA COULD IMPACT OUR BUSINESS

Since 1978, China's government has been and is expected to continue reforming its economic and political systems. These reforms have resulted in and are expected to continue to result in significant economic and social development in China. Many of the reforms are unprecedented or experimental and may be subject to change or readjustment due to a number of political, economic and social factors. We believe that the basic principles underlying the political and economic reforms will continue to be implemented and provide the framework for China's political and economic system. New reforms or the readjustment of previously implemented reforms could have a significant negative effect on our operations. Changes in China's political, economic and social conditions and governmental policies which could have a substantial impact on our business include:

- new laws and regulations or the interpretation of those laws and regulations;
- the introduction of measures to control inflation or stimulate growth;
- changes in the rate or method of taxation;
- the imposition of additional restrictions on currency conversion and remittances abroad; and
- any actions which limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

ECONOMIC POLICIES IN CHINA COULD IMPACT OUR BUSINESS

The economy of China differs from the economies of most countries belonging to the Organization for Economic Cooperation and Development in various respects such as structure, government involvement, level of

development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position. In the past, the economy of China has been primarily a planned economy subject to one- and five-year state plans adopted by central government authorities and largely implemented by provincial and local authorities, which set production and development targets.

Since 1978, increasing emphasis had been placed on decentralization and the utilization of market forces in the development of China's economy. Economic reform measures adopted by China's government may be inconsistent or ineffectual, and we may not in all cases be able to capitalize on any reforms. Further, these measures may be adjusted or modified in ways which could result in economic liberalization measures that are inconsistent from time to time or from industry to industry or across different regions of the country. China's economy has experienced significant growth in the past decade. This growth, however, has been accompanied by imbalances in China's economy and has resulted in significant fluctuations in general price levels, including periods of inflation. China's government has implemented policies from time to time to increase or restrain the rate of economic growth, control periods of inflation or otherwise regulate economic expansion. While we may be able to benefit from the effects of some of these policies, these policies and other measures taken by China's government to regulate the economy could also have a significant negative impact on economic conditions in China with a resulting negative impact on our business.

CHINA'S ENTRY INTO THE WORLD TRADE ORGANIZATION CREATES UNCERTAINTY AS TO THE FUTURE ECONOMIC AND BUSINESS ENVIRONMENTS IN CHINA

China's entry into the WTO was approved in September 2001. Entry into the WTO will require China to further reduce tariffs and eliminate non-tariff barriers, which include quotas, licenses and other restrictions by 2005 at the latest. While China's entry into the WTO and the related relaxation of trade restrictions may lead to increased foreign investment, it may also lead to increased competition in China's markets from international companies. China's entry into the WTO could have a negative impact on China's economy with a resulting negative impact on our business.

IF TAX BENEFITS AVAILABLE TO OUR SUBSIDIARIES LOCATED IN CHINA ARE REDUCED OR REPEALED, OUR BUSINESS COULD SUFFER

Our subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to foreign investment enterprises, including full exemption from national enterprise income tax for two years starting from the first profit-making year and/or a 50% reduction in national income tax rate for the following three years. In addition, local enterprise income tax is often waived or reduced during this tax holiday/incentive period. Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. All of our active subsidiaries in China were accredited as technologically advanced enterprises. Two of our principal subsidiaries, UTStarcom China and Hangzhou UTStarcom, accounted for approximately 90.1% of our revenues in 2001. The tax holidays applicable to, UTStarcom China will expire at the end of 2002. At that time, the tax rate will increase from 7.5% to 15% and will negatively impact our financial condition and results of operations. The tax holiday applicable to our other principal subsidiary, Hangzhou UTStarcom, expired in 2001 and is now subject to annual

review. Consequently, its tax rate could increase from 10% to 15% if it is unable to maintain a tax holiday in 2002. If we are unable to extend this tax holiday to 2002, our financial condition and results of operations may be negatively impacted. Additionally, the Chinese government is considering the imposition of a "unified" corporate income tax that would phase out, over time, the preferential tax treatment to which foreign-funded enterprises, such as UTStarcom, are currently entitled. While it is not certain whether the government will implement such a unified tax structure or whether, if implemented, UTStarcom will be grandfathered into the new tax structure, if the new tax structure is implemented, it will adversely affect our financial condition.

WE MAY BE EXPOSED TO CONTINGENT TAX LIABILITIES IN CHINA RESULTING FROM OUR FAILURE TO WITHHOLD SUFFICIENT AMOUNTS FOR CHINA'S INCOME TAX PURPOSES

We employ a number of U.S. citizens who work on a full time basis in China. These expatriate employees participate in our stock option plans and have exercised a number of options granted under the plans. The option exercises generated income that may be subject to personal income taxes under China's income tax laws. We did not withhold China income taxes on the option exercises, and the employees have not yet paid any taxes in China that may be due. Should the employees fail to pay the income taxes, we may be liable for such taxes in our capacity as withholding agent. In the event that it is determined that taxes are due in China, we, on behalf of our employees, will apply for a refund from the U.S. tax authorities corresponding to the amount of the foreign tax credit which would then be applicable. The refund amounts are required to be paid to us by the employees who receive them. In addition, our failure to collect and remit China withholding tax may also subject us to penalties.

CHINA'S LEGAL SYSTEM EMBODIES UNCERTAINTIES THAT COULD NEGATIVELY IMPACT OUR BUSINESS

China has a civil law system. Decided court cases do not have binding legal effect on future decisions. Since 1979, many new laws and regulations covering general economic matters have been promulgated in China. Despite this activity to develop the legal system, China's system of laws is not yet complete. Even where adequate law exists in China, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. The relative inexperience of China's judiciary in many cases creates additional uncertainty as to the outcome of any litigation. Further, interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Moreover, government policies and internal rules promulgated by governmental agencies may not be published in time, or at all. As a result, we may operate our business in violation of new rules and policies without having any knowledge of their existence.

China has adopted a broad range of related laws, administrative rules and regulations that govern the conduct and operations of foreign investment enterprises and restrict the ability of foreign companies to conduct business in China. These laws, rules and regulations provide some incentives to encourage the flow of investment into China, but also subject foreign companies, and foreign investment enterprises, including our subsidiaries in China, to a set of restrictions that may not always apply to domestic companies in China. As a result of its admission into the WTO, China is increasingly according foreign companies and foreign investment enterprises established in

China the same rights and privileges as Chinese domestic companies. These special laws, administrative rules and regulations governing foreign companies and foreign investment enterprises may still place us and our subsidiaries at a disadvantage in relation to Chinese domestic companies and may adversely affect our competitive position. Moreover, as China's legal system develops, the promulgation of new laws, changes to existing laws and the pre-emption of local regulations by national laws may adversely affect foreign investors and companies.

Many of our activities and products in China are subject to administrative review and approval by various national and local agencies of China's government. Because of the changes occurring in China's legal and regulatory structure, we may not be able to secure the requisite governmental approval for our activities and products. Failure to obtain the requisite government approval for any of our activities or products could substantially harm our business.

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RISKS RELATING TO THE OFFERING AND OUR STOCK PERFORMANCE

OUR STOCK PRICE IS HIGHLY VOLATILE

The trading price of our common stock has fluctuated significantly since our initial public offering in March 2000. Our stock price could be subject to wide fluctuations in the future in response to many events or factors, including those discussed in the preceding risk factors relating to our operations, as well as:

- actual or anticipated fluctuations in operating results;
- changes in expectations as to future financial performance or changes in financial estimates or buy/sell recommendations of securities analysts;
- changes in governmental regulations or policies in China, such as the temporary suspension of sales of our PAS systems that occurred in May and June of 2000, which caused our stock price to drop;
- our, or a competitor's, announcement of new products, services or technological innovations; and
- the operating and stock price performance of other comparable companies.

General market conditions and domestic or international macroeconomic factors unrelated to our performance may also affect our stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company's securities, securities class action litigation against a company is sometimes instituted. This type of litigation could result in substantial costs and the diversion of management time and resources.

A SUBSTANTIAL NUMBER OF SHARES OF OUR COMMON STOCK HELD BY SOFTBANK AMERICA INC. MAY BECOME AVAILABLE FOR SALE IN THE PUBLIC MARKET, WHICH COULD CAUSE THE MARKET PRICE OF OUR STOCK TO DECLINE

Following the completion of this offering, SOFTBANK America Inc. will beneficially own 34,651,630 shares, or 31.7%, of our outstanding shares of common stock. If the overallotment option is exercised in full, SOFTBANK

America Inc. will beneficially own 31.3% of our outstanding shares of common stock. Subject to compliance with Rule 144 of the Securities Act, SOFTBANK America Inc. may sell these shares in the public market. The market price of our common stock could decline if SOFTBANK America Inc. sells these shares or the market perceives that SOFTBANK America Inc. intends to sell them. In connection with this offering, SOFTBANK America Inc. has agreed, with exceptions, not to sell or transfer any common stock held by it commencing on the date of this prospectus for a period ending 180 days after the date of this prospectus, without first obtaining the written consent of Merrill Lynch.

SOFTBANK AMERICA INC. HAS SIGNIFICANT INFLUENCE OVER OUR MANAGEMENT AND AFFAIRS, WHICH IT COULD EXERCISE AGAINST YOUR BEST INTERESTS

Following the completion of this offering, SOFTBANK America Inc. will still beneficially own 31.7% of our outstanding stock. If the overallotment option is exercised in full, SOFTBANK America Inc. will beneficially own 31.3% of our outstanding shares of common stock. As a result, SOFTBANK America Inc. will have the ability to exercise significant influence over all matters submitted to our stockholders for approval and exert significant influence over our management and affairs. This concentration of ownership may delay or prevent a change of control or discourage a potential acquiror from making a tender offer or otherwise attempting to obtain control of our company, which could decrease the market price of our common stock. Matters that could require stockholder approval include:

- election and removal of directors;
- merger or consolidation of our company; and
- sale of all or substantially all of our assets.

The interests of SOFTBANK America Inc. may not always coincide with our interests. SOFTBANK America Inc. acting through its designee on the Board of Directors and through its ownership of voting securities, will have the ability to exercise significant influence over our actions irrespective of the desires of our other stockholders or directors.

DELAWARE LAW AND OUR CHARTER DOCUMENTS CONTAIN PROVISIONS THAT COULD DISCOURAGE OR PREVENT A POTENTIAL TAKEOVER, EVEN IF THE TRANSACTION WOULD BENEFIT OUR STOCKHOLDERS

Other companies may seek to acquire or merge with us. An acquisition or merger of our company could result in benefits to our stockholders, including an increase in the value of our common stock. Some provisions of our Certificate of Incorporation and Bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the Board of Directors to issue additional preferred stock;
- prohibiting cumulative voting in the election of directors;

- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- creating a classified Board of Directors pursuant to which our directors are elected for staggered three year terms; and
- establishing advance notice requirements for nominations for election to the Board of Directors and for proposing matters that can be acted on by stockholders at stockholder meetings.

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FORWARD-LOOKING STATEMENTS

This prospectus includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934 and information relating to us that are based on the beliefs of our management as well as assumptions made by and information currently available to management. We intend 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, and we are including this statement for purposes of complying with these safe harbor provisions. These forward-looking statements include but are not limited to those statements concerning the following: the growth of China's telecommunications equipment and subscriber markets; our plan to expand our presence in China and other growing telecommunications markets; our expectation that our PAS wireless access system and other communications products will continue to be allowed in China under the country's regulatory scheme; fluctuations in our overall gross profit, gross profit as a percentage of net sales, product mix and selling prices; our plans for expanding our selling and marketing campaigns; our expectation that there will be increases in selling, marketing, research and development, general and administrative expenses; the capabilities of our mSwitch, PAS and AN-2000 products; our expectation that existing cash and cash equivalents will be sufficient to finance our operations for at least the next 12 months; and our estimate of the amount of net proceeds from this offering and the intended uses for those proceeds. Additional forward looking statements may be identified by the words "anticipate," "believe," "extend," "intend," "will" and similar expressions, as they relate to us or our management.

The forward-looking statements contained in this prospectus are not guarantees of future performance and are subject to risks, uncertainties and assumptions, including those set forth under ''Risk Factors'' and the following:

- devaluation of the Renminbi and fluctuations of exchange rates;
- changes in China's government, economic or regulatory policies;
- uncertainty regarding the commercial acceptance of our network access and switching equipment and technologies;
- regarding our future operating results;
- ability to introduce new and enhanced products;
- delays or losses of sales due to long sales and delivery cycles for our products;

- the possibility of lower prices, reduced gross profit as a percentage of net sales and loss of market share due to increased competition; and

- increased demands on our resources due to unanticipated growth.

Investors are cautioned that these forward-looking statements are inherently uncertain. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results or outcomes could vary materially from those described in this prospectus. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

USE OF PROCEEDS

If the overallotment option is exercised in full, we estimate our net proceeds from the sale of the 1,500,000 shares of common stock offered by us in this prospectus will be approximately $33.3 million, based on an assumed public offering price of $23.34 per share and after deducting the underwriting discount and estimated offering expenses. We will not receive any of the proceeds from the sale of shares by SOFTBANK America Inc.

We presently intend to use any net proceeds from this offering for general corporate purposes, including research and development, expansion of our sales and marketing organization and working capital. Our management will have broad discretion in the application of the net proceeds from this offering. Pending any use, we intend to invest the net proceeds in government securities and in short term, investment-grade interest bearing securities.

From time to time we may evaluate opportunities to acquire or invest in complementary businesses, technologies or products, and may use a portion of any net proceeds from this offering to enter into these types of transactions. At this time, we do not have any understanding, commitments or agreements with respect to such material transaction.

DIVIDEND POLICY

To date, we have not paid any cash dividends on our common stock. We currently anticipate that we will retain any available funds to finance the growth and operation of our business and we do not anticipate paying any cash dividends in the foreseeable future. Certain present or future agreements to which we are a party may limit or prevent the payment of dividends on our common stock.

PRICE RANGE OF OUR COMMON STOCK

	HIGH	LOW

FISCAL 2000		
1st Quarter (from March 3, 2000)	$93.50	$41.00
2nd Quarter	77.63	16.75
3rd Quarter	32.88	18.00
4th Quarter	23.00	12.31
FISCAL 2001		
1st Quarter	$28.00	$13.56
2nd Quarter	27.28	12.50
3rd Quarter	25.61	12.98
4th Quarter	31.43	15.51
FISCAL 2002		
1st Quarter (through February 14, 2002)	$35.66	$20.67

Our common stock has been traded on The Nasdaq National Market under the symbol "UTSI" since our initial public offering on March 3, 2000. The preceding table sets forth the high and low sales prices per share of our common stock as reported on The Nasdaq National Market for the periods indicated. As of December 31, 2001 we had approximately 205 stockholders of record. On February 14, 2002 the last reported sale price of our common stock on The Nasdaq National Market was $23.34 per share.

CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2001. You should read this table in conjunction with the consolidated financial statements and notes incorporated by reference into this prospectus, and "Selected Consolidated Financial Data" included elsewhere in this prospectus.

	AS OF DECEMBER 31, 2001
	(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
Long-term debt, net of current portion	$ 12,048
Stockholders' equity:	
Preferred stock, $0.00125 par value; 5,000,000 shares authorized; no shares issued and outstanding	--
Common stock, $0.00125 par value; 250,000,000 shares authorized, 109,302,816 shares issued and outstanding	138
Additional paid-in capital	638,697

Deferred stock compensation	(6,045)
Retained earnings	49,146
Notes receivable from stockholders	(381)
Accumulated other comprehensive income	332
Total stockholders' equity	681,887
Total capitalization	$693,935

The table above excludes:

- options to purchase 12,578,417 shares of common stock outstanding under our stock option plans at a weighted average exercise price of $12.22 per share, and 2,450,501 additional shares available for grant under our stock option plans as of December 31, 2001;
- 3,716,294 shares of common stock available for purchase under our 2000 Employee Stock Purchase Plan as of December 31, 2001; and
- 32,000 shares of common stock reserved for issuance upon the exercise of warrants outstanding as of December 31, 2001 at a weighted average exercise price of $2.50 per share.

The number of shares outstanding after the offering assumes that the underwriters' overallotment option is not exercised. If the overallotment option is exercised in full, the number of shares outstanding after the offering will be 110,802,816.

SELECTED CONSOLIDATED FINANCIAL DATA

You should read the following selected consolidated financial data in conjunction with our consolidated financial statements and the related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in or incorporated by reference into this prospectus. The consolidated statement of operations data for the years ended December 31, 1999, 2000 and 2001 and consolidated balance sheet data at December 31, 2000 and 2001 are derived from, and are qualified by reference to, our audited consolidated financial statements incorporated by reference into this prospectus. The consolidated statement of operations data for the years ended December 31, 1997 and 1998 and the consolidated balance sheet data at December 31, 1997, 1998 and 1999 have been derived from audited financial statements not included in or incorporated by reference into this prospectus. Historical results are not necessarily indicative of results to be expected in any future period.

YEAR ENDED DECEMBER 31,

	1997	1998	1999	2000	2001
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
CONSOLIDATED STATEMENT OF OPERATIONS DATA:					
Net sales...	$75,597	$105,167	$187,516	$368,646	$626,8
Cost of sales (includes stock compensation expense of $0, $0, $12, $90, and $41)............	48,795	64,142	112,703	240,465	402,2
Gross profit......................................	26,802	41,025	74,813	128,181	224,5
Operating expenses:					
Selling, general and administrative (includes stock compensation expense of $0, $390, $4,256, $4,676 and $2,499).....................	21,211	23,211	35,122	48,055	75,7
Research and development (includes stock compensation expense of $0, $22, $1,285, $6,795 and $2,660)............................	8,941	14,681	18,648	41,452	59,8
Amortization of goodwill and intangible assets....	40	120	332	4,894	7,5
In-process research and development..............	--	--	3,992	--	4,7
Total operating expenses.......................	30,192	38,012	58,094	94,401	147,8
Operating income (loss)...........................	(3,390)	3,013	16,719	33,780	76,7
Interest and other income (expenses)..............	2,033	(1,138)	(2,212)	10,829	2,6
Equity in net income (loss) of affiliated companies...	73	(773)	1,348	(288)	(1,2
Income (loss) before income taxes, minority interest and cumulative effect of a change in accounting principle...........................	(1,284)	1,102	15,855	44,321	78,0
Income tax expense................................	400	1,423	626	14,021	19,8
Minority interest in (earnings) loss of consolidated subsidiaries.......................	301	914	(2,110)	(2,307)	(1,3
Income (loss) from continuing operations..........	(1,383)	593	13,119	27,993	56,9
Income (loss) from discontinued operations.........	1,413	(893)	(1,656)	--	
Cumulative effect of the application of SAB 101 "Revenue Recognition in Financial Statements".....	--	--	--	(980)	
Net income (loss).................................	30	(300)	11,463	27,013	56,9
Beneficial conversion feature of Series F preferred stock.................................	--	--	(29,977)	--	
Net income (loss) applicable to common stockholders....................................	$ 30	$ (300)	$(18,514)	$ 27,013	$ 56,9
Basic earnings (loss) per share:					
Income (loss) from continuing operations........	$ (0.19)	0.08	$ (1.94)	$ 0.35	$ 0.
Income (loss) from discontinued operations......	0.19	(0.12)	(0.19)	--	
Cumulative effect on prior years of the application of SAB 101 "Revenue Recognition in Financial Statements".....................	--	--	--	(0.01)	
Net income (loss).............................	$ 0.00	$ (0.04)	$ (2.13)	$ 0.34	$ 0.
Diluted earnings (loss) per share:					
Income (loss) from continuing operations.......	$ (0.19)	$ 0.01	$ (1.94)	$ 0.28	$ 0.
Income (loss) from discontinued operations......	0.19	(0.01)	(0.19)	--	
Cumulative effect on prior years of the application of SAB 101 "Revenue Recognition					

in Financial Statements"......................	--	--	--	(0.01)	
Net income (loss)..............................	$ 0.00	$ 0.00	$ (2.13)	$ 0.27	$ 0.
Shares used in per share calculations:					
Basic..	7,320	7,582	8,678	79,696	101,4
Diluted......................................	7,320	77,050	8,678	101,867	108,6

	AS OF DECEMBER 31,				
	1997	1998	1999	2000	2001
	(IN THOUSANDS)				
CONSOLIDATED BALANCE SHEET DATA:					
Cash and cash equivalents (1)...	$ 35,049	$ 17,626	$ 87,364	$149,112	$ 321,136
Working capital................	59,076	57,416	128,973	369,861	591,103
Total assets...................	101,097	142,121	271,788	591,837	1,005,880
Total short-term debt...........	1,579	38,426	43,338	43,381	58,434
Long-term debt.................	--	--	--	12,048	12,048
Total stockholders' equity......	72,513	72,336	165,720	412,319	681,887

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(1) Includes restricted cash of $5.2 million as of December 31, 2001.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER SUBSTANTIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF MANY FACTORS, INCLUDING THOSE DISCUSSED IN "RISK FACTORS" AND ELSEWHERE IN THIS PROSPECTUS. THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES THERETO INCORPORATED BY REFERENCE INTO THIS PROSPECTUS.

OVERVIEW

We design, manufacture and market wireline and wireless broadband access and switching equipment that enables migration to next generation IP-based networks. Our operations are conducted primarily by our foreign subsidiaries that manufacture, distribute and support our products, principally in China. Our systems and products allow service providers to offer cost-efficient and expandable voice, data and Internet access services. Because our systems are based on widely adopted international communications standards, service providers can easily integrate our systems into their existing networks and deploy our systems in new broadband, Internet Protocol and wireless network rollouts.

We incorporated in Delaware in 1991. Since our incorporation, we have focused our resources on developing products for China's communications market. We shipped our first network access products in 1993. In 1995, we acquired StarCom Network Systems, Inc. and changed our name to UTStarcom, Inc. In 1996, we introduced our advanced, V5.1 and V5.2 compliant, multi-service network access platform, the AN-2000. Late in 1996, we introduced our PAS wireless access system. In December 1999, we completed the acquisition of the portion of our Wacos, Inc. subsidiary owned by the minority shareholders. Wacos, Inc. is a research and development subsidiary that develops IP-based switching systems. In November 2001, we completed the acquisition of Advanced Communications Devices Corporation, or ACD, for $21.3 million. In addition, we issued shares of restricted common stock valued at $5.0 million to ACD employees who will continue to perform services for us, vesting over a period of five years or upon the achievement of certain performance milestones. The first milestone was met in December 2001, resulting in a charge of $1.3 million to operations. ACD is a System-on-Chip (SoC) semiconductor company focusing on LAN and IP switching technology. We conduct our operations in China through wholly owned subsidiaries and two joint ventures.

We have derived substantially all of our revenues from sales of telecommunications equipment to service providers in China. However, we are currently expanding our sales to service providers in other growing communications markets outside of China. Our customers often make a large initial purchase of our equipment followed by supplemental purchases of enhancements and upgrades. As a result, our largest revenue-producing customers typically vary from period to period. The evaluation period for our products by potential customers may span a year or more and our business generally depends on a relatively small number of large deployments. We sell our products in China through a direct sales force.

Approximately 90.3% of our net sales for the year ended December 31, 2001 and approximately 98.8% of our net sales for the year ended December 31, 2000 were made in China. Accordingly, our business, financial condition and results of operations are likely to be influenced by the political, economic and legal environment in China, and by the general state of China's economy. Our results may be adversely affected by, among other things, changes in the political, economic, competitive and social conditions in China, including changes in governmental policies with respect to laws and regulations, changes in telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation. Our first and second largest customers accounted for 6.6% and 5.9% of our net sales for the year ended December 31, 2001, and 9.0% and 5.0% of accounts receivable, respectively, as of December 31, 2001. Our first and second largest customers accounted for 12.1% and 6.0% of our net sales, respectively, for the year ended December 31, 2000 and 7.0% and 0.2% of the accounts receivable, respectively, as of December 31,

2000. Our first and second largest customers accounted for 30.2% and 10.7% of our net sales, respectively, in 1999 and 39.0% and 6.0% of the accounts receivable, respectively, as of December 31, 1999. 89.9% of our net sales during 2001 were to entities affiliated with the government of China. Accounts receivable balances from these entities or state owned enterprises were $192.8 million as of December 31, 2001. We extend credit to our customers in China without requiring collateral. We monitor our exposure for credit losses and maintain allowances for doubtful accounts.

Under China's current regulatory structure, the communications products

that we offer in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without a license, the equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and may not lower the quality or performance of other installed licensed products. The State Council's product quality supervision department, in concert with the Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. We have obtained the required network access licenses for our AN-2000 platform. We have applied for, but have not yet received, a network access license for our PAS systems and handsets. Based upon conversations with the Ministry of Information Industry, we understand that our PAS systems and handsets are considered to still be in the trial period and that sales of our PAS systems and handsets may continue to be made by us during this trial period, but a license will ultimately be required. Network access licenses will also be required for most additional products that we are selling or may sell in China, including our mSwitch platform. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. Our counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our counsel in China, either of which could have a material adverse effect on our business, financial condition and results of operations.

Remittances from China, which are of a capital nature, such as the repayment of bank loans denominated in foreign currencies, require approval from appropriate governmental authorities before Renminbi can be used to purchase foreign currency. Although the payment of cash dividends is permitted so long as our subsidiaries have sufficient reserves and adequate amounts of Renminbi to purchase foreign currency, regulations restrict the ability of our subsidiaries to transfer funds to us through intercompany loans and advances.

Additionally, business activity in China and many other countries in Asia declines considerably during the first quarter of each year in observance of the Lunar New Year. As a result, sales during the first quarter of our fiscal year have typically been lower than sales during the fourth quarter of the preceding year, and we expect this trend to continue. We do not have the ability to forecast with any degree of certainty the impact of the decreased business activity during the Lunar New Year on our sales and operating results.

Revenues from sales of telecommunications equipment are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred as evidenced by customer acceptance, the fee is fixed or determinable and collectibility is reasonably assured. Where multiple elements exist in an arrangement, revenue is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements. Revenues from sales of telecommunications equipment involving significant production, modification or customization of the product or where services being provided are deemed to be essential to the functionality of the product are recognized using the percentage of completion method if the project cost can be reasonably estimated. If the cost cannot be reasonably estimated, the completed contract method is applied. Any payments received prior to revenue recognition are recorded as deferred revenue.

Revenues from sales of telecommunications equipment incorporating software not considered incidental to the product as a whole ("software contracts") are recognized when persuasive evidence of an agreement exists, the product has been delivered as evidenced by customer acceptance, the fee is fixed or determinable and collectability is probable. Revenues from software contracts with multiple elements are recognized using the residual method when there is vendor specific objective evidence of the fair value of all undelivered elements in an arrangement but vendor specific objective evidence of fair value does not exist for one or more of the delivered elements in an arrangement. Under the residual method, the fair value of the undelivered elements, as indicated by vendor specific objective evidence, is deferred and the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements regardless of any separate prices stated within the contract for each element. If the fee due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria forit;font-size:10pt;">

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Equity securities
677

680

1,749

Total securities available-for-sale
320,659

377,978

285,365

Securities held-to-maturity:

Municipal securities	41,003	22,633	22,725
Federal Reserve Bank stock	2,732	2,732	2,346
Federal Home Loan Bank stock	3,638	3,638	3,638
Total securities	$ 368,032	406,981	314,074

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Contractual maturities of securities at December 31, 2016, were as follows. 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	Yield	Amortized Cost	Fair Value	Yield
	(Dollars in thousands)					
U.S. Treasury notes:						
Within one year	$—	—	— %	$—	—	— %
One to five years	17,063	17,099	1.91 %	—	—	— %
Five to ten years	11,117	11,046	1.99 %	—	—	— %
After ten years	—	—	— %	—	—	— %
Total U.S. Treasury notes	28,180	28,145	1.94 %	—	—	— %
U.S. Agency notes:						
Within one year	3,956	3,965	1.19 %	—	—	— %
One to five years	21,994	22,074	1.65 %	—	—	— %
Five to ten years	61,148	59,361	1.92 %	—	—	— %
After ten years	—	—	— %	—	—	— %
Total U.S. Agency notes	87,098	85,400	1.82 %	—	—	— %
Municipal securities (1):						
Within one year	8,408	8,499	3.60 %	[illegible]	3,959	2.54 %
One to five years	58,114	58,328	2.90 %	[illegible]	4,068	2.99 %
Five to ten years	59,685	58,882	3.07 %	[illegible]	9,845	2.98 %
After ten years	7,567	7,151	2.75 %	[illegible]	22,618	5.18 %
Total Municipal securities	133,774	132,860	3.01 %	[illegible]	40,490	4.17 %
U.S. Agency mortgage-backed securities	72,402	71,047	1.92 %	—	—	— %
Mutual funds	2,527	2,482	2.10 %	—	—	— %
Trust preferred securities	49	48	7.78 %	—	—	— %
Equity securities	632	677	8.30 %	—	—	— %
Totals	$324,662	320,659	2.36 %	[illegible]	40,490	4.17 %

(1) Yields on tax-exempt obligations are computed on a taxable-equivalent basis based upon a 34.2% statutory Federal income tax rate.

Excluding holdings in U.S. Treasury securities and U.S. Government Agencies, there were no investments in securities of any issuer that exceeded 10% of LCNB's consolidated shareholders' equity at December 31, 2016.

Loan Portfolio

Administration of the lending function is the responsibility of the Chief Lending Officer and certain senior lenders. Lenders perform their duties subject to oversight and policy direction from the Board of Directors and the Loan Committee. The Loan Committee consists of LCNB’s Chief Executive Officer/President, Chief Financial Officer, Cashier, Chief Lending Officer, Chief Credit Officer, Loan Operations Officer, Loan Review Officer, Credit Analysis

Officer, and the officers in charge of commercial, consumer, and real estate loans.

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Employees authorized to accept loan applications have various, designated lending limits for the approval of loans. A loan application for an amount outside a particular employee's lending limit needs to be approved by an employee with a lending limit sufficient for that loan. Residential and commercial real estate loans of any amount require the approval of two of the following designated officers: Chief Executive Officer/President, Chief Lending Officer, Chief Credit Officer, and the officers in charge of commercial, real estate, and consumer lending. Board approval is required on any loan with policy exceptions or that will exceed $3.0 million in aggregate credit to any one borrower or entity, as defined by the OCC in 12 C.F.R § 32.2(b).

Interest rates charged by LCNB vary with degree of risk, type of loan, amount, complexity, repricing frequency and other relevant factors associated with the loan.

The following table summarizes the distribution of the loan portfolio for the years indicated:

	At December 31,														
	2016			2015			2014			2013			2012		
	Amount	%		Amount	%		Amount	%		Amount	%		Amount	%	
	(Dollars in thousands)														
Commercial and industrial	$41,878	5.1	%	$45,275	5.9	%	$35,424	5.1	%	$29,337	5.1	%	$26,236	5.8	%
Commercial, secured by real estate	477,275	58.2	%	419,633	54.5	%	379,141	54.3	%	314,252	54.7	%	230,256	50.7	%
Residential real estate	265,788	32.5	%	273,139	35.4	%	254,087	36.4	%	215,587	37.6	%	183,132	40.4	%
Consumer	19,173	2.3	%	18,510	2.4	%	18,006	2.5	%	12,643	2.2	%	10,554	2.3	%
Agricultural	14,802	1.8	%	13,479	1.7	%	11,472	1.6	%	2,472	0.4	%	1,668	0.4	%
Other loans, including deposit overdrafts	633	0.1	%	665	0.1	%	680	0.1	%	91	—	%	1,875	0.4	%
	819,549	100.0	%	770,701	100.0	%	698,810	100.0	%	574,382	100.0	%	453,721	100.0	%
Deferred origination costs (fees), net	254			237			146			(28	)		62		
Total loans	819,803			770,938			698,956			574,354			453,783		
Less allowance for loan losses	3,575			3,129			3,121			3,588			3,437		
Loans, net	$816,228			$767,809			$695,835			$570,766			$450,346		

As of December 31, 2016, there were no concentrations of loans exceeding 10% of total loans that are not already disclosed as a category of loans in the above table.

The following table summarizes the commercial and agricultural loan maturities and sensitivities to interest rate change at December 31, 2016:

	(In thousands)
Maturing in one year or less	$ 31,968

Maturing after one year, but within five years	62,997
Maturing beyond five years	438,990
Total commercial and agricultural loans	$ 533,955
Loans maturing beyond one year:	
Fixed rate	$ 185,231
Variable rate	316,756
Total	$ 501,987

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Risk Elements

The following table summarizes non-accrual, past-due, and accruing restructured loans for the dates indicated:

	At December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands)				
Non-accrual loans	$5,725	1,723	5,599	2,961	2,283
Past-due 90 days or more and still accruing	23	559	203	250	128
Accruing restructured loans	11,731	13,723	14,269	15,151	13,343
Total	$17,479	16,005	20,071	18,362	15,754
Percent to total loans	2.13 %	2.08 %	2.87 %	3.20 %	3.47 %

LCNB is not committed to lend additional funds to debtors whose loans have been modified to provide a reduction or deferral of principal or interest because of deterioration in the financial position of the borrower.

At December 31, 2016, there were no material additional loans not classified as acquired credit impaired or already disclosed as non-accrual, accruing restructured, or accruing past due 90 days or more where known information about possible credit problems of the borrowers causes management to have serious doubts as to the ability of such borrowers to comply with present loan repayment terms.

Summary of Loan Loss Experience

The table summarizing the activity related to the allowance for loan losses is included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

Allocation of the Allowance for Loan Losses

The following table presents the allocation of the allowance for loan loss:

	At December 31,									
	2016		2015		2014		2013		2012	
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)									
Commercial and industrial	$350	5.1 %	$244	5.9 %	$129	5.1 %	$175	5.1 %	$320	5.8 %
Commercial, secured by real estate	2,179	58.2 %	1,908	54.5 %	1,990	54.3 %	2,520	54.7 %	2,296	50.7 %
Residential real estate	885	32.5 %	854	35.4 %	926	36.4 %	826	37.6 %	712	40.4 %
Consumer	96	2.3 %	54	2.4 %	63	2.5 %	66	2.2 %	108	2.3 %
Agricultural	60	1.8 %	66	1.7 %	11	1.6 %	—	0.4 %	—	0.4 %
Other loans, including deposit overdrafts	5	0.1 %	3	0.1 %	2	0.1 %	1	— %	1	0.4 %
Unallocated	—	—	—	—	—	—	—	—	—	—
Total	$3,575	100.0 %	$3,129	100.0 %	$3,121	100.0 %	$3,588	100.0 %	$3,437	100.0 %

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Deposits

The statistical information regarding average amounts and average rates paid for the deposit categories is included in the "Distribution of Assets, Liabilities and Shareholders' Equity" table included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following table presents the contractual maturity of time deposits of $100,000 or more at December 31, 2016:

	(In thousands)
Maturity within 3 months	$ 7,129
After 3 but within 6 months	2,588
After 6 but within 12 months	7,306
After 12 months	60,747
	$ 77,770

Return on Equity and Assets

The statistical information regarding the return on assets, return on equity, dividend payout ratio, and equity to assets ratio is presented in Item 6, Selected Financial Data.

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Item 1A. Risk Factors

There are risks inherent in LCNB's operations, many beyond management's control, which may adversely affect its financial condition and results from operations and should be considered in evaluating the Company. Credit, market, operational, liquidity, interest rate and other risks are described elsewhere in this report. Other risk factors may include the items described below.

New capital requirements could adversely affect LCNB's capital ratios
On July 2, 2013, the Federal Reserve Board approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. bank holding companies as well as state banks that are members of the Federal Reserve System and savings and loan holding companies (commonly known as Basel III). On July 9, 2013, the OCC adopted the same rules for national banks and federal savings associations, and the FDIC approved the same provisions, as an interim final rule, for state nonmember banks and state savings associations.

Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by banks and savings associations. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The final rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and require a minimum leverage ratio of 4.0%.

The phase-in period for the final rules began for LCNB on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule. While management expects that LCNB's capital ratios under Basel III will continue to exceed the well capitalized minimum capital requirements, there can be no assurance that such will be the case. If LCNB is unable to meet or exceed the applicable minimum capital requirements, it may become subject to supervisory actions ranging in severity from losing its financial holding company status, to being precluded from making acquisitions or engaging in new activities or becoming subject to informal or formal regulatory enforcement actions.

LCNB's earnings are significantly affected by market interest rates.
Fluctuations in interest rates may negatively impact LCNB's profitability. A primary source of income from operations is net interest income, which is equal to the difference between interest income earned on loans and investment securities and the interest paid for deposits and other borrowings. These rates are highly sensitive to many factors beyond LCNB's control, including general economic conditions, the slope of the yield curve (that is, the relationship between short and long-term interest rates), and the monetary and fiscal policies of the United States Federal government. LCNB expects the current level of interest rates and the current slope of the yield curve will cause further downward pressure on its net interest margin.

Increases in general interest rates could have a negative impact on LCNB's results of operations by reducing the ability of borrowers to repay their current loan obligations. Some residential real estate mortgage loans, most home equity line of credit loans, and many of LCNB's commercial loans have adjustable rates. Borrower inability to make scheduled loan payments due to a higher loan cost could result in increased loan defaults, foreclosures, and write-offs and may necessitate additions to the allowance for loan losses. In addition, increases in the general level of interest rates may decrease the demand for new consumer and commercial loans, thus limiting LCNB's growth and profitability. A general increase in interest rates may also result in deposit disintermediation, which is the flow of deposits away from banks and other depository institutions into direct investments that have the potential for higher

rates of return, such as stocks, bonds, and mutual funds. If this occurs, LCNB may have to rely more heavily on borrowings as a source of funds in the future, which could negatively impact its net interest margin.

Gains from sales of mortgage loans may experience significant volatility.

Gains from sales of mortgage loans are highly influenced by the level and direction of mortgage interest rates, real estate activity, and refinancing activity. Current historically low market interest rates created a refinancing demand for residential fixed-rate mortgage loans. The increased volume of refinancing activity increased gains from sales of mortgage loans as LCNB sold most of these loans to the Federal Home Loan Mortgage Corporation. An increase in market interest rates may decrease the demand for refinanced loans and decrease the gains from sales of mortgage loans recognized in LCNB's consolidated statements of income. Gains from sales of mortgage loans may also be impacted by changes in LCNB's strategy to manage its residential mortgage portfolio. For example, LCNB may occasionally change the proportion of loan originations that are sold in the secondary market and instead add a greater proportion to its loan portfolio.

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Banking competition in Southwestern and South Central Ohio is intense.
LCNB faces strong competition for deposits, loans, trust accounts, and other services from other banks, savings banks, credit unions, mortgage brokers, and other financial institutions. Many of LCNB's competitors include major financial institutions that have been in business for many years and have established customer bases, numerous branches, and substantially higher regulatory lending limits. Competitors in the Southwestern and South Central Ohio areas include U.S. Bank, PNC Bank, Fifth Third Bank, Chase, KeyBank, Park National Bank, Huntington National Bank, and First Financial Bank. In addition, credit unions are growing larger due to more flexible membership requirement regulations and are offering more financial services than they legally could in the past.

LCNB also competes with numerous real estate brokerage firms, some owned by realty companies, for residential real estate mortgage loans. Incentives offered by captive finance companies owned by the major automobile companies have limited the banking industry's opportunities for growth in the new automobile loan market. The banking industry now competes with brokerage firms and mutual fund companies for funds that would have historically been held as bank deposits. Technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of these competitors have fewer regulatory constraints and may have lower cost structures.

If LCNB is unable to attract and retain loan, deposit, brokerage, and trust customers, its growth and profitability levels may be negatively impacted.

Economic conditions in Southwestern and South Central Ohio could adversely affect LCNB's financial condition and results of operations.
LCNB conducts its operations from offices that are located in nine Southwestern and South Central Ohio counties, from which substantially all of its customer base is drawn. Because of this geographic concentration of operations and customer base, LCNB's financial performance is heavily influenced by economic conditions in these areas. Any material deterioration in economic conditions in these markets could have material direct or indirect adverse impacts on LCNB's customers and on LCNB. Such deterioration could increase the number of customers experiencing financial distress, negatively impacting their ability to obtain new loans or to repay existing loans. As a result, LCNB may experience increases in the levels of impaired loans, increased charge-offs, and increased provisions for loan losses. Deteriorating economic conditions may also effect the ability of depositors to maintain or add to deposit balances and may effect the demand for loans, trust, brokerage, and other products and services offered by LCNB. Such losses and decreased demand could have material adverse effects on LCNB's financial position, results of operations, and cash flows.

The allowance for loan losses may be inadequate.
The provision for loan losses is determined by management based upon its evaluation of the amount needed to maintain the allowance for loan losses at a level considered appropriate in relation to the estimated 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, the fair value of any underlying collateral, borrowers' cash flows, and current economic conditions that may affect borrowers' ability to make payments. Increases in the allowance result in an expense for the period. By its nature, the evaluation is imprecise and requires significant judgment. Actual results may vary significantly from management's assumptions. If, as a result of general economic conditions or a decrease in asset quality, management determines that additional increases in the allowance for loan losses are necessary, LCNB will incur additional expenses.

LCNB's loan portfolio includes a substantial amount of commercial and industrial loans and commercial real estate loans, which may have more risks than residential or consumer loans.

LCNB's commercial and industrial and commercial real estate loans comprise a substantial portion of its total loan portfolio. These loans generally carry larger loan balances and involve a greater degree of financial and credit risk than home equity, residential mortgage, or consumer loans. The increased financial and credit risk associated with these types of loans is a result of several factors, including the concentration of principal in a limited number of loans, the size of loan balances, the effects of general economic conditions on income-producing properties, and the increased difficulty of evaluating and monitoring these types of loans.

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The repayment of loans secured by commercial real estate is often dependent upon the successful operation, development, or sale of the related real estate or commercial business and may, therefore, be subject to adverse conditions in the real estate market or economy. If the cash flow from operations is reduced, the borrower's ability to repay the loan may be impaired. In such cases, LCNB may take one or more actions to protect its financial interest in the loan. Such actions may include foreclosure on the real estate securing the loan, taking possession of other collateral that may have been pledged as security for the loan, or modifying the terms of the loan. If foreclosed on, commercial real estate is often unique and may not be as salable as a residential home.

The fair value of LCNB's investments could decline.
Most of LCNB's investment securities portfolio is designated as available-for-sale. Accordingly, unrealized gains and losses, net of tax, in the estimated fair value of the available-for-sale portfolio is recorded as other comprehensive income, a separate component of shareholders' equity. The fair value of LCNB's investment portfolio may decline, causing a corresponding decline in shareholders' equity. Management believes that several factors will affect the fair values of the investment portfolio including, but not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation, and the slope of the interest rate yield curve. These and other factors may impact specific categories of the portfolio differently and the effect any of these factors may have on any specific category of the portfolio cannot be predicted.

Many state and local governmental authorities have experienced deterioration of financial condition in recent years due to declining tax revenues, increased demand for services, and various other factors. To the extent LCNB has any municipal securities in its portfolio from issuers who are experiencing deterioration of financial condition or who may experience future deterioration of financial condition, the value of such securities may decline and could result in other-than-temporary impairment charges, which could have an adverse effect on LCNB's financial condition and results of operations. Additionally, a general, industry-wide decline in the fair value of municipal securities could significantly affect LCNB's financial condition and results of operations.

Changes in income tax laws or interpretations or in accounting standards could materially affect LCNB's financial condition or results of operations.
Changes in income tax laws could be enacted, or interpretations of existing income tax laws could change, causing an adverse effect to LCNB's financial condition or results of operations. Similarly, new accounting standards may be issued by the Financial Accounting Standards Board (the "FASB") or existing standards revised, changing the methods for preparing financial statements. These changes are not within LCNB's control and may significantly impact its reported financial condition and results of operations.

A decrease to the corporate federal income tax rate may impair the Company's deferred tax assets ("DTAs").
At December 31, 2016, LCNB's DTAs were approximately $1.6 million. While a decline in the corporate tax rate may lower the Company's tax provision expense, it may also significantly impair the value of the LCNB's DTAs in the year the rate decrease is enacted. Such impairment could have a material adverse effect on the Company's financial condition and results of operations.

LCNB is subject to environmental liability risk associated with lending activities.
A significant portion of the Bank's loan portfolio is secured by real property. During the ordinary course of business, the Bank may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Bank may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the

Bank to incur substantial expenses and may materially reduce the affected property's value or limit the Bank's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Bank's exposure to environmental liability. Although the Bank has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on LCNB's financial condition and results of operations.

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The banking industry is highly regulated.
LCNB is subject to regulation, supervision, and examination by the Federal Reserve Board and the Bank is subject to regulation, supervision, and examination by the OCC. LCNB and the Bank are also subject to regulation and examination by the FDIC as the deposit insurer. The CFPB is responsible for most consumer protection laws and has broad authority, with certain exceptions, to regulate financial products offered by banks. Federal and state laws and regulations govern numerous matters including, but not limited to, changes in the ownership or control of banks, maintenance of adequate capital, permissible business operations, maintenance of deposit insurance, protection of customer financial privacy, the level of reserves held against deposits, restrictions on dividend payments, the making of loans, and the acceptance of deposits. See the previous section titled “Supervision and Regulation” for more information on this subject.
Federal regulators may initiate various enforcement actions against a financial institution that violates laws or regulations or that operates in an unsafe or unsound manner. These enforcement actions may include, but are not limited to, the assessment of civil money penalties, the issuance of cease-and-desist or removal orders, and the imposition of written agreements.

Proposals to change the laws governing financial institutions are periodically introduced in Congress and proposals to change regulations are periodically considered by the regulatory bodies. Such future legislation and/or changes in regulations could increase or decrease the cost of doing business, limit or expand permissible activities, or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The likelihood of any major changes in the future and their effects are impossible to predict.

FDIC deposit insurance assessments may materially increase in the future.
Deposits of LCNB are insured up to statutory limits by the Federal Deposit Insurance Corporation (FDIC) and, accordingly, LCNB and other banks and financial institutions pay quarterly premiums to the FDIC to maintain the Deposit Insurance Fund. The likelihood and extent of future rate increases are indeterminable.

Future growth and expansion opportunities may contain risks.
From time to time LCNB may seek to acquire other financial institutions or parts of those institutions or may engage in de novo branch expansion. It may also consider and enter into new lines of business or offer new products or services. Such activities involve a number of risks, which may include potential inaccuracies in estimates and judgments used to evaluate the expansion opportunity, diversion of management and employee attention, lack of experience in a new market or product or service, and difficulties in integrating a future acquisition or introducing a new product or service. There is no assurance that such growth or expansion activities will be successful or that they will achieve desired profitability levels.

The financial services industry, as well as the broader economy, may be subject to new legislation, regulation, and government policy.
At this time, it is difficult to predict the legislative and regulatory changes that will result from the combination of a new President of the United States and the first year since 2010 in which both Houses of Congress and the White House have majority memberships from the same political party. In recent years, however, both the new President and senior members of the House of Representatives have advocated for significant reduction of financial services regulation, to include amendments to the Dodd-Frank Act and structural changes to the CFPB. The new Administration and Congress also may cause broader economic changes due to changes in governing ideology and governing style. New appointments to the Board of Governors of the Federal Reserve could affect monetary policy and interest rates and changes in fiscal policy could affect broader patterns of trade and economic growth. Future

legislation, regulation, and government policy could affect the banking industry as a whole, including LCNB's business and results of operations, in ways that are difficult to predict. In addition, LCNB's results of operations could be adversely affected by changes in the way in which existing statutes and regulations are interpreted or applied by courts and government agencies.

LCNB’s controls and procedures may fail or be circumvented.
Management regularly reviews and updates LCNB’s internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of LCNB’s controls and procedures or failure to comply with regulations related to its controls and procedures could have a material adverse effect on LCNB’s business, results of operations, and financial condition.

LCNB's information systems may experience an interruption or breach in security.
LCNB relies heavily on communications and information systems to conduct its business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in LCNB's customer relationship management, general ledger, deposit, loan, and other systems. While LCNB has policies and procedures designed to prevent or limit the effect of the failure, interruption, or security breach of its information systems, there can be no assurance that any such occurrences will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions, or security breaches of LCNB's information systems could damage LCNB's reputation, result in a loss of customer business, subject LCNB to additional regulatory scrutiny, or expose LCNB to civil litigation and possible financial liability, any of which could have a material adverse effect on its financial condition and results of operations.

LCNB continually encounters technological change.
The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. LCNB's future success depends, in part, upon its ability to address customer needs by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in LCNB's operations. LCNB may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could negatively affect LCNB's growth, revenue and profit.

Emergence of nonbank alternatives to the financial system.
Consumers may decide not to use banks to complete their financial transactions. Technology and other changes, including the emergence of "Fintech Companies," are allowing parties to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can complete transactions, such as paying bills and/or transferring funds, directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Risk factors related to LCNB's trust business.
Competition for trust business is intense. Competitors include other commercial bank and trust companies, brokerage firms, investment advisory firms, mutual fund companies, accountants, and attorneys.

LCNB's trust business is directly affected by conditions in the debt and equity securities markets. The debt and equity securities markets are affected by, among other factors, domestic and foreign economic conditions and the monetary and fiscal policies of the United States Federal government, all of which are beyond LCNB's control. Changes in economic conditions may directly affect the economic performance of the trust accounts in which clients' assets are invested. A decline in the fair value of the trust accounts caused by a decline in general economic conditions directly affects LCNB's trust fee income because such fees are primarily based on the fair value of the trust accounts. In addition, a sustained decrease in the performance of the trust accounts or a lack of sustained growth may encourage clients to seek alternative investment options.

The management of trust accounts is subject to the risk of mistaken distributions, poor investment choices, and miscellaneous other incorrect decisions. Such mistakes may give rise to surcharge actions by beneficiaries, with damages substantially in excess of the fees earned from management of the accounts.

LCNB's ability to pay cash dividends is limited.
LCNB is dependent upon the earnings of the Bank for funds to pay dividends on its common shares. The payment of dividends by LCNB and the Bank is subject to certain regulatory restrictions. As a result, any payment of dividends in the future will be dependent, in large part, on the ability of LCNB and the Bank to satisfy these regulatory restrictions and on the Bank's earnings, capital levels, financial condition, and other factors. Although LCNB's financial earnings and financial condition have allowed it to declare and pay periodic cash dividends to shareholders, there can be no assurance that the current dividend policy or the amount of dividend distributions will continue in the future.

Item 1B. Unresolved Staff Comments

Not applicable

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LCNB CORP. AND SUBSIDIARY

Item 2. Properties

The Bank conducts its business from the following offices:

	Name of Office	Address	County	
1.	Main Office	2 North Broadway Lebanon, Ohio 45036	Warren	Owned
2.	Auto Bank	Silver and Mechanic Streets Lebanon, Ohio 45036	Warren	Owned
3.	Barron Street Office	1697 North Barron Street Eaton, Ohio 45320	Preble	Leased
4.	Bridge Street Office	1240 North Bridge Street Chillicothe, Ohio 45601	Ross	Owned
5.	Brookville Office	225 West Upper Lewisburg Salem Road Brookville, Ohio 45309	Montgomery	Owned
6.	Centerville Office	9605 Dayton-Lebanon Pike Centerville, Ohio 45458	Montgomery	Owned
7.	Chillicothe Office	33 West Main Street Chillicothe, Ohio 45601	Ross	Owned
8.	Clarksburg Office (closed January 24, 2017)	10820 Main Street Clarksburg, Ohio 43115	Ross	Owned
9.	Colerain Township Office	3209 West Galbraith Road Cincinnati, Ohio 45239	Hamilton	Owned
10.	Columbus Avenue Office	730 Columbus Avenue Lebanon, Ohio 45036	Warren	Owned
11.	Eaton Office	110 West Main Street Eaton, Ohio 45320	Preble	Owned
12.	Fairfield Office	765 Nilles Road Fairfield, Ohio 45014	Butler	Leased
13.	Frankfort Office	Springfield and Main Streets Frankfort, Ohio 45628	Ross	Owned
14.	Goshen Office	6726 Dick Flynn Blvd.	Clermont	Owned

	Goshen, Ohio 45122		
15. Hamilton Office	794 NW Washington Blvd. Hamilton, Ohio 45013	Butler	Owned
16. Hay Avenue Office	121 Hay Avenue Brookville, Ohio 45309	Montgomery	Owned
17. Hunter Office	3878 State Route 122 Franklin, Ohio 45005	Warren	Owned
18. Lewisburg Office	522 South Commerce Street Lewisburg, Ohio 45338	Preble	Owned

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	Name of Office	Address	County	
19.	Loveland Office	500 Loveland-Madeira Road Loveland, OH 45140	Hamilton	Owned
20.	Maineville Office	7795 South State Route 48 Maineville, Ohio 45039	Warren	Owned
21.	Mason/West Chester Office	1050 Reading Road Mason, Ohio 45040	Warren	Owned
22.	Middletown Office	4441 Marie Drive Middletown, Ohio 45044	Butler	Owned
23.	Monroe Office	101 Clarence F. Warner Drive Monroe, Ohio 45050	Butler	Owned
24.	New Paris Office	201 South Washington Street New Paris, Ohio 45347	Preble	Owned
25.	Oakwood Office	2705 Far Hills Avenue Oakwood, Ohio 45419	Montgomery	(2)
26.	Otterbein Office	Otterbein Retirement Community State Route 741 Lebanon, Ohio 45036	Warren	Leased
27.	Oxford Office (1)	30 West Park Place Oxford, Ohio 45056	Butler	(2)
28.	Rochester/Morrow Office	Route 22-3 at 123 Morrow, Ohio 45152	Warren	Owned
29.	South Lebanon Office	603 Corwin Nixon Blvd. South Lebanon, Ohio 45065	Warren	Owned
30.	Springboro/Franklin Office	525 West Central Avenue Springboro, Ohio 45066	Warren	Owned
31.	Warrior Office	Lebanon High School 1916 Drake Road Lebanon, Ohio 45036	Warren	Leased
32.	Washington Court House Office	100 Crossings Drive Washington Court House, Ohio 43160	Fayette	Owned

33. Waynesville Office	9 North Main Street Waynesville, Ohio 45068	Warren	Owned
34. West Alexandria Office	55 East Dayton Street West Alexandria, Ohio 45381	Preble	Owned
35. Western Avenue Office	1006 Western Avenue Chillicothe, Ohio 45601	Ross	Owned
36. Wilmington Office	1243 Rombach Avenue Wilmington, Ohio 45177	Clinton	Owned

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	Name of Office	Address	County	
37.	Operations Center (under construction)	105 North Broadway Lebanon, Ohio 45036	Warren	Owned

(1) Excess space in this office is leased to third parties.
(2) The Bank owns the Oakwood and Oxford office buildings and leases the land.

Item 3. Legal Proceedings

Except for routine litigation incidental to its businesses, LCNB is not a party to any material pending legal proceedings and none of its property is the subject of any material proceedings.

Item 4. Mine Safety Disclosures

Not Applicable

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LCNB CORP. AND SUBSIDIARY

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities.

LCNB had approximately 980 registered holders of its common stock as of December 31, 2016. The number of shareholders includes banks and brokers who act as nominees, each of whom may represent more than one shareholder. LCNB's stock trades on the NASDAQ Capital Market exchange under the symbol "LCNB."

Trade prices for shares of LCNB Common Stock and cash dividends per share declared and paid are set forth below. The trade prices shown below are interdealer without retail markups, markdowns, or commissions.

	2016			2015		
	High	Low	Dividends Declared	High	Low	Dividends Declared
First Quarter	$17.75	15.51	0.16	16.40	13.95	0.16
Second Quarter	17.24	15.69	0.16	17.88	15.01	0.16
Third Quarter	19.13	15.73	0.16	16.40	15.26	0.16
Fourth Quarter	25.00	16.55	0.16	17.18	15.07	0.16
Total dividends declared			0.64			0.64

It is expected that LCNB will continue to pay dividends on a similar schedule, to the extent permitted by business and potential factors beyond management's control.

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, as defined, for the current year plus retained net income for the previous two years. Prior approval from the OCC, the Bank's primary regulator, would be 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 ordinary dividends to LCNB without needing to request approval.

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

On April 17, 2001, LCNB's Board of Directors authorized three separate stock repurchase programs, two of which continue to be in effect – the "Market Repurchase Program and the "Private Sale Repurchase Program." Any shares purchased will be held for future corporate purposes.

Under the Market Repurchase Program, LCNB was originally authorized to purchase up to 200,000 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 400,000 total shares. Through December 31, 2016, 290,444 shares have been purchased under this program. No shares were purchased under the Market Repurchase Program during 2016 and 2015.

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 466,018 shares have been purchased under this program since its inception through December 31, 2016. No shares were purchased under the Private Sale Repurchase Program during 2016 and 2015.

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

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The 2015 Ownership Incentive Plan (the "2015 Plan") was approved 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. This plan provides for the issuance of up to 450,000 shares and will terminate on April 28, 2025, unless earlier terminated by the Compensation Committee.

The following table shows information relating to stock options outstanding under the 2002 Plan and 2015 Plan at December 31, 2016:

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options	Weighted Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders	24,669	$ 12.17	433,962
Equity compensation plans not approved by security holders	—	—	—
Total	24,669	$ 12.17	433,962

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The graph below provides an indicator of cumulative total shareholder returns for LCNB as compared with the NASDAQ Composite, the SNL Midwest OTC-BB and Pink Sheet Banks, and the SNL Midwest Bank indexes. This graph covers the period from December 31, 2011 through December 31, 2016. The cumulative total shareholder returns included in the graph reflect the returns for the shares of common stock of LCNB. The information provided in the graph assumes that $100 was invested on December 31, 2011 in LCNB common stock, the NASDAQ Composite, and the SNL Midwest Bank Index and that all dividends were reinvested.

	Period Ending					
Index	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016
LCNB Corp.	$ 100.00	110.94	149.93	131.71	148.83	219.25
NASDAQ Composite	$ 100.00	117.45	164.57	188.84	201.98	219.89
SNL Midwest Bank index	$ 100.00	120.36	164.78	179.14	181.86	242.99

Source : SNL Financial LC, Charlottesville, VA
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Item 6. Selected Financial Data

The following represents selected consolidated financial data of LCNB for the years ended December 31, 2012 through 2016 and are derived from LCNB's consolidated financial statements. Certain prior year data presented in this table have been reclassified to conform with the current year presentation. This data should be read in conjunction with the consolidated financial statements and the notes thereto included in Item 8 of this Form 10-K and Management's Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosures about Market Risk included in Items 7 and 7A, respectively, of this Form 10-K, and are qualified in their entirety thereby and by other detailed information elsewhere in this Form 10-K.

	For the Years Ended December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands, except ratios and per share data)				
Income Statement:					
Interest income	$43,750	42,659	39,477	33,497	29,938
Interest expense	3,504	3,328	3,590	4,065	4,889
Net interest income	40,246	39,331	35,887	29,432	25,049
Provision for loan losses	913	1,366	930	588	1,351
Net interest income after provision for loan losses	39,333	37,965	34,957	28,844	23,698
Non-interest income	10,853	10,123	9,142	9,090	9,049
Non-interest expenses	33,261	32,392	30,844	26,212	21,682
Income before income taxes	16,925	15,696	13,255	11,722	11,065
Provision for income taxes	4,443	4,222	3,386	2,942	2,795
Net income	$12,482	11,474	9,869	8,780	8,270
Dividends per common share	$0.64	0.64	0.64	0.64	0.64
Earnings per common share:					
Basic	1.26	1.18	1.06	1.12	1.23
Diluted	1.25	1.17	1.05	1.10	1.22
Balance Sheet:					
Securities	$368,032	406,981	314,074	279,021	276,970
Loans, net	816,228	767,809	695,835	570,766	450,346
Total assets	1,306,799	1,280,531	1,108,066	932,338	788,637
Total deposits	1,110,905	1,087,160	946,205	785,761	671,471
Short-term borrowings	42,040	37,387	16,645	8,655	13,756
Long-term debt	598	5,947	11,357	12,102	13,705
Total shareholders' equity	142,944	140,108	125,695	118,873	82,006
Selected Financial Ratios and Other Data:					
Return on average assets	0.96 %	0.94 %	0.88 %	0.93 %	1.02 %
Return on average equity	8.60 %	8.43 %	8.04 %	9.02 %	10.22 %
Equity-to-assets ratio	10.94 %	10.94 %	11.34 %	12.75 %	10.40 %
Dividend payout ratio	50.79 %	54.24 %	60.38 %	57.14 %	52.03 %
Net interest margin, fully taxable equivalent	3.51 %	3.64 %	3.66 %	3.57 %	3.52 %

First Capital merged with and into LCNB as of the close of business on January 11, 2013. As of the date of the merger, LCNB recorded additional loans of $98.9 million and additional deposits of $136.8 million.
An underwritten public offering of common stock was conducted during the fourth quarter 2013. The offering increased shareholders' equity by $26.9 million, which was the net proceeds LCNB received after deducting offering expenses. The proceeds were used to fund the acquisition of Eaton National on January 24, 2014 and the remainder was used for general corporate purposes.

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Eaton National merged with and into LCNB as of the close of business on January 24, 2014. As of the date of the merger, LCNB recorded additional loans of $115.9 million and additional deposits of $165.3 million.
BNB merged with and into LCNB as of the close of business on April 30, 2015. As of the date of the merger, LCNB recorded additional loans of $34.7 million and additional deposits of $99.1 million.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

The following is management's discussion and analysis of the consolidated financial condition and consolidated results of operations of LCNB. It is intended to amplify certain financial information regarding LCNB and should be read in conjunction with the consolidated financial statements and related notes contained in the 2016 Annual Report to Shareholders.

Overview

Net income for 2016 was $12,482,000 (basic and diluted earnings per share of $1.26 and $1.25, respectively), compared to $11,474,000 (basic and diluted earnings per share of $1.18 and $1.17) in 2015 and $9,869,000 (total basic and diluted earnings per share of $1.06 and $1.05) in 2014.

The following items significantly affected earnings for the years indicated:
1. The completion of a merger with BNB Bancorp, Inc. on April 30, 2015.
2. The completion of a merger with Eaton National Bank & Trust Co. on January 24, 2014.
3. Impaired loans with a carrying value of approximately $4.5 million were sold during the second quarter 2015, significantly improving LCNB's loan quality metrics.
4. Net gain on sales of securities was significantly greater in 2016 as compared to 2015 and 2014 due primarily to market rates at the time of the sales.
5. Other real estate owned expense was significantly greater in 2016 and 2015 as compared to 2014 because of valuation writedowns and losses on sales recognized during 2016 and 2015.
6. Other non-interest expense for 2016 included a $251,000 penalty incurred to pre-pay a Federal Home Loan Bank borrowing bearing an interest rate of 5.25%. The borrowing was pre-paid to reduce future interest expense.

Net Interest Income

LCNB's primary source of earnings is net interest income, which is the difference between earnings from loans and other investments and interest paid on deposits and other liabilities. The following table presents, for the years indicated, 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.

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LCNB CORP. AND SUBSIDIARY

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

	Years ended December 31,								
	2016			2015			2014		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Loans (1)	$792,526	35,600	4.49%	$740,626	35,285	4.76%	$679,223	32,706	4.82%
Federal funds sold	—	—	— %	452	1	0.22%	—	—	— %
Interest-bearing demand deposits	12,394	59	0.48%	12,245	30	0.24%	12,450	29	0.23%
Federal Reserve Bank stock	2,732	164	6.00%	2,495	152	6.09%	2,100	126	6.00%
Federal Home Loan Bank stock	3,638	146	4.01%	3,638	146	4.01%	3,571	146	4.09%
Investment securities:									
Taxable	243,559	4,582	1.88%	245,410	4,197	1.71%	219,131	3,757	1.71%
Non-taxable (2)	140,692	4,862	3.46%	115,215	4,315	3.75%	102,902	4,111	4.00%
Total earning assets	1,195,541	45,413	3.80%	1,120,081	44,126	3.94%	1,019,377	40,875	4.01%
Non-earning assets	112,909			107,919			104,413		
Allowance for loan losses	(3,318)			(2,888)			(3,275)		
Total assets	$1,305,132			$1,225,112			$1,120,515		
Savings deposits	$654,891	652	0.10%	$608,925	545	0.09%	$544,698	474	0.09%
IRA and time certificates	217,228	2,788	1.28%	219,562	2,464	1.12%	223,555	2,687	1.20%
Short-term borrowings	17,952	38	0.21%	15,105	24	0.16%	14,820	22	0.15%
Long-term debt	826	26	3.15%	6,177	295	4.78%	11,546	407	3.53%
Total interest-bearing liabilities	890,897	3,504	0.39%	849,769	3,328	0.39%	794,619	3,590	0.45%
Demand deposits	259,060			230,608			196,273		
Other liabilities	10,014			8,590			6,907		
Capital	145,161			136,145			122,716		
Total liabilities and capital	$1,305,132			$1,225,112			$1,120,515		
Net interest rate spread (3)			3.41%			3.55%			3.56%
Net interest income and net interest margin on a tax equivalent basis (4)		41,909	3.51%		40,798	3.64%		37,285	3.66%
Ratio of interest-earning assets to interest-bearing liabilities	134.20%			131.81%			128.29%		

(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% for 2015 and 2014.

(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 SUBSIDIARY

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The following table presents the changes in 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 years indicated. 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.

	For the years ended December 31,					
	2016 vs. 2015			2015 vs. 2014		
	Increase (decrease) due to			Increase (decrease) due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest income attributable to:						
Loans (1)	$2,395	(2,080)	315	2,929	(350)	2,579
Federal funds sold	(1)	—	(1)	1	—	1
Interest-bearing demand deposits	—	29	29	—	1	1
Federal Reserve Bank stock	14	(2)	12	24	2	26
Federal Home Loan Bank stock	—	—	—	3	(3)	—
Investment securities:						
Taxable	(32)	417	385	449	(9)	440
Non-taxable (2)	900	(353)	547	472	(268)	204
Total interest income	3,276	(1,989)	1,287	3,878	(627)	3,251
Interest expense attributable to:						
Savings deposits	43	64	107	57	14	71
IRA and time certificates	(26)	350	324	(47)	(176)	(223)
Short-term borrowings	5	9	14	—	2	2
Long-term debt	(193)	(76)	(269)	(227)	115	(112)
Total interest expense	(171)	347	176	(217)	(45)	(262)
Net interest income	$3,447	(2,336)	1,111	4,095	(582)	3,513

(1) Non-accrual loans, if any, are included in average loan balances.
(2) Change in interest income from non-taxable investment securities is computed based on interest income determined on a taxable-equivalent yield 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% for 2015 and 2014, respectively.

2016 vs. 2015. Net interest income on a fully tax-equivalent basis for 2016 totaled $41,909,000, an increase of $1,111,000 from 2015. The increase resulted from an increase in total taxable-equivalent interest income of $1,287,000, slightly offset by an increase in total interest expense of $176,000.

The increase in taxable-equivalent interest income was due to a $75.5 million increase in total average interest-earning assets, slightly offset by a 14 basis point (a basis point equals 0.01%) decrease in the average rate earned on interest-earning assets. The increase in total average interest-earning assets reflects an increase of $51.9 million in average loans and a $25.5 million increase in non-taxable investment securities. The decrease in the average rate earned was primarily due to general decreases in market rates.

Interest expense increased primarily due to a 16 basis point increase in the average rate paid on IRA and time certificates and a 1 basis point increase in the average rate paid on savings deposits, partially offset by a 163 basis point decrease in the rate paid on long-term debt. The rate variance was partially offset by a $5.4 million decrease in average long-term debt. The decrease in the average rate paid on long-term debt and the decrease in the average balance of long-term debt was due to the pre-payment in full during the first quarter of 2016 of a $5.0 million borrowing from the Federal Home Loan Bank of Cincinnati bearing an interest rate of 5.25%. The borrowing was pre-paid to reduce future interest expense.

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2015 vs. 2014. Net interest income on a fully tax-equivalent basis for 2015 totaled $40,798,000, an increase of $3,513,000 from 2014. The increase resulted from an increase in total taxable-equivalent interest income of $3,251,000 and a decrease in total interest expense of $262,000.

The increase in taxable-equivalent interest income was due to a $100.7 million increase in total average interest-earning assets, slightly offset by a 7 basis point decrease in the average rate earned on interest-earning assets. The increase in total average interest-earning assets reflects an increase of $61.4 million in average loans, partially from the BNB merger and partially from organic growth, and a $38.6 million increase in investment securities. The decrease in the average rate earned was primarily due to general decreases in market rates.

Interest expense decreased primarily due to a $5.4 million decrease in average long term debt, primarily due the payment in full of a $5.0 million advance from the Federal Home Loan Bank of Cincinnati during the first quarter 2015, and to a 6 basis point decrease in the average rate paid on total interest-bearing liabilities.

Provisions and Allowance for Loan Losses

The following table presents the total loan loss provision and the other changes in the allowance for loan losses for the years 2012 through 2016:

	2016	2015	2014	2013	2012
	(Dollars in thousands)				
Balance – Beginning of year	$3,129	3,121	3,588	3,437	2,931
Loans charged off:					
Commercial and industrial	234	100	261	119	159
Commercial, secured by real estate	185	1,133	573	58	234
Residential real estate	127	304	652	244	486
Consumer	85	52	129	181	134
Agricultural	—	67	—	—	—
Other loans, including deposit overdrafts	119	74	79	67	85
Total loans charged off	750	1,730	1,694	669	1,098
Recoveries:					
Commercial and industrial	26	7	42	4	—
Commercial, secured by real estate	98	96	63	26	71
Residential real estate	52	107	40	31	7
Consumer	53	60	108	127	123
Agricultural	—	67	—	—	—
Other loans, including deposit overdrafts	54	35	44	44	52
Total recoveries	283	372	297	232	253
Net charge offs	467	1,358	1,397	437	845
Provision charged to operations	913	1,366	930	588	1,351
Balance - End of year	$3,575	3,129	3,121	3,588	3,437
Ratio of net charge-offs during the period to average loans outstanding	0.06 %	0.18 %	0.21 %	0.08 %	0.18 %
Ratio of allowance for loan losses to total loans at year-end	0.44 %	0.41 %	0.45 %	0.62 %	0.76 %

Charge-offs for the commercial, secured by real estate category had an elevated balance during 2015 due to the sale of impaired loans. Charge-offs for the commercial and industrial loan category for 2014 included a charge-off of $222,000 on one loan and charge-offs in the commercial, secured by real estate category for the same year included charge-offs totaling $469,000 on three loans.

Charge-offs and recoveries classified as “Other” include charge-offs and recoveries on checking and NOW account overdrafts. LCNB charges off such overdrafts when considered uncollectible, but no later than 60 days from the date first overdrawn.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

LCNB continuously reviews the loan portfolio for credit risk through the use of its lending and loan review functions. Independent loan reviews analyze specific loans, providing validation that credit risks are appropriately identified and reported to the Loan Committee and Board of Directors. In addition, the Board of Directors' Audit Committee receives loan review reports throughout each year. New credits meeting specific criteria are analyzed prior to origination and are reviewed by the Loan Committee and Board of Directors.
Inputs from all of the Bank's credit risk identification processes are used by management to analyze and validate the adequacy and methodology of the allowance quarterly. The analysis includes two basic components: specific allocations for individual loans and general loss allocations for pools of loans based on average historic loss ratios for the thirty-six preceding months adjusted for identified economic and other risk factors. Due to the number, size, and complexity of loans within the loan portfolio, there is always a possibility of inherent undetected losses.

Non-Interest Income

2016 vs. 2015. Total non-interest income for 2016 was $730,000 greater than for 2015 primarily due to a $587,000 increase in net gains on sales of securities and secondarily to a $121,000 increase in bank owned life insurance income. Net gains from sales of securities increased primarily due to market rates at the times of sales. Bank owned life insurance income increased primarily due to $4 million of new policies purchased during the first quarter 2016. Increases in non-interest income was slightly offset by a $99,000 decrease in gains from sales of loans due to market pricing at the times of the sales.

2015 vs. 2014. Total non-interest income for 2015 was $981,000 greater than for 2014 primarily due to increases in trust income, net gains on sales of securities, and gains from sales of mortgage loans. Trust income increased $359,000 primarily due to an increase in the fair value of trust assets and brokerage accounts managed. Net gains from sales of securities increased $346,000 and gains from sales of loans increased $196,000 primarily due to higher sales volumes.

Non-Interest Expense

2016 vs. 2015. Total non-interest expense was $869,000 greater in 2016 than in 2015 primarily due to a $622,000 increase in salaries and employee benefits, a $251,000 penalty incurred to pre-pay a now high-rate Federal Home Loan Bank borrowing, a $135,000 increase in other real estate owned expense, and a $191,000 increase in various contracted services. 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. The FHLB advance had an interest rate of 5.25% and was paid off to reduce interest expense on long-term debt. Other real estate owned expense increased primarily due to writedowns recognized prior to the sale of a commercial property. These increases were partially offset by the absence of merger-related expenses during the 2016 period.

2015 vs. 2014. Total non-interest expense was $1,548,000 greater in 2015 than in 2014 primarily due to a $1,831,000 increase in salaries and employee benefits, partially offset by a $757,000 decrease in merger related expenses (consisting primarily of professional fees, data system conversion costs, and employee severance payments). Salaries and employee benefits increased due to salary and wage increases, employees retained from the BNB and Eaton National acquisitions, an increase in the number of employees outside of the acquisitions, and increased retirement plan expenses. Costs related to the acquisition of BNB in April 2015 were less than the costs associated with the acquisition of Eaton National in January 2014.

Amortization of intangibles increased $126,000 due to amortization of BNB's core deposit intangible. Other real estate owned expenses increased $204,000 primarily due to impairment charges recognized on a commercial property.

Income Taxes

LCNB's effective tax rates for the years ended December 31, 2016, 2015, and 2014 were 26.3%, 26.9%, and 25.5%, respectively. The difference between the statutory rate of 34.2% for 2016 and 34.0% for 2015 and 2014 and the effective tax rate is primarily due to tax-exempt interest income and tax-exempt earnings from bank owned life insurance. The statutory rate for 2016 is higher because LCNB's taxable income is slightly above the next tax bracket.

Assets

Available-for-sale investment securities at December 31, 2016 was $57.3 million lower than the balance at December 31, 2015. During 2016, LCNB purchased $124.9 million in new securities. These additions were more than offset by sales, maturities, and calls of investment securities.

Held-to-maturity investment securities at December 31, 2016 was $18.4 million greater than at December 31, 2015. Purchases during 2016 totaled $25.0 million, mostly from government entities within LCNB's market area. These additions were partially offset by maturities and calls of other held-to-maturity securities.

Net loans at year-end 2016 was $48.4 million greater than at year-end 2015, primarily due to a $57.6 million increase in the commercial, secured by real estate category. The increase in the loan portfolio does not reflect $11.2 million of residential fixed-rate real estate loans that were originated and sold to the Federal Home Loan Mortgage Corporation during 2016.

Net premises and equipment at December 31, 2016 was $8.1 million greater than at December 31, 2015 primarily due to land
and construction costs paid during 2016 for construction of a new Operations Center in Lebanon, Ohio.

Bank owned life insurance at December 31, 2016 was $4.7 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.

Liabilities

Total deposits at December 31, 2016 were $23.7 million greater than at December 31, 2015, including a $21.0 million increase in non-interest-bearing deposits and a $2.7 million increase in interest-bearing deposits. Total deposits increased despite a $9.4 million decrease in public fund deposits from local government entities. 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.

Short-term borrowings at December 31, 2016 was $4.7 million greater than at December 31, 2015 primarily due to the decrease in public fund deposits.

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

Liquidity

Liquidity is the ability to have funds available at all times to meet the commitments of LCNB. These commitments may include paying dividends to shareholders, funding new loans for borrowers, funding withdrawals by depositors, paying general and administrative expenses, and funding capital expenditures. Sources of liquidity include growth in deposits, principal payments received on loans, proceeds from the sale of loans, the sale or maturation of investment

securities, cash generated by operating activities, and the ability to borrow funds. Management closely monitors the level of liquid assets available to meet ongoing funding requirements. 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 during the past year as a result of current liquidity levels.

The liquidity of LCNB is enhanced by the fact that 85.0% of total deposits at December 31, 2016 were "core" deposits. Core deposits, for this purpose, are defined as total deposits less public funds and certificates of deposit greater than $100,000.

Liquid assets include cash and cash equivalents, federal funds sold and securities available-for-sale. Except for investments in the stock of the Federal Reserve Bank and the Federal Home Loan Bank of Cincinnati (“FHLB”) and certain local municipal securities, all of LCNB's investment portfolio is classified as "available-for-sale" and can be readily sold to meet liquidity needs, subject to certain pledging commitments for public funds, repurchase agreements, and other requirements. At December 31, 2016, LCNB's liquid assets amounted to $339.5 million or 26.0% of total assets, compared to $393.0 million or 30.7% of total assets at December 31, 2015. The ratio for 2016 is less than 2015 because of a decrease in securities available-for-sale.

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LCNB CORP. AND SUBSIDIARY

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

An additional source of funding is borrowings from the FHLB. Long-term advances totaling $598,000 and short-term advances totaling $25.0 million were outstanding at December 31, 2016. LCNB is approved to borrow up to $64.0 million in short-term advances through the FHLB's Cash Management Advance program. Total remaining available borrowing capacity with the FHLB, including short-term advances available through the Cash Management Advance program, at December 31, 2016 was approximately $79.5 million. One of the factors limiting availability of FHLB borrowings is a bank's ownership of FHLB stock. LCNB could increase its available borrowing capacity by purchasing more FHLB stock.

Besides short-term FHLB advances, short-term borrowings may include repurchase agreements, federal funds purchased, and advances from lines of credit with two other financial institutions. At December 31, 2016, LCNB could borrow up to $30 million through the lines of credit and up to $10 million under a federal funds arrangements with another financial institution.

Commitments to extend credit at December 31, 2016 totaled $123.6 million, including standby letters of credit totaling $0.7 million, and are more fully described in Note 14 - Commitments and Contingent Liabilities to LCNB's consolidated financial statements. Since many commitments to extend credit may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The following table provides information concerning LCNB's contractual obligations at December 31, 2016:

	Payments due by period				
	Total	1 year or less	Over 1 through 3 years	Over 3 through 5 years	More than 5 years
	(In thousands)				
Short-term borrowings	$42,040	42,040	—	—	—
Long-term debt obligations	598	295	303	—	—
Operating lease obligations	4,785	448	491	353	3,493
Estimated pension plan contribution for 2017	189	189	—	—	—
Commitment to purchase municipal security when issued	235	235	—	—	—
Funding commitments for affordable housing tax credit limited partnerships	1,617	610	587	145	275
Estimated capital expenditure obligations	4,750	4,750	—	—	—
Certificates of deposit:					
$100,000 and over	77,770	17,023	27,698	32,132	917
Other time certificates	136,994	46,165	41,455	47,491	1,883
Total	$268,978	111,755	70,534	80,121	6,568

The following table provides information concerning LCNB's commitments at December 31, 2016:

	Amount of Commitment Expiration Per Period			
Total Amounts Committed	1 year or less	Over 1 through 3 years	Over 3 through 5 years	More than 5 years

	(In thousands)				
Commitments to extend credit	$15,819	15,819	—	—	—
Unused lines of credit	107,076	41,790	28,480	17,131	19,675
Standby letters of credit	657	657	—	—	—
Total	$123,552	58,266	28,480	17,131	19,675

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LCNB CORP. AND SUBSIDIARY

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Capital Resources

LCNB and the Bank are required by banking regulators to meet certain minimum levels of capital adequacy. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on LCNB's and the Bank's financial statements. These minimum levels 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. The first three ratios, which are based on the degree of credit risk in the Bank'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. Information summarizing the regulatory capital of LCNB and the Bank at December 31, 2016 and 2015 and corresponding regulatory minimum requirements is included in Note 15 - Regulatory Matters of the consolidated financial statements.

The FDIC, the insurer of deposits in financial institutions, has adopted a risk-based insurance premium system based in part on an institution's capital adequacy. Under this system, a depository institution is required to pay successively higher premiums depending on its capital levels and its supervisory rating by its primary regulator. It is management's intention to maintain sufficient capital to permit the Bank to maintain a "well capitalized" designation (the FDIC's highest rating).
On April 17, 2001, LCNB's Board of Directors authorized three separate stock repurchase programs, two of which continue to be in effect – the “Market Repurchase Program” and the “Private Sale Repurchase Program.” Any shares purchased will be held for future corporate purposes.

Under the Market Repurchase Program, LCNB was originally authorized to purchase up to 200,000 shares of its stock, as restated for a 100% stock dividend issued in May, 2007, 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 400,000 total shares, as restated for a stock dividend. Through December 31, 2016, 290,444 shares, as restated for the stock dividend, had been purchased under this program. No shares were purchased under this program during 2016.

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. A total of 466,018 shares, as restated for the stock dividend, had been purchased under this program at December 31, 2016. No shares were purchased under this program during 2016.

LCNB established an Ownership Incentive Plan during 2002 that allowed for stock-based awards to eligible employees. Under the plan, awards could be in the form of stock options, share awards, and/or appreciation rights. The plan provided for the issuance of up to 200,000 shares, as restated for a stock dividend. The plan expired on April 16, 2012. Any outstanding unexercized options, however, continue to be exercisable in accordance with their terms.

The 2015 Ownership Incentive Plan (the "2015 Plan") was approved 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.

On January 9, 2009, LCNB issued 13,400 shares of Fixed Rate Cumulative Preferred Stock, Series A and a warrant for the purchase of 217,063 common shares of LCNB stock at an exercise price of $9.26 per share to the U.S. Treasury Department. LCNB allocated $583,000 of the proceeds from the preferred stock issuance to the warrant. The warrant carried a ten year term and was 100% vested at grant. On October 21, 2009, LCNB redeemed the preferred stock that had been issued under the Capital Purchase Program agreement. LCNB redeemed the warrant during the first quarter 2016.

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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 collectibility 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 collectibility 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.
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 December 31, 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 fixed-rate 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.

Fair Value Accounting for Investment Securities. Securities classified as available-for-sale are carried at estimated fair value. Unrealized gains and losses, net of taxes, are reported as accumulated other comprehensive income or loss in shareholders' equity. Fair value is estimated using market quotations for U.S. Treasury and equity investments. Fair value for the majority of the remaining available-for-sale securities is estimated using the discounted cash flow method for each security with discount rates based on rates observed in the market.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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. 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. 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 December 31, 2016 IRSA indicates that an increase in interest rates at all shock levels will have a positive effect on net interest income. The changes in net interest income for all rate assumptions are within LCNB’s acceptable ranges.

Rate Shock Scenario in Basis Points	Amount (In thousands)	$ Change in Net Interest Income	% Change in Net Interest Income
Up 300	$ 43,790	2,663	6.48 %
Up 200	42,857	1,730	4.21 %
Up 100	41,968	841	2.04 %
Base	41,127	—	— %

IRSA shows the effect 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. As shown below, the December 31, 2016 EVE analysis indicates that an increase in interest rates would have a negative effect on the EVE for all shock levels. The changes in the EVE for all rate assumptions are within LCNB’s acceptable ranges.

Rate Shock Scenario in Basis Points	Amount (In thousands)	$ Change in EVE	% Change in EVE
Up 300	$ 135,135	(4,595)	(3.29)%
Up 200	135,815	(3,915)	(2.80)%
Up 100	136,397	(3,333)	(2.39)%
Base	139,730	—	— %

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 SUBSIDIARY

Item 8. Financial Statements and Supplementary Data

REPORT OF MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

LCNB Corp. ("LCNB") is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. Management of LCNB and its subsidiary is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15f. LCNB's internal control over financial reporting is a process designed under the supervision of LCNB's Chief Executive Officer and the Chief Financial Officer. The purpose is to provide reasonable assurance to the Board of Directors regarding the reliability of financial reporting and the preparation of LCNB's consolidated financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management maintains internal controls over financial reporting. The internal controls contain control processes and actions are taken to correct deficiencies as they are identified. The internal controls are evaluated on an ongoing basis by LCNB's management and Audit Committee. Even effective internal controls, no matter how well designed, have inherent limitations – including the possibility of circumvention or overriding of controls – and therefore can provide only reasonable assurance with respect to financial statement preparation. Also, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed LCNB's internal controls as of December 31, 2016, in relation to criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework (2013)" issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2016, LCNB's internal control over financial reporting met the criteria.

BKD LLP, an independent registered public accounting firm, has issued an attestation report on the effectiveness of LCNB's internal control over financial reporting as of December 31, 2016.

Submitted by:

LCNB Corp.

/s/ Steve P. Foster	/s/ Robert C. Haines II
Steve P. Foster	Robert C. Haines II
Chief Executive Officer & President	Executive Vice President &
March 8, 2017	Chief Financial Officer
	March 8, 2017

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LCNB CORP. AND SUBSIDIARY

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Shareholders
LCNB Corp.
Lebanon, Ohio

We have audited LCNB Corp. and subsidiary's (Company) internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Company's management's assessment of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were also conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of LCNB Corp.'s internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C).(A) A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate. In our opinion, LCNB Corp. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of LCNB Corp. and subsidiaries and our report dated March 8, 2017, expressed an unqualified opinion thereon.

/s/ BKD, LLP

BKD, LLP

Indianapolis, Indiana
March 8, 2017

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LCNB CORP. AND SUBSIDIARY

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Shareholders
LCNB Corp.
Lebanon, Ohio

We have audited the accompanying consolidated balance sheets of LCNB Corp. and subsidiary as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2016. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of LCNB Corp. and subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), LCNB Corp. and subsidiary's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 8, 2017, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ BKD, LLP
BKD, LLP

Indianapolis, Indiana
March 8, 2017

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LCNB CORP. AND SUBSIDIARY

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
LCNB CORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
At December 31,
(Dollars in thousands)

	2016	2015
ASSETS:		
Cash and due from banks	$18,378	14,155
Interest-bearing demand deposits	487	832
Total cash and cash equivalents	18,865	14,987
Investment securities:		
Available-for-sale, at fair value	320,659	377,978
Held-to-maturity, at cost	41,003	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	816,228	767,809
Premises and equipment, net	30,244	22,100
Goodwill	30,183	30,183
Core deposit and other intangibles	4,582	5,396
Bank owned life insurance	27,307	22,561
Other assets	11,358	10,514
TOTAL ASSETS	$1,306,799	1,280,531
LIABILITIES:		
Deposits:		
Non-interest-bearing	$271,332	250,306
Interest-bearing	839,573	836,854
Total deposits	1,110,905	1,087,160
Short-term borrowings	42,040	37,387
Long-term debt	598	5,947
Accrued interest and other liabilities	10,312	9,929
TOTAL LIABILITIES	1,163,855	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 December 31, 2016 and 2015, respectively; issued 10,751,652 and 10,679,174 shares at December 31, 2016 and 2015, respectively	76,490	76,908
Retained earnings	80,736	74,629
Treasury shares at cost, 753,627 shares at December 31, 2016 and 2015	(11,665)	(11,665)
Accumulated other comprehensive income (loss), net of taxes	(2,617)	236
TOTAL SHAREHOLDERS' EQUITY	142,944	140,108

TOTAL LIABILITES AND SHAREHOLDERS' EQUITY	$1,306,799	1,280,531

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

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LCNB CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
For the years ended December 31,
(Dollars in thousands, except per share data)

	2016	2015	2014
INTEREST INCOME:			
Interest and fees on loans	$ 35,600	35,285	32,706
Interest on investment securities:			
Taxable	4,582	4,197	3,757
Non-taxable	3,199	2,848	2,713
Other investments	369	329	301
TOTAL INTEREST INCOME	43,750	42,659	39,477
INTEREST EXPENSE:			
Interest on deposits	3,440	3,009	3,161
Interest on short-term borrowings	38	24	22
Interest on long-term debt	26	295	407
TOTAL INTEREST EXPENSE	3,504	3,328	3,590
NET INTEREST INCOME	40,246	39,331	35,887
PROVISION FOR LOAN LOSSES	913	1,366	930
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	39,333	37,965	34,957
NON-INTEREST INCOME:			
Trust income	3,286	3,262	2,903
Service charges and fees on deposit accounts	5,008	4,920	4,838
Net gain on sales of securities	1,082	495	149
Bank owned life insurance income	746	625	671
Gains from sales of loans	244	343	147
Other operating income	487	478	434
TOTAL NON-INTEREST INCOME	10,853	10,123	9,142
NON-INTEREST EXPENSE:			
Salaries and employee benefits	18,215	17,593	15,762
Equipment expenses	1,048	1,257	1,316
Occupancy expense, net	2,271	2,307	2,232
State franchise tax	1,114	1,001	955
Marketing	696	720	703
Amortization of intangibles	753	700	574
FDIC premiums	547	598	660
ATM expense	721	698	624
Computer maintenance and supplies	790	782	794
Telephone expense	746	707	690
Contracted services	1,033	842	880
Other real estate owned	624	489	285
Merger-related expenses	—	643	1,400
Other non-interest expense	4,703	4,055	3,969
TOTAL NON-INTEREST EXPENSE	33,261	32,392	30,844

INCOME BEFORE INCOME TAXES	16,925	15,696	13,255
PROVISION FOR INCOME TAXES	4,443	4,222	3,386
NET INCOME	$ 12,482	11,474	9,869
Earnings per common share:			
Basic	$ 1.26	1.18	1.06
Diluted	1.25	1.17	1.05
Weighted average common shares outstanding:			
Basic	9,948,057	9,704,965	9,297,019
Diluted	9,976,370	9,811,467	9,406,346

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

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LCNB CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the years ended December 31,
(Dollars in thousands)

	2016	2015	2014
Net income	$12,482	11,474	9,869
Other comprehensive income (loss):			
Net unrealized gain (loss) on available-for-sale securities (net of tax expense (benefit) of $(1,242), $(169), and $1,476 for 2016, 2015, and 2014, respectively)	(2,390)	(329)	2,865
Reclassification adjustment for net realized gain on sale of available-for-sale securities included in net income (net of taxes of $370, $168, and $51 for 2016, 2015 and 2014, respectively)	(712)	(327)	(98)
Change in nonqualified pension plan unrecognized net gain (loss) and unrecognized prior service cost (net of tax expense (benefit) of $128, $55, and $(133) for 2016, 2015, and 2014, respectively)	249	107	(260)
Other comprehensive income (loss)	(2,853)	(549)	2,507
TOTAL COMPREHENSIVE INCOME	$9,629	10,925	12,376

SUPPLEMENTAL INFORMATION:
COMPONENTS OF ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX, AS OF YEAR-END:

	2016	2015	2014
Net unrealized gain (loss) on securities available-for-sale	$(2,633)	469	1,125
Net unfunded liability for nonqualified pension plan	16	(233)	(340)
Balance at year-end	$(2,617)	236	785

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

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LCNB CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the years ended December 31,
(Dollars in thousands, except share data)

	Common Shares Outstanding	Common Shares	Retained Earnings	Treasury Shares	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2013	9,287,536	$66,785	65,475	(11,665)	(1,722)	118,873
Net income			9,869			9,869
Other comprehensive income (loss), net of taxes					2,507	2,507
Dividend Reinvestment and Stock Purchase Plan	23,782	372				372
Compensation expense relating to stock options		24				24
Common stock dividends, $0.64 per share			(5,950)			(5,950)
Balance, December 31, 2014	9,311,318	67,181	69,394	(11,665)	785	125,695
Net income			11,474			11,474
Other comprehensive income (loss), net of taxes					(549)	(549)
Dividend Reinvestment and Stock Purchase Plan	24,610	390				390
Acquisition of BNB Bancorp, Inc.	560,132	9,063				9,063
Exercise of stock options	13,449	152				152
Excess tax (benefit) expense on exercise and forfeiture of stock options		13				13
Compensation expense relating to stock options		19				19
Compensation expense relating to restricted stock	16,038	90				90
Common stock dividends, $0.64 per share			(6,239)			(6,239)
Balance, December 31, 2015	9,925,547	76,908	74,629	(11,665)	236	140,108
Net income			12,482			12,482
Other comprehensive income (loss), net of taxes					(2,853)	(2,853)
Dividend Reinvestment and Stock Purchase Plan	21,088	379				379
Repurchase of stock warrants		(1,545)				(1,545)
Exercise of stock options	51,390	592				592
Excess tax benefit on exercise and forfeiture of stock options and vesting of restricted common stock		61				61
Compensation expense relating to stock options		5				5

Compensation expense relating to restricted stock		90				90
Common stock dividends, $0.64 per share			(6,375)			(6,375)
Balance, December 31, 2016	9,998,025	$76,490	80,736	(11,665)	(2,617)	142,944

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

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LCNB CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31,
(Dollars in thousands)

	2016	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$12,482	11,474	9,869
Adjustments to reconcile net income to net cash flows from operating activities-			
Depreciation, amortization and accretion	2,557	2,997	2,991
Provision for loan losses	913	1,366	930
Deferred income tax provision (benefit)	928	(58)	192
Increase in cash surrender value of bank owned life insurance	(746)	(625)	(671)
Realized gain on sales of securities available-for-sale	(1,082)	(495)	(149)
Realized loss (gain) on sale of premises and equipment	33	(1)	(128)
Realized loss from sale and write-downs of other real estate owned and repossessed assets	534	378	85
Origination of mortgage loans for sale	(11,217)	(7,725)	(7,480)
Realized gains from sales of loans	(244)	(343)	(147)
Proceeds from sales of loans	11,353	7,809	7,552
Penalty for prepayment of long-term debt	251	—	—
Compensation expense related to stock options	5	19	24
Compensation expense related to restricted stock	90	90	—
Changes in:			
Income receivable	(216)	(160)	414
Other assets	(791)	(3,302)	1,898
Other liabilities	634	1,815	560
TOTAL ADJUSTMENTS	3,002	1,765	6,071
NET CASH FLOWS FROM OPERATING ACTIVITIES	15,484	13,239	15,940
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sales of investment securities available-for-sale	92,455	97,981	67,296
Proceeds from maturities and calls of investment securities:			
Available-for-sale	84,529	29,700	36,716
Held-to-maturity	6,640	3,515	4,688
Purchases of investment securities:			
Available-for-sale	(124,934)	(163,859)	(92,180)
Held-to-maturity	(25,010)	(3,413)	(11,090)
Proceeds from redemption of Federal Reserve Bank stock	—	—	41
Purchase of Federal Reserve Bank stock	—	(256)	(743)
Proceeds from sale of impaired loans	—	4,559	—
Net increase in loans	(48,153)	(42,530)	(10,081)
Purchase of bank owned life insurance	(4,000)	—	—
Proceeds from redemption of bank owned life insurance	—	—	3,633
Proceeds from sales of other real estate owned and repossessed assets	526	245	750
Additions to other real estate owned	(182)	(20)	(45)
Purchases of premises and equipment	(9,450)	(504)	(1,052)
Proceeds from sales of premises and equipment	63	22	179

Net cash acquired from (paid for) acquisition	—	8,993	(9,114)
NET CASH FLOWS USED IN INVESTING ACTIVITIES	(27,516)	(65,567)	(11,002)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase (decrease) in deposits	23,745	41,822	(4,797)
Net increase in short-term borrowings	4,653	20,742	7,339
Principal payments on long-term debt	(5,349)	(5,410)	(745)
Penalty for prepayment of long-term debt	(251)	—	—
Proceeds from issuance of common stock	52	66	58
Repurchase of stock warrants	(1,545)	—	—
Proceeds from exercise of stock options	592	152	—
Excess tax benefit from exercise of stock options and vesting of restricted common stock	61	13	—
Cash dividends paid on common stock	(6,048)	(5,915)	(5,636)
NET CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES	15,910	51,470	(3,781)
NET CHANGE IN CASH AND CASH EQUIVALENTS	3,878	(858)	1,157
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	14,987	15,845	14,688
CASH AND CASH EQUIVALENTS AT END OF YEAR	$18,865	14,987	15,845
SUPPLEMENTAL CASH FLOW INFORMATION:			
CASH PAID DURING THE YEAR FOR:			
Interest	$3,542	3,396	3,502
Income taxes	4,420	4,820	2,610
SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING ACTIVITY:			
Transfer from loans to other real estate owned and repossessed assets	32	79	435

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

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

LCNB Corp. (the "Company" or “LCNB”), an Ohio corporation formed in December 1998, is a financial holding company whose principal activity is the ownership of LCNB National Bank (the "Bank"). The Bank was founded in 1877 and provides full banking services, including trust and brokerage services, to customers primarily in Southwestern and South Central Ohio.

BASIS OF PRESENTATION
The consolidated financial statements include the accounts of the Company and its subsidiary. Significant intercompany accounts and transactions are eliminated in consolidation. The accounting and reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices in the banking industry.

Certain prior period data presented in the financial statements have been reclassified to conform with the current year presentation. These reclassifications had no effect on net income.

USE OF ESTIMATES
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.

CASH AND CASH EQUIVALENTS
For purposes of reporting cash flows, cash and cash equivalents include cash, balances due from banks, federal funds sold, and interest-bearing demand deposits with original maturities of twelve months or less. Deposits with other banks routinely have balances greater than FDIC insured limits. Management considers the risk of loss to be very low with respect to such deposits.

INVESTMENT SECURITIES
Certain municipal debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and recorded at amortized cost. Securities not classified as held-to-maturity are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, a separate component of shareholders’ equity. Amortization of premiums and accretion of discounts are recognized as adjustments to interest income using the level-yield method. Realized gains or losses from the sale of securities are recorded on the trade date and are computed using the specific identification method.

Declines in the fair value of securities below their cost that are deemed to be other-than-temporarily impaired and for which the Company does not intend to sell the securities and it is not more likely than not that the securities will be sold before the anticipated recovery of the impairment are separated into losses related to credit factors and losses related to other factors. The losses related to credit factors are recognized in earnings and losses related to other factors are recognized in other comprehensive income. In estimating other than temporary impairment losses, management considers the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The Company's consolidated statements of income as of December 31, 2016, 2015, and 2014, do not reflect any such impairment.

Federal Home Loan Bank ("FHLB") stock is an equity interest in the Federal Home Loan Bank of Cincinnati. It can be sold only at its par value of $100 per share and only to the FHLB or to another member institution. In addition, the equity ownership rights are more limited than would be the case for a public company because of the oversight role exercised by the Federal Housing Finance Agency in the process of budgeting and approving dividends. Federal Reserve Bank stock is similarly restricted in marketability and value. Both investments are carried at cost, which is their par value.

FHLB and Federal Reserve Bank stock are both subject to minimum ownership requirements by member banks. The required investments in common stock are based on predetermined formulas.

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

LOANS
The Company's loan portfolio includes most types of commercial and industrial loans, commercial loans secured by real estate, residential real estate loans, consumer loans, agricultural loans and other types of loans. Most of the properties collateralizing the loan portfolio are located within the Company's market area.

Loans are stated at the principal amount outstanding, net of unearned income, deferred origination fees and costs, and the allowance for loan losses. Interest income is accrued on the unpaid principal balance. The delinquency status of a loan is based on contractual terms and not on how recently payments have been received. Generally, a loan is placed on non-accrual status when it is classified as impaired or there is an indication that the borrower's cash flow may not be sufficient to make payments as they come due, unless the loan is well secured and in the process of collection. Subsequent cash receipts on non-accrual loans are recorded as a reduction of principal and interest income is recorded once principal recovery is reasonably assured. The current year's accrued interest on loans placed on non-accrual status is charged against earnings. Previous years' accrued interest is charged against the allowance for loan losses. Non-accrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer a reasonable doubt as to the timely collection of interest or principal.

Loan origination fees and certain direct loan origination costs are deferred and the net amount amortized as an adjustment of loan yields. These amounts are being amortized over the lives of the related loans.

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded. The credit risk associated with these commitments is evaluated in a manner similar to the allowance for loan losses.

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 collectibility of the principal is unlikely. Consumer loans are charged off when they reach 120 days past due. Subsequent recoveries, if any, are credited to the allowance.

The provision for loan losses is determined by management based upon its evaluation of the amount needed to maintain the allowance for loan losses at a level considered appropriate in relation to the estimated risk of losses inherent in the portfolio. Current methodology used by management to estimate the allowance takes into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, historic categorical trends, current delinquency levels as related to historical levels, portfolio growth rates, changes in composition of the portfolio, the current economic environment, as well as current allowance adequacy in relation to the portfolio. Management is cognizant that reliance on historical information coupled with the cyclical nature of the economy, including credit cycles, affects the allowance. Management considers all of these factors prior to making any adjustments to the allowance due to the subjectivity and imprecision involved in allocation methodology. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are specifically reviewed for impairment. For such loans, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers loans not specifically reviewed for impairment and homogeneous loan pools, such as residential real estate and consumer loans. The general component is measured for each loan category separately based on each category’s average of historical loss experience over a trailing thirty-six month period, adjusted for qualitative factors. Such qualitative factors may include current economic conditions if different from the three-year historical loss period, trends in underperforming loans, trends in volume and terms of loan categories, concentrations of credit, and trends in loan quality.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

A loan is considered impaired when management believes, based on current information and events, it is probable that the Bank will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. An impaired loan is measured by the present value of expected future cash flows using the loan's effective interest rate. An impaired collateral-dependent loan may be measured based on collateral value. Smaller-balance homogeneous loans, including residential mortgage and consumer installment loans, that are not evaluated individually are collectively evaluated for impairment.

Loans acquired from a merger 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 FASB 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.

PREMISES AND EQUIPMENT

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on both the straight-line and accelerated methods over the estimated useful lives of the assets, generally 15 to 40 years for premises and 3 to 10 years for equipment. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Costs incurred for maintenance and repairs are expensed as incurred. Premises and equipment are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of a particular asset may not be recoverable.

OTHER REAL ESTATE OWNED

Other real estate owned includes properties acquired through foreclosure. Such property is held for sale and is initially recorded at fair value, less costs to sell, establishing a new cost basis. Fair value is primarily based on a property appraisal obtained at the time of transfer and any periodic updates that may be obtained thereafter. The allowance for loan losses is charged for any write down of the loan’s carrying value to fair value at the date of acquisition. Any subsequent reductions in fair value and expenses incurred from holding other real estate owned are charged to other non-interest expense. Costs, excluding interest, relating to the improvement of other real estate owned are capitalized. Gains and losses from the sale of other real estate owned are included in other non-interest expense.

GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is the excess of the purchase price over the fair value of the net identifiable assets acquired in a business combination. Goodwill is not amortized, but is instead subject to an annual review for impairment.

Mortgage servicing rights on originated mortgage loans that have been sold are initially recorded at their estimated fair values. Mortgage servicing rights are amortized to loan servicing income in proportion to and over the period of estimated servicing income. Such assets are periodically evaluated as to the recoverability of their carrying value.

The Company's other intangible assets relate to core deposits acquired from business combinations. These intangible assets are amortized on a straight-line basis over their estimated useful lives. Management evaluates whether events or circumstances have occurred that indicate the remaining useful life or carrying value of the amortizing intangible should be revised.

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

BANK OWNED LIFE INSURANCE
The Company has purchased life insurance policies on certain officers of the Company. The Company is the beneficiary of these policies and has recorded the estimated cash surrender value in other assets in the consolidated balance sheets. Income on the policies, based on the increase in cash surrender value and any incremental death benefits, is included in other non-interest income in the consolidated statements of income.

AFFORDABLE HOUSING TAX CREDIT LIMITED PARTNERSHIP
LCNB has elected to account for its investment in an affordable housing tax credit limited partnership using the proportional amortization method described in FASB ASU 2014-01, "Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (A Consensus of the FASB Emerging Issues Task Force)." Under the proportional amortization method, an investor amortizes the initial cost of the investment to income tax expense in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense. The investment in the limited partnership is included in other assets and the unfunded amount is included in accrued interest and other liabilities in LCNB's consolidated balance sheets.

FAIR VALUE MEASUREMENTS
Accounting guidance establishes a fair value hierarchy to prioritize the inputs to valuation techniques used to measure fair value. A financial instrument’s level within the hierarchy is based on the lowest level of input that is significant to the fair value measurement. The three broad input levels are:

- 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; and
- Level 3 - inputs that are unobservable for the asset or liability.

Accounting guidance permits, but does not require, companies to measure many financial instruments and certain other items at fair value. The decision to elect the fair value option is made individually for each instrument and is irrevocable once made. Changes in fair value for the selected instruments are recorded in earnings. The Company did not select any financial instruments for the fair value election in 2016 or 2015.

ADVERTISING EXPENSE
Advertising costs are expensed as incurred and are recorded as a marketing expense, a component of non-interest expense.

PENSION PLANS
Eligible employees of the Company hired before 2009 participate in a multiple-employer qualified noncontributory defined benefit retirement plan. This plan is accounted for as a multi-employer plan because assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

Citizens National had a qualified noncontributory, defined benefit pension plan, which has been assumed by the Company, that covers eligible employees hired before May 1, 2005. This is a single employer plan.

TREASURY STOCK

Common stock shares repurchased are recorded at cost. Cost of shares retired or reissued is determined using the weighted average method.

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

STOCK OPTIONS AND RESTRICTED STOCK AWARD PLANS
The cost of employee services received in exchange for stock option grants is the grant-date fair value of the award estimated using an option-pricing model. The compensation cost for restricted stock awards is based on the market price of the Company's common stock at the date of grant multiplied by the number of shares granted that are expected to vest. The estimated cost is recognized on a straight-line basis over the period the employee is required to provide services in exchange for the award, usually the vesting period. The Company uses a Black-Scholes pricing model and related assumptions for estimating the fair value of stock option grants and a five-year vesting period for stock options and restricted stock.

INCOME TAXES
Deferred income taxes are determined using the asset and liability method of accounting. Under this method, the net deferred tax asset or liability is determined based on the tax effects of temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Management analyzes material tax positions taken in any income tax return for any tax jurisdiction and determines the likelihood of the positions being sustained in a tax examination. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

EARNINGS PER SHARE
Basic earnings per share allocated to common shareholders is calculated using the two-class method and is computed by dividing net income allocated to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is adjusted for the dilutive effects of stock based compensation and warrants and is calculated using the two-class method or the treasury stock method. The diluted average number of common shares outstanding has been increased for the assumed exercise of stock based compensation and warrants with the proceeds used to purchase treasury shares at the average market price for the period.

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:

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"

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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. LCNB's revenue is comprised of net interest income, which is explicitly excluded from the scope of ASU No. 2014-09, and non-interest income. The update may require LCNB to change how it recognizes certain recurring revenue streams related to non-interest income. However, it is not expected to have a material impact on LCNB's results of operations or financial position. Management continues to monitor the guidance from the FASB and the Transition Resource Group for Revenue Recognition in determining the impact of ASU No. 2014-09 on various types of non-interest income.

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.

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.

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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 estimates that it will recognize discounted right of use assets and and lease liabilities totaling approximately $5 million for the leases disclosed in Note 8 - Leases. This projection is based on various assumptions, including the level of interest rates and no significant increases in leasing activity, that may change between now and the effective date.

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.

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.

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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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. If the provisions of the ASU had been adopted in 2014, excess tax benefits from the exercise of stock options and the vesting of restricted common stock would have reduced the provision for income taxes for 2016 and 2015 by $61,000 and $13,000, respectively. There were no excess tax benefits during 2014.

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.

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. While LCNB's Loan Committee expects that the implementation of ASU No. 2016-13 will increase the balance of the allowance for loan losses, it is continuing to evaluate the potential impact on LCNB's results of operations and financial position.

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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments"
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.

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 National"), a wholly-owned subsidiary of BNB, was merged into LCNB National Bank. Brookville National 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.

On October 28, 2013, LCNB and Colonial Banc Corp. (“Colonial”) entered into a Stock Purchase Agreement (“Purchase Agreement”) pursuant to which LCNB purchased from Colonial on January 24, 2014 all of the issued and outstanding shares of Eaton National Bank & Trust Co. ("Eaton National"). Immediately following the acquisition, Eaton National was merged into the Bank. Eaton National operated five full–service branches with a main office and another facility in Eaton, Ohio and branch offices in each of West Alexandria, Ohio, New Paris, Ohio, and Lewisburg, Ohio. These offices became branches of the Bank after the merger.

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NOTE 2 – ACQUISITIONS (Continued)

The mergers with BNB and Eaton National were 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 respective merger dates, as summarized in the following table (in thousands):

	BNB	Eaton National
Consideration Paid:		
Common shares issued	$ 9,063	—
Cash paid to shareholder(s)	4,403	24,750
Total consideration paid	13,466	24,750
Identifiable Assets Acquired:		
Cash and cash equivalents	13,396	15,635
Investment securities	58,239	35,859
Federal Reserve Bank stock	130	41
Federal Home Loan Bank stock	—	784
Loans	34,661	115,944
Premises and equipment	2,311	1,314
Bank owned life insurance	—	3,618
Core deposit intangible	1,418	2,466
Other real estate owned	—	262
Other assets	532	1,624
Total identifiable assets acquired	110,687	177,547
Liabilities Assumed:		
Deposits	99,133	165,335
Short-term borrowings	—	651
Deferred income taxes	576	—
Other liabilities	57	263
Total liabilities assumed	99,766	166,249
Total Identifiable Net Assets Acquired	10,921	11,298
Goodwill resulting from merger	2,545	13,452

The amount of goodwill recorded reflects LCNB's entrance into new markets and related synergies that are expected to result from the acquisitions and represents 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 for BNB and Eaton National is being amortized over nine years and eight years, respectively, using the straight-line method.

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

The results of operations are included in the consolidated statements of income from the dates of the mergers.

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NOTE 3 - INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
2016				
Investment Securities Available-for-Sale:				
U.S. Treasury notes	$ 28,180	41	76	28,145
U.S. Agency notes	87,098	150	1,848	85,400
U.S. Agency mortgage-backed securities	72,402	89	1,444	71,047
Municipal securities:				
Non-taxable	114,064	574	1,623	113,015
Taxable	19,710	220	85	19,845
Mutual funds	2,527	—	45	2,482
Trust preferred securities	49	—	1	48
Equity securities	632	55	10	677
	$ 324,662	1,129	5,132	320,659
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	$ 31,015	56	352	30,719
Taxable	9,988	—	217	9,771
	$ 41,003	56	569	40,490
2015				
Investment Securities 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
Investment Securities 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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NOTE 3 - INVESTMENT SECURITIES (Continued)

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

	Less Than Twelve Months		Twelve Months or More	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2016				
Investment Securities Available-for-Sale:				
U.S. Treasury notes	$16,076	76	—	—
U.S. Agency notes	69,784	1,848	—	—
U.S. Agency mortgage-backed securities	64,564	1,310	3,518	134
Municipal securities:				
Non-taxable	72,867	1,621	451	2
Taxable	9,721	82	450	3
Mutual funds	1,205	37	277	8
Trust preferred securities	49	1	—	—
Equity securities	201	10	—	—
	$234,467	4,985	4,696	147
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	$20,429	251	2,564	101
Taxable	8,030	217	—	—
	$28,459	468	2,564	101
2015				
Investment Securities 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
Investment Securities Held-to-Maturity:				
Municipal securities:				
Non-taxable	$832	3	3,426	94
Taxable	399	1	—	—
	$1,231	4	3,426	94

Management has determined that the unrealized losses at December 31, 2016 are primarily due to fluctuations in market interest rates and do not reflect credit quality deterioration of the securities. Because the Company does not have the intent to sell the investments and it is more likely than not that the Company will not be required to sell the investments before recovery of their amortized cost, the Company does not consider these investments to be other-than-temporarily impaired.

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(Continued)

NOTE 3 - INVESTMENT SECURITIES (Continued)

Contractual maturities of investment securities at December 31, 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	$12,364	12,464	3,955	3,959
Due from one to five years	97,171	97,501	4,125	4,068
Due from five to ten years	131,950	129,289	10,081	9,845
Due after ten years	7,567	7,151	22,842	22,618
	249,052	246,405	41,003	40,490
U.S. Agency mortgage-backed securities	72,402	71,047	—	—
Mutual funds	2,527	2,482	—	—
Trust preferred securities	49	48	—	—
Equity securities	632	677	—	—
	$324,662	320,659	41,003	40,490

Investment securities with a market value of $149,990,000 and $215,952,000 at December 31, 2016 and 2015, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

Certain information concerning the sale of investment securities available-for-sale for the years ended December 31 was as follows (in thousands):

	2016	2015	2014
Proceeds from sales	$92,455	97,981	67,296
Gross realized gains	1,103	627	252
Gross realized losses	21	132	103

NOTE 4 - LOANS

Major classifications of loans at December 31 were as follows (in thousands):

	2016	2015
Commercial and industrial	$41,878	45,275
Commercial, secured by real estate	477,275	419,633
Residential real estate	265,788	273,139
Consumer	19,173	18,510
Agricultural	14,802	13,479
Other loans, including deposit overdrafts	633	665
	819,549	770,701
Deferred origination costs, net	254	237
	819,803	770,938
Less allowance for loan losses	3,575	3,129
Loans-net	$816,228	767,809

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NOTE 4 - LOANS (Continued)

Loans acquired from the mergers with Eaton National and BNB were 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. Management estimated the cash flows expected to be collected at acquisition using a third-party risk model, which incorporated the estimate of current key assumptions, such as default rates, severity, and prepayment speeds.

Impaired loans acquired are accounted for under FASB 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 current 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.

The following table provides certain information at the acquisition date on loans acquired from BNB on April 30, 2015 and from Eaton National on January 24, 2014, not including loans considered to be impaired (in thousands):

	BNB	Eaton National
Contractually required principal at acquisition	$32,174	102,483
Less fair value adjustment	199	1,347
Fair value of acquired loans	$31,975	101,136
Contractual cash flows not expected to be collected	$195	1,702

The following table provides details on acquired impaired loans obtained through the mergers with BNB and Eaton National that are accounted for in accordance with FASB ASC 310-30 (in thousands):

	BNB	Eaton National
Contractually required principal at acquisition	$3,511	23,414
Contractual cash flows not expected to be collected (nonaccretable difference)	(404)	(6,088)
Expected cash flows at acquisition	3,107	17,326
Interest component of expected cash flows (accretable discount)	(413)	(2,163)
Fair value of acquired impaired loans	$2,694	15,163

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NOTE 4 - LOANS (Continued)

Non-accrual, past-due, and accruing restructured loans at December 31 were as follows (in thousands):

	2016	2015
Non-accrual loans:		
Commercial and industrial	$—	—
Commercial, secured by real estate	4,312	876
Agricultural	334	48
Residential real estate	1,079	799
Total non-accrual loans	5,725	1,723
Past-due 90 days or more and still accruing	23	559
Total non-accrual and past-due 90 days or more and still accruing	5,748	2,282
Accruing restructured loans	11,731	13,723
Total	$17,479	16,005
Percentage of total non-accrual and past-due 90 days or more and still accruing to total loans	0.70 %	0.30 %
Percentage of total non-accrual, past-due 90 days or more and still accruing, and accruing restructured loans to total loans	2.13 %	2.08 %

Interest income that would have been recorded during 2016 and 2015 if loans on non-accrual status at December 31, 2016 and 2015 had been current and in accordance with their original terms was approximately $220,000 and $137,000, respectively.

The Company is not committed to lend additional funds to debtors whose loans have been modified to provide a reduction or deferral of principal or interest because of deterioration in the financial position of the borrower.

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NOTE 4 - LOANS (Continued)

The allowance for loan losses and recorded investment in loans for the years ended December 31 were as follows (in thousands):

	Commercial & Industrial	Commercial, Secured by Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
December 31, 2016							
Allowance for loan losses:							
Balance, beginning of year	$ 244	1,908	854	54	66	3	3,129
Provision charged to expenses	314	358	106	74	(6)	67	913
Losses charged off	(234)	(185)	(127)	(85)	—	(119)	(750)
Recoveries	26	98	52	53	—	54	283
Balance, end of year	$ 350	2,179	885	96	60	5	3,575
Individually evaluated for impairment	$ 9	55	100	13	—	—	177
Collectively evaluated for impairment	341	1,832	785	83	60	5	3,106
Acquired credit impaired loans	—	292	—	—	—	—	292
Balance, end of year	$ 350	2,179	885	96	60	5	3,575
Loans:							
Individually evaluated for impairment	$ 337	12,580	1,518	52	334	—	14,821
Collectively evaluated for impairment	41,466	458,059	262,266	19,192	14,475	178	795,636
Acquired credit impaired loans	98	6,305	2,471	17	—	455	9,346
Balance, end of year	$ 41,901	476,944	266,255	19,261	14,809	633	819,803
December 31, 2015							
Allowance for loan losses:							
Balance, beginning of year	$ 129	1,990	926	63	11	2	3,121
Provision charged to expenses	208	955	125	(17)	55	40	1,366
Losses charged off	(100)	(1,133)	(304)	(52)	(67)	(74)	(1,730)
Recoveries	7	96	107	60	67	35	372
Balance, end of year	$ 244	1,908	854	54	66	3	3,129
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 year	$ 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 year	$ 45,287	419,320	273,581	18,599	13,486	665	770,938

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NOTE 4 - LOANS (Continued)

	Commercial & Industrial	Commercial, Secured by Real Estate	Residential Real Estate	Consumer	Agricultural	Other	Total
December 31, 2014							
Allowance for loan losses:							
Balance, beginning of year	$ 175	2,520	826	66	—	1	3,588
Provision charged to expenses	173	(20)	712	18	11	36	930
Losses charged off	(261)	(573)	(652)	(129)	—	(79)	(1,694)
Recoveries	42	63	40	108	—	44	297
Balance, end of year	$ 129	1,990	926	63	11	2	3,121
Individually evaluated for impairment	$ 10	415	89	—	—	—	514
Collectively evaluated for impairment	119	1,273	836	63	11	2	2,304
Acquired credit impaired loans	—	302	1	—	—	—	303
Balance, end of year	$ 129	1,990	926	63	11	2	3,121

The risk characteristics of LCNB's material loan portfolio segments were 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.”

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NOTE 4 - LOANS (Continued)

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 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 collectibility 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.

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

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

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NOTE 4 - LOANS (Continued)

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

	Pass	OAEM	Substandard	Doubtful	Total
December 31, 2016					
Commercial & industrial	$41,178	304	419	—	41,901
Commercial, secured by real estate	443,781	5,479	27,684	—	476,944
Residential real estate	261,839	442	3,974	—	266,255
Consumer	19,182	—	79	—	19,261
Agricultural	13,311	—	1,498	—	14,809
Other	633	—	—	—	633
Total	$779,924	6,225	33,654	—	819,803
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

The Company evaluates the loan risk grading system definitions and allowance for loan loss methodology on an ongoing basis. No significant changes were made to either during the past year.

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NOTE 4 - LOANS (Continued)

A loan portfolio aging analysis at December 31 is as follows (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Total Loans Greater Than 90 Days and Accruing
December 31, 2016							
Commercial & industrial	$19	—	—	19	41,882	41,901	—
Commercial, secured by real estate	99	69	127	295	476,649	476,944	—
Residential real estate	686	80	727	1,493	264,762	266,255	20
Consumer	59	16	3	78	19,183	19,261	3
Agricultural	125	—	—	125	14,684	14,809	—
Other	115	—	—	115	518	633	—
Total	$1,103	165	857	2,125	817,678	819,803	23
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 for the years ended December 31 were as follows (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2016					
With no related allowance recorded:					
Commercial & industrial	$ 109	263	—	998	151
Commercial, secured by real estate	14,195	15,522	—	15,274	1,140
Residential real estate	3,238	4,286	—	3,736	369
Consumer	26	27	—	37	29
Agricultural	334	334	—	392	136
Other	455	629	—	481	77
Total	$ 18,357	21,061	—	20,918	1,902
With an allowance recorded:					
Commercial & industrial	$ 326	326	9	341	19
Commercial, secured by real estate	4,690	4,946	347	4,194	257
Residential real estate	751	751	100	651	36
Consumer	43	43	13	43	3
Agricultural	—	—	—	—	—
Other	—	—	—	—	—
Total	$ 5,810	6,066	469	5,229	315
Total:					
Commercial & industrial	$ 435	589	9	1,339	170
Commercial, secured by real estate	18,885	20,468	347	19,468	1,397
Residential real estate	3,989	5,037	100	4,387	405
Consumer	69	70	13	80	32
Agricultural	334	334	—	392	136
Other	455	629	—	481	77
Total	$ 24,167	27,127	469	26,147	2,217

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LCNB CORP. AND SUBSIDIARY
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NOTE 4 - LOANS (Continued)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2015					
With no related allowance recorded:					
Commercial & industrial	$ 1,205	1,500	—	1,467	206
Commercial, secured by real estate	16,345	18,335	—	18,575	2,229
Residential real estate	3,734	5,055	—	4,092	453
Consumer	81	109	—	106	25
Agricultural	48	151	—	81	487
Other	486	701	—	510	82
Total	$ 21,899	25,851	—	24,831	3,482
With an allowance recorded:					
Commercial & industrial	$ 356	356	9	370	21
Commercial, secured by real estate	3,883	4,014	306	4,007	114
Residential real estate	846	958	48	864	37
Consumer	2	1	—	—	—
Agricultural	—	—	—	—	—
Other	—	—	—	—	—
Total	$ 5,087	5,329	363	5,241	172
Total:					
Commercial & industrial	$ 1,561	1,856	9	1,837	227
Commercial, secured by real estate	20,228	22,349	306	22,582	2,343
Residential real estate	4,580	6,013	48	4,956	490
Consumer	83	110	—	106	25
Agricultural	48	151	—	81	487
Other	486	701	—	510	82
Total	$ 26,986	31,180	363	30,072	3,654

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NOTE 4 - LOANS (Continued)

	Average Recorded Investment	Interest Income Recognized
December 31, 2014		
With no related allowance recorded:		
Commercial & industrial	1,823	161
Commercial, secured by real estate	23,360	1,373
Residential real estate	4,645	379
Consumer	179	14
Agricultural	121	20
Other	550	43
Total	30,678	1,990
With an allowance recorded:		
Commercial & industrial	319	19
Commercial, secured by real estate	4,108	117
Residential real estate	1,026	44
Consumer	18	2
Agricultural	—	—
Other	—	—
Total	5,471	182
Total:		
Commercial & industrial	2,142	180
Commercial, secured by real estate	27,468	1,490
Residential real estate	5,671	423
Consumer	197	16
Agricultural	121	20
Other	550	43
Total	36,149	2,172

Of the interest income recognized on impaired loans during 2016, 2015, and 2014, approximately $51,000, $96,000, and $8,000, respectively, were recognized on a cash basis. The Company continued to accrue interest on certain loans classified as impaired during 2016, 2015, and 2014 because they were restructured or considered well secured and in the process of collection.

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NOTE 4 - LOANS (Continued)

Loan modifications that were classified as troubled debt restructurings during the years ended December 31 were as follows (dollars in thousands):

	2016			2015			2014		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Commercial and industrial	—	$ —	$ —	—	$ —	$ —	8	$ 658	$ 340
Commercial, secured by real estate	4	2,142	2,215	1	75	74	2	896	1,214
Residential real estate	6	139	139	7	217	221	2	82	82
Consumer	3	39	39	2	9	9	3	40	40
	13	$ 2,320	$ 2,393	10	$ 301	$ 304	15	$ 1,676	$ 1,676

The pre-modification and post-modification recorded balances for the commercial and industrial and commercial, secured by real estate categories in 2014 changed because a borrower had multiple loans classified as commercial and industrial and a loan classified as commercial, secured by real estate, which were all modified into a loan classified as commercial, secured by real estate.

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NOTE 4 - LOANS (Continued)

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. Post-modification balances of newly restructured troubled debt by type of modification for the years ended December 31 were as follows (dollars in thousands):

	Term Modification	Rate Modification	Interest Only	Combination	Total Modifications
December 31, 2016					
Commercial & industrial	—	—	—	—	—
Commercial, secured by real estate	1,539	—	304	372	2,215
Residential real estate	38	47	—	54	139
Consumer	—	28	—	11	39
Total	1,577	75	304	437	2,393
December 31, 2015					
Commercial & industrial	—	—	—	—	—
Commercial, secured by real estate	74	—	—	—	74
Residential real estate	221	—	—	—	221
Consumer	9	—	—	—	9
Total	304	—	—	—	304
December 31, 2014					
Commercial & industrial	340	—	—	—	340
Commercial, secured by real estate	—	1,136	—	78	1,214
Residential real estate	82	—	—	—	82
Consumer	38	—	—	2	40
Total	460	1,136	—	80	1,676

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 years ended December 31, 2016, 2015, and 2014. Two commercial, secured by real estate loans to the same borrower totaling $1,236,000 that were modified during the fourth quarter 2016 subsequently defaulted in February 2017.

All troubled debt restructurings are considered impaired loans. The allowance for loan loss on such restructured loans is based on the present value of future expected cash flows.

Approximately $881,000 of impaired loans without a valuation allowance and $1,168,000 of impaired loans with a valuation allowance at December 31, 2016 consisted of loans that were modified during 2016 and were determined to be troubled debt restructurings. Approximately $147,000 of impaired loans without a valuation allowance and

$125,000 of impaired loans with a valuation allowance at December 31, 2015 consisted of loans that were modified during 2015 and were determined to be troubled debt restructurings.

Mortgage loans sold to and serviced for the Federal Home Loan Mortgage Corporation and other investors are not included in the accompanying consolidated balance sheets. The unpaid principal balances of those loans at December 31, 2016, 2015 and 2014 were approximately $100,982,000, $111,837,000, and $120,433,000, respectively.

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NOTE 4 - LOANS (Continued)

Mortgage servicing right assets are included in core deposit and other intangibles in the consolidated balance sheets. Amortization of mortgage servicing rights is an adjustment to loan servicing income, which is included with other operating income in the consolidated statements of income. Activity in the mortgage servicing rights portfolio during the years ended December 31 was as follows (in thousands):

	2016	2015	2014
Balance, beginning of year	$488	591	498
Amount capitalized to mortgage servicing rights	109	78	292
Amortization of mortgage servicing rights	(169)	(181)	(199)
Balance, end of year	$428	488	591

NOTE 5 - ACQUIRED CREDIT IMPAIRED LOANS

The following table provides, as of December 31, the major classifications of loans acquired that are accounted for in accordance with FASB ASC 310-30 (in thousands):

	2016	2015
Commercial & industrial	$98	1,191
Commercial, secured by real estate	6,305	7,877
Residential real estate	2,471	3,039
Consumer	17	27
Agricultural	—	48
Other loans, including deposit overdrafts	455	486
	9,346	12,668
Less allowance for loan losses	292	—
Loans, net	$9,054	12,668

The following table provides the outstanding balance and related carrying amount for acquired impaired loans at December 31 (in thousands):

	2016	2015
Outstanding balance	$12,289	16,507
Carrying amount	9,346	12,668

Activity during 2016 and 2015 for the accretable discount related to acquired impaired loans is as follows (in thousands):

	2016	2015
Accretable discount, beginning of year	$1,503	2,674
Accretable discount acquired during period	—	413
Reclass from nonaccretable discount to accretable discount	423	983
Less disposals	(5)	(850)
Less accretion	(841)	(1,717)
Accretable discount, end of year	$1,080	1,503

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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 balance sheets. Changes in other real estate owned were as follows (in thousands):

	2016	2015
Balance, beginning of year	$846	1,370
Additions	214	99
Reductions due to sales	(484)	(205)
Reductions due to valuation write downs	(576)	(418)
Balance, end of year	$—	846

Other real estate owned at December 31 consisted of (in thousands):

	2016	2015
Commercial real estate	$ —	846

The total recorded investment in residential consumer mortgage loans secured by residential real estate that was in the process of foreclosure at December 31, 2016 was $456,000.

NOTE 7 - PREMISES AND EQUIPMENT

Premises and equipment at December 31 are summarized as follows (in thousands):

	2016	2015
Land	$8,277	6,660
Buildings	21,400	21,463
Equipment	13,065	13,005
Construction in progress	7,362	9
Total	50,104	41,137
Less accumulated depreciation	19,860	19,037
Premises and equipment, net	$30,244	22,100

Depreciation charged to expense was, $1,210,000 in 2016, and $1,427,000 in 2015, and $1,479,000 in 2014.

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NOTE 8 - LEASES

Some of the Bank's branches, telephone equipment, and other equipment are leased under agreements expiring at various dates through 2050. These leases are accounted for as operating leases. The leases generally provide for renewal options and most require periodic changes in rental amounts based on various indices. Minimum annual rentals for each of the years 2017 through 2021 and thereafter for non-cancelable leases having terms in excess of one year were as follows (in thousands):

2017	$448
2018	267
2019	224
2020	193
2021	160
Thereafter	3,493
Total	$4,785

Rental expense for all leased branches and equipment was approximately $545,000 in 2016, $542,000 in 2015, and $537,000 in 2014.

NOTE 9 - GOODWILL AND OTHER INTANGIBLE ASSETS

Changes in goodwill during 2016 and 2015 were as follows (in thousands):

	2016	2015
Balance, beginning of year	$30,183	27,638
Additions from acquisitions	—	2,545
Balance, end of year	$30,183	30,183

Other intangible assets in the consolidated balance sheets at December 31, 2016 and 2015 were as follows (in thousands):

	2016			2015		
	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
Core deposit intangibles	$6,458	2,304	4,154	6,458	1,550	4,908
Mortgage servicing rights	1,188	760	428	1,496	1,008	488
Total	$7,646	3,064	4,582	7,954	2,558	5,396

The estimated aggregate future amortization expense for each of the next five years for intangible assets remaining as of December 31, 2016 is as follows (in thousands):

2017	$864
2018	843
2019	825
2020	808
2021	795

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NOTE 10 - AFFORDABLE HOUSING TAX CREDIT LIMITED PARTNERSHIP

LCNB is a limited partner in limited partnerships that sponsor affordable housing projects utilizing the Low Income Housing Tax Credit (LIHTC) pursuant to Section 42 of the Internal Revenue Code. The purpose of the investments 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 partnerships 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 December 31 (in thousands):

	2016	2015
Affordable housing tax credit investment	$2,000	1,000
Less amortization	93	12
Net affordable housing tax credit investment	$1,907	988
Unfunded commitment	$1,617	907

LCNB expects to fund the unfunded commitment over ten years.

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

	Year ended December 31,		
	2016	2015	2014
Tax credits and other tax benefits recognized	$103	14	—
Tax credit amortization expense included in provision for income taxes	81	12	—

NOTE 11 - CERTIFICATES OF DEPOSIT

Contractual maturities of time deposits at December 31, 2016 were as follows (in thousands):

2017	$63,188
2018	44,305
2019	24,848
2020	46,499
2021	33,124
Thereafter	2,800
	$214,764

The aggregate amount of time deposits in denominations of $250,000 or more at December 31, 2016 and 2015 was $22,410,000 and $20,987,000, respectively.

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NOTE 12 - BORROWINGS

Funds borrowed from the FHLB at December 31 by year of maturity were as follows (dollars in thousands):

	Outstanding Balance	Average Rate
December 31, 2016		
2017	$ 295	2.82 %
2018	248	2.82 %
2019	55	2.82 %
Total	$ 598	2.82 %
December 31, 2015		
2016	$ 349	2.82 %
2017	5,295	5.11 %
2018	248	2.82 %
2019	55	2.82 %
Total	$ 5,947	4.86 %

All advances from the FHLB are secured by a blanket pledge of the Company's 1-4 family first lien mortgage loans in the amount of approximately $229 million and $231 million at December 31, 2016 and 2015, respectively. Additionally, the Company was required to hold minimum levels of FHLB stock, based on the outstanding borrowings. Total remaining borrowing capacity, including short-term borrowing arrangements, at December 31, 2016 was approximately $79.5 million. One of the factors limiting remaining borrowing capacity is ownership of FHLB stock. The Company could increase its remaining borrowing capacity by purchasing additional FHLB stock.

Short-term borrowings at December 31 were as follows (dollars in thousands):

	2016		2015	
	Amount	Rate	Amount	Rate
Line of credit	$—	— %	$13,187	1.00%
FHLB short-term advance	25,000	0.63%	10,000	0.35%
Repurchase agreements	17,040	0.10%	14,200	0.10%
	$42,040	0.42%	$37,387	0.48%

At December 31, 2016, the Company had short-term borrowing arrangements with three financial institutions and the Federal Home Loan Bank of Cincinnati. The first arrangement is a short-term line of credit for a maximum amount of $10 million at the interest rate in effect at the time of the borrowing. The second arrangement provides that the Company can borrow up to $10 million in federal funds at the interest rate in effect at the time of the borrowing. The third arrangement is a short-term line of credit for a maximum amount of $20 million at an interest rate equal to the lending institution's federal funds rate plus a spread of 50 basis points.

Under the terms of the Cash Management Advance program with the Federal Home Loan Bank of Cincinnati, the Company can borrow up to $64.0 million in short-term advances, subject to total remaining borrowing capacity limitations. The Company has the option of selecting a variable rate of interest for up to 90 days or a fixed rate of

interest for up to 30 days. The interest rate on the Cash Management Advance program is the published rate in effect at the time of the advance. This agreement expires on August 25, 2017.

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NOTE 12 - BORROWINGS (continued)

Repurchase agreements are an option customers may use in managing their cash positions. The repurchase agreements mature the next business day after issuance. They are fully secured by U.S. Agency notes and such collateral securities are held by the Federal Reserve Bank. The maximum amount of outstanding agreements at any month-end during 2016 and 2015 totaled $18,715,000 and $16,250,000, respectively. The average balance during 2016 and 2015 was $13,891,000 and $12,699,000, respectively.

As of December 31, 2016 and 2015, approximately $3.1 million and $1.6 million, respectively, of the repurchase agreements outstanding were held by a company owned by a member of the Company's Board of Directors.

NOTE 13 - INCOME TAXES

The provision for federal income taxes consists of (in thousands):

	2016	2015	2014
Income taxes currently payable	$3,515	4,280	3,194
Deferred income tax provision (benefit)	928	(58)	192
Provision for income taxes	$4,443	4,222	3,386

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

	2016	2015	2014
Statutory tax rate	34.2 %	34.0 %	34.0 %
Increase (decrease) resulting from -			
Tax exempt interest	(6.3)%	(6.0)%	(6.8)%
Tax exempt income on bank owned life insurance	(1.5)%	(1.4)%	(1.7)%
Other – net	(0.1)%	0.3 %	— %
Effective tax rate	26.3 %	26.9 %	25.5 %

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NOTE 13 - INCOME TAXES (continued)

Deferred tax assets and liabilities, included with Other Assets in the Consolidated Balance Sheets, at December 31 consist of the following (in thousands):

	2016	2015
Deferred tax assets:		
Allowance for loan losses	$1,223	1,064
Net unrealized losses on investment securities available-for-sale	1,369	246
Fair value adjustment on loans acquired from merger with First Capital	592	847
Write-down of other real estate owned	—	338
Pension and deferred compensation	1,157	971
Other	546	440
	4,887	3,906
Deferred tax liabilities:		
Depreciation of premises and equipment	(1,332)	(1,332)
Amortization of intangibles	(1,567)	(840)
Deferred loan fees	(2)	(2)
FHLB stock dividends	(351)	(349)
Fair value adjustment on securities acquired from merger with First Capital	(19)	(70)
	(3,271)	(2,593)
Net deferred tax assets	$1,616	1,313

As of December 31, 2016 and 2015 there were no unrecognized tax benefits and the Company does not anticipate the total amount of unrecognized tax benefits will significantly change within the next twelve months. There were no amounts recognized for interest and penalties in the consolidated statements of income for the three-year period ended December 31, 2016.

The Company is no longer subject to examination by federal tax authorities for years before 2013.

NOTE 14 - 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. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contract amount of those instruments.

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.

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NOTE 14 - COMMITMENTS AND CONTINGENT LIABILITIES (continued)

Financial instruments whose contract amounts represent off-balance-sheet credit risk at December 31 were as follows (in thousands):

	2016	2015
Commitments to extend credit:		
Commercial loans	$10,350	8,160
Other loans:		
Fixed rate	4,425	2,293
Adjustable rate	1,044	1,362
Unused lines of credit:		
Fixed rate	9,731	6,378
Adjustable rate	80,222	90,153
Unused overdraft protection amounts on demand and NOW accounts	17,123	10,057
Standby letters of credit	657	457
	$123,552	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 or agreement. 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.

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

Capital expenditures include the construction or acquisition of new office buildings, improvements to LCNB's offices, purchases of furniture and equipment, and additions or improvements to LCNB's information technology system. Commitments outstanding for capital expenditures as of December 31, 2016 totaled approximately $4,750,000, which includes estimated remaining costs for a new operations center being built in Lebanon, Ohio.

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

NOTE 15 - REGULATORY MATTERS

The Federal Reserve Act requires depository institutions to maintain cash reserves with the Federal Reserve Bank. In 2016 and 2015, the Bank maintained average reserve balances of $10,903,000 and $11,329,000, respectively. The reserve balances at December 31, 2016 and 2015 were $4,313,000 and $633,000, respectively.

The principal source of income and funds for LCNB Corp. is dividends paid by the Bank. The payment of dividends is subject to restriction by regulatory authorities. For 2017, the restrictions generally limit dividends to the aggregate of net income for the year 2017 plus the net earnings retained for 2016 and 2015. In addition, dividend payments may not reduce capital levels below minimum regulatory guidelines. At December 31, 2016, approximately $14,147,000 of the Bank's earnings retained was available for dividends in 2017 under this guideline. Dividends in excess of these limitations would require the prior approval of the Comptroller of the Currency.

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NOTE 15 - REGULATORY MATTERS (continued)

The Company (consolidated) and the Bank must meet certain minimum capital requirements set by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's and Bank's financial statements. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

A new rule requiring a Capital Conservation Buffer began phase-in on January 1, 2016 and will be fully implemented in 2019. 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.

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

	Minimum Requirement		Minimum Requirement with Capital Conservation Buffer		To Be Considered Well-Capitalized	
Ratio of Common Equity Tier 1 Capital to risk-weighted assets	4.5	%	5.125	%	6.5	%
Ratio of tier 1 capital to risk-weighted assets	6.0	%	6.625	%	8.0	%
Ratio of total capital (tier 1 capital plus tier 2 capital) to risk-weighted assets	8.0	%	8.625	%	10.0	%
Leverage ratio (tier 1 capital to adjusted quarterly average total assets)	4.0	%	N/A		5.0	%

As of the most recent notification from their regulators, the Company and Bank 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 category.

A summary of the regulatory capital of the Consolidated Company and Bank at December 31 follows (dollars in thousands):

	2016		2015	
	Consolidated Company	Bank	Consolidated Company	Bank
Regulatory Capital:				
Shareholders' equity	$142,944	141,325	140,108	138,396
Goodwill and other intangible assets	(32,676)	(32,676)	(32,146)	(32,146)
Accumulated other comprehensive (income) loss	2,617	2,605	(256)	(261)
Tier 1 risk-based capital	112,885	111,254	107,706	105,989
Eligible allowance for loan losses	3,575	3,575	3,129	3,129
Total risk-based capital	$116,460	114,829	110,835	109,118
Capital Ratios:				

Common Equity Tier 1 Capital to risk-weighted assets	13.00 %	12.82 %	13.46 %	13.26 %
Tier 1 capital to risk-weighted assets	13.00 %	12.82 %	13.46 %	13.26 %
Total capital (tier 1 capital plus tier 2 capital) to risk-weighted assets	13.41 %	13.24 %	13.85 %	13.65 %
Leverage ratio (tier 1 capital to adjusted quarterly average total assets)	8.81 %	8.69 %	8.62 %	8.49 %

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NOTE 15 - REGULATORY MATTERS (continued)

LCNB Corp. filed a Registration Statement on Form S-3 with the SEC on July 27, 2011 to register 400,000 shares for use in its Amended and Restated Dividend Reinvestment and Stock Purchase Plan (the "Amended Plan"). Formerly LCNB purchased the shares needed for its Dividend and Stock Purchase Plan in the secondary market. Under the Amended Plan, LCNB has the option of purchasing shares in the secondary market, using treasury shares, or issuing new shares.

Two warrants for the purchase of an aggregate total of 217,063 common shares of LCNB stock at an exercise price of $9.26 per share were outstanding at December 31, 2015. The warrants carried a ten year term and were 100% vested at the date of grant, which was January 9, 2009. During March 2016, LCNB repurchased both warrants for $1,545,000, which was accounted for as a reduction to common shares in the shareholders' equity section of the consolidated balance sheets.

NOTE 16 - ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in accumulated other comprehensive income (loss) for 2016 and 2015 were as follows (in thousands):

	2016			2015		
	Unrealized Gains and Losses on Available-for-Sale Securities	Changes in Pension Plan Assets and Benefit Obligations	Total	Unrealized Gains and Losses on Available-for-Sale Securities	Changes in Pension Plan Assets and Benefit Obligations	Total
Balance at beginning of year	$469	(233)	236	1,126	(341)	785
Before reclassifications	(2,390)	249	(2,141)	(330)	108	(222)
Reclassifications	(712)	—	(712)	(327)	—	(327)
Balance at end of year	$(2,633)	16	(2,617)	469	(233)	236

Reclassifications out of accumulated other comprehensive income (loss) during 2016 and 2015 and the affected line items in the consolidated statements of income were as follows (in thousands):

	2016	2015	Affected Line Item in the Consolidated Statements of Income
Realized gain on sales of securities	$1,082	495	Net gain on sale of securities
Less provision for income taxes	370	168	Provision for income taxes
Reclassification adjustment, net of taxes	$712	327	

NOTE 17 - RETIREMENT PLANS

Prior to January 1, 2009, the Company had a single-employer qualified noncontributory defined benefit retirement plan that covered substantially all regular full-time employees. Effective January 1, 2009, the Company redesigned the plan and merged it into a multiple-employer plan, which is accounted for as a multi-employer plan because assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees

of that employer. Employees hired on or after January 1, 2009 are not eligible to participate in this plan.

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NOTE 17 - RETIREMENT PLANS (continued)

Effective February 1, 2009, the Company amended the plan to reduce benefits for those whose age plus vesting service equaled less than 65 at that date. Also effective February 1, 2009, an enhanced 401(k) plan was made available to those hired on or after January 1, 2009 and to those who received benefit reductions from the amendments to the noncontributory defined benefit retirement plan. Employees hired on or after January 1, 2009 receive a 50% employer match on their contributions into the 401(k) plan, up to a maximum company contribution of 3% of each individual employee's annual compensation. Employees who received a benefit reduction under the retirement plan amendments receive an automatic contribution of 5% or 7% of annual compensation, depending on the sum of an employee's age and vesting service, into the 401(k) plan, regardless of the contributions made by the employees. This contribution is made annually and these employees will not receive any employer matches to their 401(k) contributions.

Certain information pertaining to the qualified noncontributory defined benefit retirement plan is as follows:

Legal name	Pentegra Defined Benefit Plan for Financial Institutions
Plan's employer identification number	13-5645888
Plan number	333

The plan is at least 80% funded as of July 1, 2016 and 2015. A funding improvement or rehabilitation plan has not been implemented, nor has a surcharge been paid to the plan.

Funding and administrative costs of the qualified noncontributory defined benefit retirement plan and 401(k) plan charged to salaries and employee benefits in the consolidated statements of income for the years ended December 31 were as follows (in thousands):

	2016	2015	2014
Qualified noncontributory defined benefit retirement plan	$969	984	967
401(k) plan	359	346	326

The Company expects a minimum contribution of $189,000 to the qualified noncontributory defined benefit retirement plan in 2017. The Company expects to contribute $250,000 to the 401(k) plan in 2017. The Company's contributions to the qualified noncontributory defined benefit retirement plan do not represent more than 5% of total contributions to the plan.

Citizens National had a qualified noncontributory defined benefit pension plan which covered employees hired before May 1, 2005. The Company assumed this plan at the time of the merger. At December 31, 2016, the amount of the asset for this plan was $30,000, representing the funded status of the plan.

The Bank has a benefit plan which permits eligible officers to defer a portion of their compensation. The deferred compensation balance, which accrues interest at 8% annually, is distributable in cash after retirement or termination of employment. The amount of such deferred compensation liability at December 31, 2016 and 2015 was $3,407,000 and $3,199,000, respectively.

The Bank also has supplemental income plans which provide certain employees an amount based on a percentage of average compensation, payable in accordance with individually defined schedules upon retirement. The projected benefit obligation included in other liabilities for the supplemental income plans at December 31, 2016 and 2015 is $1,284,000 and $1,295,000, respectively. The average discount rate used to determine the present value of the obligations was approximately 5.2% in 2016 and 5.0% in 2015. The service cost associated with the plans was $0 for 2016, $183,000 for 2015, and $43,000 for 2014. Interest costs were $63,000, $56,000, and $56,000 for 2016, 2015, and 2014, respectively.

The deferred compensation plan and supplemental income plans are nonqualified and unfunded. Participation in each plan is limited to a select group of management.

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NOTE 17 - RETIREMENT PLANS (continued)

Effective February 1, 2009, the Company established a nonqualified defined benefit retirement plan, which is also unfunded, for certain highly compensated employees. 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 years ended December 31 are summarized as follows (in thousands):

	2016	2015	2014
Service cost	$41	38	68
Interest cost	78	68	60
Amortization of unrecognized (gain) loss	168	171	—
Amortization of unrecognized prior service cost	—	—	15
Net periodic pension cost	$287	277	143

A reconciliation of changes in the projected benefit obligation of the nonqualified defined benefit retirement plan at December 31 follows (in thousands):

	2016	2015	2014
Projected benefit obligation at beginning of year	$1,843	1,741	1,213
Service cost	41	38	68
Interest cost	78	68	60
Actuarial (gain) or loss	(209)	10	407
Benefits paid	(26)	(14)	(7)
Projected benefit obligation at end of year	$1,727	1,843	1,741

Amounts recognized in other liabilities in the consolidated balance sheets for the nonqualified defined benefit retirement plan at December 31, 2016 and 2015 were $1,727,000 and $1,843,000, respectively.

The accumulated benefit obligation for the nonqualified defined benefit retirement plan at December 31, 2016 and 2015 was $1,727,000 and $1,752,000, respectively.

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

	2016	2015	2014
Net actuarial (gain)/loss	$(16)	233	339
Past service cost	—	—	—
	$(16)	233	339

The estimated unrecognized net actuarial gain that will be amortized from accumulated other comprehensive income into net periodic benefit cost during 2017 for the nonqualified defined benefit retirement plan is $0.

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NOTE 17 - RETIREMENT PLANS (continued)

Key weighted-average assumptions used to determine the benefit obligation and net periodic pension costs for the nonqualified defined benefit retirement plan for the years ended December 31 were as follows:

	2016	2015	2014
Benefit obligation:			
Discount rate	4.14%	4.34%	3.95%
Salary increase rate	2.00%	2.00%	2.00%
Net periodic pension cost:			
Discount rate	4.34%	3.95%	4.95%
Salary increase rate	2.00%	2.00%	3.00%
Amortization period in years	1.00	1.98	3.95

The nonqualified defined benefit retirement plan is not funded. Therefore no contributions will be made in 2017. Estimated future benefit payments reflecting expected future service for the years ended after December 31, 2016 are (in thousands):

2017	$105
2018	122
2019	122
2020	122
2021	122
2022-2026	600

NOTE 18 - 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 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 approved 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 18 - STOCK-BASED COMPENSATION (continued)

LCNB has not granted stock options since 2012. Option awards 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 December 31, 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	2.1	4,356	$ 9.00	2.1
$11.00 - 12.99	17,797	12.13	3.8	16,052	12.08	3.7
$17.00 - 18.99	2,516	17.88	0.1	2,516	17.88	0.1
	24,669	12.17	3.1	22,924	12.13	3.0

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

	2016		2015		2014	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at January 1,	83,861	12.39	99,810	$ 12.16	104,966	$ 12.43
Granted	—	—	—	—	—	—
Exercised	(51,390)	11.53	(13,449)	11.31	—	—
Expired	(7,802)	18.76	(2,500)	9.00	(5,156)	17.66
Outstanding at December 31,	24,669	12.17	83,861	12.39	99,810	12.16
Exercisable at December 31,	22,924	12.13	75,072	12.40	79,909	12.18

The following table provides information related to stock options exercised during the years indicated (in thousands):

	2016	2015	2014
Intrinsic value of options exercised	$ 288	67	—
Cash received from options exercised	592	152	—
Tax benefit realized from options exercised	59	13	—

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 December 31, 2016 that were "in the money" (market price greater than exercise price) was $273,000. The aggregate intrinsic value at that date for only the options that were exercisable was $255,000. The aggregate intrinsic value for options outstanding at December 31, 2015 that were in the money was $360,000 and the aggregate intrinsic value at that date for only the options that were exercisable was $324,000. The intrinsic value changes based on changes in the market value of the Company's stock.

Total expense related to options included in salaries and wages in the consolidated statements of income for the years ended December 31, 2016, 2015, and 2014 was $5,000, $19,000, and $24,000, respectively. The related tax benefit for 2016, 2015, and 2014 was $2,000, $6,000, and $8,000, respectively. Total compensation cost related to option awards to be recognized through the first quarter of 2017 is approximately $1,000.

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NOTE 18 - 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 at January 1,	16,038	$ 15.47	—	$ —
Granted	—	—	16,038	15.47
Vested	(7,414)	15.47	—	—
Forfeited	—	—	—	—
Outstanding at December 31,	8,624	$ 15.47	16,038	$ 15.47

Total expense related to restricted stock awards included in salaries and wages in the consolidated statements of income for the years ended December 31, 2016 and 2015 was $90,000 and $90,000, respectively. The related tax benefit for the years ended December 31, 2016 and 2015 was $31,000 and $31,000, respectively. Unrecognized compensation expense for restricted stock awards was $68,000 at December 31, 2016 and is expected to be recognized over a period of four years.

NOTE 19 - EARNINGS PER SHARE

LCNB has granted restricted stock awards with non-forfeitable dividend rights, which are considered participating securities. Accordingly, earnings per share is computed using the two-class method as required by FASB ASC 260-10-45. Basic earnings per common share is calculated by dividing net income allocated to common shareholders by the weighted average number of common shares outstanding during the period, which excludes the participating securities. 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.

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NOTE 19 - EARNINGS PER SHARE (continued)

Earnings per share for the years ended December 31 were calculated as follows (in thousands, except share and per share data):

	2016	2015	2014
Net income	$ 12,482	11,474	9,869
Less allocation of earnings and dividends to participating securities	13	—	—
Net income allocated to common shareholders	12,469	11,474	9,869
Weighted average common shares outstanding, gross	9,958,300	9,704,965	9,297,019
Less average participating securities	10,243	—	—
Weighted average number of shares outstanding used in the calculation of basic earnings per common share	9,948,057	9,704,965	9,297,019
Add dilutive effect of:			
Stock options	10,765	17,174	18,545
Stock warrants	17,548	89,328	90,782
Adjusted weighted average number of shares outstanding used in the calculation of diluted earnings per common share	9,976,370	9,811,467	9,406,346
Earnings per common share:			
Basic	$ 1.26	1.18	1.06
Diluted	1.25	1.17	1.05

Options to purchase 12,962, and 12,962 shares of common stock at weighted average prices of $18.41 and $18.41 per share were outstanding at December 31, 2015 and 2014, respectively, and 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 prices of the common shares. There were no such options at December 31, 2016.

NOTE 20 - RELATED PARTY TRANSACTIONS

LCNB has entered into related party transactions with various directors and executive officers. Management believes these transactions do not involve more than a normal risk of collectibility or present other unfavorable features. The following table provides a summary of the loan activity for these officers and directors for the years ended December 31 (in thousands):

	2016	2015
Beginning balance	$ 1,091	1,192
New loans and advances	64	106
Change in composition of related parties	506	—
Reductions	(214)	(207)
Ending Balance	$ 1,447	1,091

Deposits from executive officers, directors and related interests of such persons held by the Company at December 31, 2016 and 2015 amounted to $4,618,000 and $3,577,000, respectively.

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NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS

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 four 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 and equity securities. Investments in mutual funds that are publicly traded in active markets and that publish daily net asset values are considered to have level 1 inputs. 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 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

The following table summarizes the valuation of LCNB's assets recorded at fair value by input levels as of December 31 (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)
December 31, 2016				
Recurring fair value measurements:				
Investment securities available-for-sale:				
U.S. Treasury notes	$ 28,145	28,145	—	—
U.S. Agency notes	85,400	—	85,400	—
U.S. Agency mortgage-backed securities	71,047	—	71,047	—
Certificates of deposit with other banks	—	—	—	—
Municipal securities:				
Non-taxable	113,015	—	113,015	—

Taxable	19,845	—	19,845	—
Mutual funds	1,000	—	1,000	—
Mutual funds measured at net asset value (a)	1,482			
Trust preferred securities	48	48	—	—
Equity securities	677	677	—	—
Total recurring fair value measurements	$ 320,659	28,870	290,307	—
Nonrecurring fair value measurements:				
Impaired loans	$ 5,340	—	—	5,340
December 31, 2015				
Recurring fair value measurement:				
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	249	—	249	—

with other banks				
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 Balance Sheets.

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NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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

	Fair Value	Valuation Technique	Unobservable Inputs	Range		Weighted Average
				High	Low	
2016						
Impaired loans	$5,340	Estimated sales price	Adjustments for comparable properties, discounts to reflect current market conditions	Not applicable		
		Discounted cash flows	Discount rate	8.25%	4.50%	5.56 %
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			

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

Carrying amounts and estimated fair values of financial instruments as of December 31 were as follows (in thousands):

	Carrying Amount	Fair Value	Fair Value Measurements at the End of the Reporting Period Using		
			Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2016					
FINANCIAL ASSETS:					
Cash and cash equivalents	$ 18,865	18,865	18,865	—	—
Investment securities, held-to-maturity	41,003	40,490	—	—	40,490
Federal Reserve Bank stock	2,732	2,732	2,732	—	—
Federal Home Loan Bank stock	3,638	3,638	3,638	—	—
Loans, net	816,228	799,791	—	—	799,791
Accrued interest receivable	3,559	3,559	—	3,559	—
FINANCIAL LIABILITIES:					
Deposits	1,110,905	1,113,187	896,147	217,040	—
Short-term borrowings	42,040	42,040	42,040	—	—
Long-term debt	598	614	—	614	—
Accrued interest payable	307	307	—	307	—
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	—

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 December 31, 2016 and 2015.

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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 the Company. 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 securities, held-to-maturity is estimated using discounted cash flow analysis, using interest rates offered on investments with similar maturities and investment quality.

Federal Home Loan Bank 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.

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)

NOTE 22 – QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following table sets forth certain quarterly results for the years ended December 31, 2016 and 2015 (dollars in thousands, except per share data):

	Three Months Ended			
	March 31	June 30	Sep. 30	Dec. 31
2016				
Interest income	$10,621	11,008	10,895	11,226
Interest expense	849	883	885	887
Net interest income	9,772	10,125	10,010	10,339
Provision for loan losses	90	396	372	55
Net interest income after provision	9,682	9,729	9,638	10,284
Total non-interest income	2,642	2,750	2,846	2,615
Total non-interest expenses	8,292	8,468	8,593	7,908
Income before income taxes	4,032	4,011	3,891	4,991
Provision for income taxes	1,068	1,043	995	1,337
Net income	$2,964	2,968	2,896	3,654
Earnings per common share:				
Basic	$0.30	0.30	0.29	0.37
Diluted	0.30	0.29	0.29	0.37
2015				
Interest income	$10,090	11,348	10,409	10,812
Interest expense	762	748	912	906
Net interest income	9,328	10,600	9,497	9,906
Provision for loan losses	69	677	240	380
Net interest income after provision	9,259	9,923	9,257	9,526
Total non-interest income	2,306	2,831	2,386	2,600
Total non-interest expenses	7,649	8,426	8,088	8,229
Income before income taxes	3,916	4,328	3,555	3,897
Provision for income taxes	1,082	1,205	922	1,013
Net income	$2,834	3,123	2,633	2,884
Earnings per common share:				
Basic	$0.30	0.33	0.26	0.29
Diluted	0.30	0.32	0.26	0.29

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)

NOTE 23 - PARENT COMPANY FINANCIAL INFORMATION

Condensed financial information for LCNB Corp., parent company only, follows (in thousands):
Condensed Balance Sheets:

December 31,	2016	2015
Assets:		
Cash on deposit with subsidiary	$491	534
Investment securities available-for-sale, at fair value	893	888
Investment in subsidiary	141,325	138,396
Other assets	235	290
Total assets	$142,944	140,108
Liabilities	$—	—
Shareholders' equity	142,944	140,108
Total liabilities and shareholders' equity	$142,944	140,108

Condensed Statements of Income

Year ended December 31,	2016	2015	2014
Income:			
Dividends from subsidiary	$7,300	5,400	8,800
Interest and dividends	38	58	91
Net gain on sales of securities	8	254	10
Total income	7,346	5,712	8,901
Total expenses	1,014	1,016	1,077
Income before income tax expense/benefit and equity in undistributed income of subsidiary	6,332	4,696	7,824
Income tax benefit	336	250	350
Equity in undistributed income of subsidiary	5,814	6,528	1,695
Net income	$12,482	11,474	9,869

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LCNB CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016
(Continued)
NOTE 23 - PARENT COMPANY FINANCIAL INFORMATION (continued)

Condensed Statements of Cash Flows

Year ended December 31,	2016	2015	2014
Cash flows from operating activities:			
Net income	$12,482	11,474	9,869
Adjustments for non-cash items -			
Increase in undistributed income of subsidiary	(5,814)	(6,528)	(1,695)
Other, net	126	42	(474)
Net cash flows from operating activities	6,794	4,988	7,700
Cash flows from investing activities:			
Purchases of securities available-for-sale	(177)	(215)	(107)
Proceeds from maturities of securities available-for-sale	55	—	—
Proceeds from sales of available-for-sale securities	173	1,217	227
Cash paid for business acquisition	—	(3,757)	(24,750)
Net cash flows from (used in) investing activities	51	(2,755)	(24,630)
Cash flows from financing activities:			
Proceeds from issuance of common stock	379	390	372
Repurchase of stock warrants	(1,545)	—	—
Cash dividends paid on common stock	(6,375)	(6,239)	(5,950)
Other	653	165	—
Net cash flows used in financing activities	(6,888)	(5,684)	(5,578)
Net change in cash	(43)	(3,451)	(22,508)
Cash at beginning of year	534	3,985	26,493
Cash at end of year	$491	534	3,985

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LCNB CORP. AND SUBSIDIARY

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

An evaluation of the effectiveness of LCNB’s internal controls over financial reporting was carried out under the supervision and with the participation of LCNB’s management, including the Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that LCNB’s disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Internal Control Over Financial Reporting

Information required by this item is set forth in the “Report of Management’s Assessment of Internal Control over Financial Reporting” and the “Report of Independent Registered Public Accounting Firm” included in Item 8 of this 2016 Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting

During the fourth quarter 2016, 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.

Item 9B. Other Information

None

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LCNB CORP. AND SUBSIDIARY

PART III

Portions of the Company’s Definitive Proxy Statement (the “Proxy Statement”) included in the Notice of Annual Meeting of Shareholders to be held April 25, 2017, which Proxy Statement will be mailed to shareholders within 120 days from the end of the fiscal year ended December 31, 2016, are incorporated by reference into Part III.
Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item concerning the Executive Officers and Directors of the Registrant is incorporated herein by reference under the caption "Directors and Executive Officers" of the Proxy Statement.

The information required by this item concerning the Audit Committee and Code of Business Conduct and Ethics is incorporated herein by reference under the captions "Board of Directors Meetings and Committees," "Audit Committee Report," and "Code of Ethics" of the Proxy Statement.

The information required by this item concerning Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" of the proxy Statement.

Item 11. Executive Compensation

The information contained in the Proxy Statement under the captions "Board of Directors Meetings and Committees" "Compensation Committee Interlocks and Insider Participation" "Equity Compensation Plan Information," "Compensation of Executive Officers," and "Compensation Committee Report on Executive Compensation" is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information contained in the Proxy Statement under the captions "Market Price of Stock and Dividend Data" and "Voting Securities and Principal Holders" is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information contained in the Proxy Statement under the captions "Election of Directors," "Directors and Executive Officers," "Board of Directors Meetings and Committees," and "Certain Relationships and Related Transactions" is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The information contained in the Proxy Statement under the captions "Independent Registered Accounting Firm" and "Board of Directors Meetings and Committees" is incorporated herein by reference.

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LCNB CORP. AND SUBSIDIARY

PART IV
Item 15. Exhibits, Financial Statement Schedules

(a)1. Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
FINANCIAL STATEMENTS
Consolidated Balance Sheets as of December 31, 2016 and 2015.
Consolidated Statements of Income for the Years Ended December 31, 2016, 2015, and 2014.
Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2016, 2015, and 2014.
Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2016, 2015, and 2014.
Consolidated Statements of Cash Flows for the Years Ended December 31, 2016, 2015, and 2014.
Notes to Consolidated Financial Statements

2. Financial Statement Schedules – None

3. Exhibits required by Item 601 Regulation S-K.

(a) Exhibit No.	Exhibit Description
2.1	Agreement and Plan of Merger dated as of October 9, 2012 by and between LCNB Corp. and First Capital Bancshares, Inc. – incorporated by reference to the Registrant's Form S-4 filed on October 29, 2012, Part I, Annex A.
2.2	Stock Purchase Agreement between LCNB Corp. and Colonial Banc Corp. dated as of October 28, 2013 - incorporated by reference to the Registrant's Current Report on Form 8-K filed on October 28, 2013, Exhibit 2.1.
2.3	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.
10.5	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.
10.7	Form of Restricted Share Grant Agreement under the LCNB Corp. 2015 Ownership Incentive Plan - incorporated by reference to Registrant's 2015 Form 10-K, Exhibit 10.7.
14.1	

	LCNB Corp. Code of Business Conduct and Ethics - incorporated by reference to Registrant's 2003 Form 10-K, Exhibit 14.1.
14.2	LCNB Corp. Code of Ethics for Senior Financial Officers - Incorporated by reference to Registrant's 2003 Form 10-K, Exhibit 14.2.

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LCNB CORP. AND SUBSIDIARY

(a)

Exhibit No.	Exhibit Description
21	LCNB Corp. subsidiary.
23.1	Consent of Independent Registered Public Accounting Firm.
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 Annual Report on Form 10-K for the year ended December 31, 2016 is formatted in Extensible Business Reporting Language: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements, tagged as blocks of text.

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LCNB CORP. AND SUBSIDIARY

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.
(Registrant)

/s/ Steve P. Foster
Steve P. Foster
Chief Executive Officer & President
March 8, 2017

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

/s/ Steve P. Foster
Steve P. Foster
Chief Executive Officer, President, & Director
(Principal Executive Officer)
March 8, 2017

/s/ Robert C. Haines II
Robert C. Haines II
Executive Vice President & Chief Financial Officer (Principal Financial and Accounting Officer)
March 8, 2017

/s/ Stephen P. Wilson
Stephen P. Wilson
Chairman of the Board of Directors
March 8, 2017

/s/ Spencer S. Cropper
Spencer S. Cropper
Director
March 8, 2017

/s/ William H. Kaufman
William H. Kaufman
Director
March 8, 2017

/s/ Anne E. Krehbiel
Anne E. Krehbiel
Director
March 8, 2017

John H. Kochensparger III
Director
March 8, 2017

/s/ Valerie S. Krueckeberg
Valerie S. Krueckeberg
Director
March 8, 2017

/s/ George L. Leasure
George L. Leasure
Director

March 8, 2017

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