QNB CORP
Form 10-K
March 30, 2011

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

Form 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the fiscal year ended December 31, 2010

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from ________________ to ________________ .

Commission file number 0-17706

(Exact name of registrant as specified in its charter)

Pennsylvania	23-2318082
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)
15 North Third Street, Quakertown, PA	18951-9005
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (215) 538-5600

Securities registered pursuant to Section 12(b) of the Act: None.

Name of each exchange on which registered
N/A

Securities registered pursuant to Section 12(g) of the Act:
Title of class
Common Stock, $0.625 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES ¨ NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
YES ¨ NO þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
YES þ NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
YES ¨ NO ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company þ

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES ¨ NO þ

As of February 28, 2011, 3,134,405 shares of common stock of the registrant were outstanding. As of June 30, 2010, the aggregate market value of the common stock of the registrant held by nonaffiliates was approximately $52,929,000 based upon the average bid and asked prices of the common stock as reported on the OTC BB.

DOCUMENTS INCORPORATED BY REFERENCE
Portions of registrant's Proxy Statement for the annual meeting of its shareholders to be held May 24, 2011 are incorporated by reference in Part III of this report.

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PART I

FORWARD-LOOKING STATEMENTS

In addition to historical information, this document contains forward-looking statements. Forward-looking statements are typically identified by words or phrases such as “believe,” “expect,” “anticipate,” “intend,” “estimate,” “project” and varia of such words and similar expressions, or future or conditional verbs such as “will,” “would,” “should,” “could,” “may” similar expressions. The U.S. Private Securities Litigation Reform Act of 1995 provides a safe harbor in regard to the inclusion of forward-looking statements in this document and documents incorporated by reference.

Shareholders should note that many factors, some of which are discussed elsewhere in this document and in the documents that are incorporated by reference, could affect the future financial results of QNB Corp. and its subsidiary and could cause those results to differ materially from those expressed in the forward-looking statements contained or incorporated by reference in this document. These factors include, but are not limited to, the following:

- Volatility in interest rates and shape of the yield curve;
- Credit risk;
- Liquidity risk;
- Operating, legal and regulatory risks;
- Economic, political and competitive forces affecting QNB Corp.’s line of business;
- The risk that the Federal Deposit Insurance Corporation (FDIC) could levy additional insurance assessments on all insured institutions inorder to replenish the Deposit Insurance Fund based on the level of bank failures in the future; and
- The risk that the analysis of these risks and forces could be incorrect, and/or that the strategies developed to address them could be unsuccessful.

QNB Corp. (herein referred to as QNB or the Company) cautions that these forward-looking statements are subject to numerous assumptions, risks and uncertainties, all of which change over time, and QNB assumes no duty to update forward-looking statements. Management cautions readers not to place undue reliance on any forward-looking statements. These statements speak only as of the date of this Annual Report on Form 10-K, even if subsequently made available by QNB on its website or otherwise, and they advise readers that various factors, including those described above, could affect QNB’s financial performance and could cause actual results or circumstances for future periods to differ materially from those anticipated or projected. Except as required by law, QNB does not undertake, and specifically disclaims any obligation, to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

ITEM 1. BUSINESS

Overview

QNB was incorporated under the laws of the Commonwealth of Pennsylvania on June 4, 1984. QNB is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956 and conducts its business through its wholly-owned subsidiary, QNB Bank (the Bank).

Prior to December 28, 2007, the Bank was a national banking association organized in 1877 as Quakertown National Bank and was chartered under the National Banking Act and was subject to Federal and state laws applicable to national banks. Effective December 28, 2007, the Bank became a Pennsylvania chartered commercial bank and changed its name to QNB Bank. The Bank’s principal office is located in Quakertown, Bucks County, Pennsylvania. The Bank also operates eight other full-service community banking offices in Bucks, Montgomery and Lehigh counties in southeastern Pennsylvania.

The Bank is engaged in the general commercial banking business and provides a full range of banking services to its customers. These banking services consist of, among other things, attracting deposits and using these funds in making commercial loans, residential mortgage loans, consumer loans, and purchasing investment securities. These deposits are in the form of time, demand and savings accounts. Time deposits include certificates of deposit and individual retirement accounts. The Bank's demand and savings accounts include money market accounts, interest-bearing demand accounts including a high-yield checking account, club accounts, traditional statement savings accounts, and a high-yield online savings account.

At December 31, 2010, QNB had total assets of $809,260,000, total loans of $482,182,000, total deposits of $694,977,000 and total shareholders' equity of $61,090,000. For the year ended December 31, 2010, QNB reported net income of $7,217,000 compared to net income for the year ended December 31, 2009 of $4,227,000.

At February 28, 2011, the Bank had 148 full-time employees and 24 part-time employees. The Bank's employees have a customer-oriented philosophy, a strong commitment to service and a "sincere interest" in their customers' success. They maintain close contact with both the residents and local business people in the communities in which they serve, responding to changes in market conditions and customer requests in a timely manner.

Competition and Market Area

The banking business is highly competitive, and the profitability of QNB depends principally upon the Bank's ability to compete in its market area. QNB faces intense competition within its market, both in making loans and attracting deposits. The upper Bucks, southern Lehigh, and northern Montgomery counties have a high concentration of financial institutions, including large national and regional banks, community banks, savings institutions and credit unions. Some of QNB's competitors offer products and services that QNB currently does not offer, such as traditional trust services and full-service insurance. In addition, as a result of consolidation in the banking industry, some of QNB's competitors may enjoy advantages such as greater financial resources, a wider geographic presence, more favorable pricing alternatives and lower origination and operating costs. However, QNB has been able to compete effectively with other financial institutions by emphasizing the establishment of long-term relationships and customer loyalty. A strong focus on small-business solutions, providing fast local decision-making on loans, exceptional personal customer service and technology solutions, including internet-banking and electronic bill pay, also enable QNB to compete successfully.

Competition for loans and deposits comes principally from commercial banks, savings institutions, credit unions and non-bank financial service providers. Factors in successfully competing for deposits include providing excellent customer service, convenient locations and hours of operation, attractive rates, low fees, and alternative delivery systems. One such delivery system is a courier service offered to businesses to assist in their daily banking needs without having to leave their workplace. Successful loan origination tends to depend on being responsive and flexible to the customers' needs, as well as the interest rate and terms of the loan. While many competitors within the Bank's primary market have substantially higher legal lending limits, QNB often has the ability, through loan participations, to meet the larger lending needs of its customers.

QNB's success is dependent to a significant degree on economic conditions in southeastern Pennsylvania, especially upper Bucks, southern Lehigh and northern Montgomery counties, which it defines as its primary market. The banking industry is affected by general economic conditions, including the effects of recession, unemployment, declining real estate values, inflation, trends in the national and global economies, and other factors beyond QNB's control.

MONETARY POLICY AND ECONOMIC CONDITIONS

The business of financial institutions is affected not only by general economic conditions, but also by the policies of various governmental regulatory agencies, including the Federal Reserve Board. The Federal Reserve Board regulates money, credit conditions and interest rates to influence general economic conditions primarily through open market operations in U.S. government securities, changes in the discount rate on bank borrowings and changes in the reserve requirements against depository institutions' deposits. These policies and regulations significantly affect the overall growth and distribution of loans, investments and deposits, as well as the interest rates charged on loans and the interest rates paid on deposits.

The monetary policies of the Federal Reserve Board have had a significant effect on the operating results of financial institutions in the past and are expected to continue to have significant effects in the future. In view of the changing conditions in the economy and the financial markets in addition to the activities of monetary and fiscal authorities, the prediction of future changes in interest rates, credit availability or deposit levels is very challenging.

The recession, which economists suggest began in October 2007, became a major force over the past several years in the United States of America (U.S.) and around the world. In the U.S., the Government provided support for financial institutions that requested it in order to strengthen capital, increase liquidity and ease the credit markets. In the U.S., these actions provided capital for some banks and other financial institutions and generally increased regulations and oversight on virtually all banks. QNB has not requested or received any capital provided by the U.S. Government

under these programs.

SUPERVISION AND REGULATION

Banks and bank holding companies operate in a highly regulated environment and are regularly examined by Federal and state regulatory authorities. Federal statutes that apply to QNB and its subsidiary include the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Gramm-Leach-Bliley Act (GLBA), the Bank Holding Company Act of 1956 (BHCA), the Federal Reserve Act and the Federal Deposit Insurance Act (FDIA). In general, these statutes regulate the corporate governance of the Bank and eligible business activities of QNB, certain merger and acquisition restrictions, intercompany transactions, such as loans and dividends, and capital adequacy, among other restrictions. Other corporate governance requirements are imposed on QNB by Federal laws, including the Sarbanes-Oxley Act, described later.

The Company is under the jurisdiction of the Securities and Exchange Commission and of state securities commissions for matters relating to the offering and sale of its securities. In addition, the Company is subject to the Securities and Exchange Commission’s rules and regulations relating to periodic reporting, proxy solicitation and insider trading.

To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by references to the particular statutory or regulatory provisions themselves. Proposals to change banking laws and regulations are frequently introduced in Congress, the state legislatures, and before the various bank regulatory agencies. QNB cannot determine the likelihood of passage or timing of any such proposals or legislation or the impact they may have on QNB and its subsidiary. A change in law, regulations or regulatory policy may have a material effect on QNB and its subsidiary.

Bank Holding Company Regulation

QNB is registered as a bank holding company and is subject to the regulations of the Board of Governors of the Federal Reserve System (the Federal Reserve) under the BHCA. In addition, QNB Corp., as a Pennsylvania business corporation, is also subject to the provisions of Section 115 of the Pennsylvania Banking Code of 1965 and the Pennsylvania Business Corporation Law of 1988, as amended.

Bank holding companies are required to file periodic reports with, and are subject to examination by, the Federal Reserve. The Federal Reserve's regulations require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve, pursuant to its "source of strength" regulations, may require QNB to commit its resources to provide adequate capital funds to the Bank during periods of financial distress or adversity.

Federal Reserve approval may be required before QNB may begin to engage in any non-banking activity and before any non-banking business may be acquired by QNB.

Regulatory Restrictions on Dividends

Dividend payments made by the Bank to the Company are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally retained earnings). The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. Under the FDIA, the Bank is prohibited from paying any dividends, making other distributions or paying any management fees if, after such payment, it would fail to satisfy its minimum capital requirements. The Pennsylvania Banking Code restricts the availability of capital funds for payment of dividends by the Bank generally to its accumulated net earnings. See also "Supervision and Regulation – Bank Regulation".

In addition to the dividend restrictions described above, the banking regulators have the authority to prohibit or to limit the payment of dividends by the Bank if, in the banking regulator's opinion, payment of a dividend would constitute an unsafe or unsound practice in light of the financial condition of the Bank.

Under Pennsylvania law, QNB may not pay a dividend, if, after giving effect thereto, it would be unable to pay its debts as they become due in the usual course of business and, after giving effect to the dividend, the total assets of QNB would be less than the sum of its total liabilities plus the amount that would be needed, if QNB were to be dissolved at the time of distribution, to satisfy the preferential rights upon dissolution of shareholders whose rights are superior to those receiving the dividend.

It is also the policy of the Federal Reserve that a bank holding company generally only pay dividends on common stock out of net income available to common shareholders over the past year and only if the prospective rate of earnings retention appears consistent with a bank holding company's capital needs, asset quality, and overall financial condition. In the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged dividend pay-out ratios at the 100% level unless both asset quality and capital are very strong. A bank holding company also should not maintain a dividend level that places undue pressure on the capital of such institution's subsidiaries, or that may undermine the bank holding company's ability to serve as a source of strength for such subsidiaries.

Under these policies and subject to the restrictions applicable to the Bank, to remain "well-capitalized," the Bank had approximately $6,658,000 available for payment of dividends to the Company at December 31, 2010.

Capital Adequacy

Bank holding companies are required to comply with the Federal Reserve's risk-based capital guidelines. The required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of total capital must be Tier 1 capital. Tier 1 capital consists principally of common shareholders' equity, plus retained earnings, less certain intangible assets. The remainder of total capital may consist of the allowance for loan losses, which is considered Tier 2 capital. At December 31, 2010, QNB's Tier 1 capital and total capital (Tier 1 and Tier 2 combined) ratios were 10.52% and 11.82%, respectively.

In addition to the risk-based capital guidelines, the Federal Reserve requires a bank holding company to maintain a minimum leverage ratio. This requires a minimum level of Tier 1 capital (as determined under the risk-based capital rules) to average total consolidated assets of 4% for those bank holding companies that have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. The Federal Reserve expects all other bank holding companies to maintain a ratio of at least 1% to 2% above the stated minimum. At December 31, 2010, QNB's leverage ratio was 7.42%.

Pursuant to the prompt corrective action provisions of the FDIA, the Federal banking agencies have specified, by regulation, the levels at which an insured institution is considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized. Under these regulations, an institution is considered well capitalized if it satisfies each of the following requirements:

- Total risk-based capital ratio of 10% or more,
- Tier 1 risk-based capital ratio of 6% or more,
- Leverage ratio of 5% or more, and
- Not subject to any order or written directive to meet and maintain a specific capital level

At December 31, 2010, the Bank qualified as well capitalized under these regulatory standards. See Note 19 of the Notes to Consolidated Financial Statements included at Item 8 of this Report.

Bank Regulation

As a Pennsylvania chartered, insured commercial bank, the Bank is subject to extensive regulation and examination by the Pennsylvania Department of Banking (the Department) and by the FDIC, which insures its deposits to the maximum extent permitted by law.

The Federal and state laws and regulations applicable to banks regulate, among other things, the scope of their business, their investments, the reserves required to be kept against deposits, the timing of the availability of deposited funds, the nature and amount of collateral for certain loans, the activities of a bank with respect to mergers and consolidations, and the establishment of branches. The laws and regulations governing the Bank generally have been promulgated to protect depositors and not for the purpose of protecting QNB's shareholders. This regulatory structure also gives the Federal and state banking agencies extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulation, whether by the Department, the FDIC or the United States Congress, could have a material impact on the Company, the Bank and their operations.

As a subsidiary bank of a bank holding company, the Bank is subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to QNB, on investments in the stock or other securities of QNB, and on taking such stock or securities as collateral for loans.

FDIC Insurance Assessments

The Bank's deposits are insured to the applicable limits as determined by the FDIC, which is currently $250,000 per depositor, with the exception of non-interest bearing transaction accounts which have unlimited coverage through December 31, 2013.

The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution's ranking in one of four risk categories based on their examination ratings and capital ratios. Well-capitalized institutions with the CAMELS ratings of 1 or 2 are grouped in Risk Category I. Deposit insurance premiums are billed quarterly and in arrears. For the quarter beginning January 1, 2009, the FDIC raised the base annual assessment rate for institutions in Risk Category I to between 12 and 14 basis points while the base annual assessment rates for institutions in Risk Categories II, III and IV were increased to 17, 35 and 50 basis points, respectively. For the quarter beginning April 1, 2009 the FDIC set the base annual assessment rate for institutions in Risk Category I to between 12 and 16 basis points and the base annual assessment rates for institutions in Risk Categories II, III and IV at 22, 32 and 45 basis points, respectively. An institution's assessment rate could be adjusted for several factors: ratio of its long-term unsecured debt to deposits, ratio of certain amounts of Tier 1 capital to adjusted assets, high levels of brokered deposits, high levels of asset growth (other than through acquisitions) and a ratio of brokered deposits to deposits in excess of 10%. An institution's base assessment rate would also be increased if

an institution's ratio of secured liabilities (including FHLB advances and repurchase agreements) to deposits exceeds 25%.

On May 22, 2009, the FDIC Board of Directors took further action to strengthen the DIF by adopting a final rule imposing a special assessment on insured institutions of 5 basis points on June 30, 2009 (payable at the end of September 2009). The amount of this special assessment for QNB was $332,000. On September 29, 2009, the FDIC adopted an Amended Restoration Plan to allow the DIF to return to a reserve ratio of 1.15% within eight years as mandated by statute, and simultaneously adopted higher annual risk-based assessment rates effective January 1, 2011. In 2009, the DIF's liquid assets have been used to protect depositors of failed institutions. Because of bank failures and projected bank failures, the FDIC determined that it needed more liquidity to protect depositors. Pursuant to this Amended Plan, the FDIC amended its assessment regulations to require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, as estimated by the FDIC. The assessment paid by the Bank at that time was $3,407,000, of which $2,219,000 remains in a prepaid asset account at December 31, 2010. It will be expensed monthly during the years of 2011 through 2012 based on actual FDIC assessment rate calculations.

Beginning with the second quarter of 2011, as mandated by the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the assessment base that the FDIC will use to calculate assessment premiums will be a bank's average assets minus average tangible equity. As the asset base of the banking industry is larger than the deposit base, the range of assessment rates will change to a low of 2.5 basis points to a high of 45 basis points, per $100 of assets; however, the dollar amount of the actual premiums is expected to be roughly the same.

The FDIC is required under the Dodd-Frank Act to establish assessment rates that will allow the Deposit Insurance Fund to achieve a reserve ratio of 1.35% of Insurance Fund insured deposits by September 2020. In addition, the FDIC has established a "designated reserve ratio" of 2.0%, a target ratio that, until it is achieved, will not likely result in the FDIC reducing assessment rates. In attempting to achieve the mandated 1.35% ratio, the FDIC is required to implement assessment formulas that charge banks over $10 billion in asset size more than banks under that size. Those new formulas begin in the second quarter of 2011, but do not affect the Bank. Under the Dodd-Frank Act, the FDIC is authorized to make reimbursements from the insurance fund to banks if the reserve ratio exceeds 1.50%, but the FDIC has adopted the "designated reserve ratio" of 2.0% and has announced that any reimbursements from the fund are indefinitely suspended.

For the years ended December 31, 2010 and 2009, the Bank recorded $974,000 and $1,151,000, respectively, in FDIC deposit insurance premium expense.

In addition, all insured institutions of the FDIC are required to pay assessments to fund interest payments on Financing Corporation (FICO) bonds. The Financing Corporation was created by Congress to issue bonds to finance the resolution of failed thrift institutions. Prior to 1997, only thrift institutions were subject to assessments to raise funds to pay the FICO bonds; however, beginning in 2000, commercial banks and thrifts are subject to the same assessment for FICO bonds. The FDIC has the authority to set the Financing Corporation assessment rate every quarter. The expense for 2010 and 2009 recorded by QNB was $67,000 and $60,000, respectively. These assessments will continue until the Financing Corporation bonds mature in 2017.

FDIC Temporary Liquidity Guarantee Program

On October 13, 2008, the FDIC established a Temporary Liquidity Guarantee Program under which the FDIC will fully guarantee all non-interest bearing transaction accounts until December 31, 2009 (the "Transaction Account Guarantee Program") and certain senior unsecured debt of insured depository institutions or their qualified holding companies issued between October 14, 2008 and June 30, 2009 (the "Debt Guarantee Program"). After being extended, the Transaction Account Guarantee Program expired on December 31, 2010. In March 2009, the FDIC extended the Debt Program until October 31, 2009. Further, for any senior debt issued on or after April 1, 2009, the Debt Program will extend the FDIC guarantee until December 31, 2012. The FDIC also adopted new surcharges on debt issued under the Debt Program that have a maturity of one year or more and are issued on or after April 1, 2009. These surcharges will be deposited in the DIF.

All eligible institutions participated in the program without cost for the first 30 days of the program. After November 12, 2008, institutions were assessed at the rate of 10 basis points for transaction account balances in excess of $250,000 and at the rate of between 50 and 100 basis points of the amount of debt issued. Beginning in January 2010, institutions that did not opt out of the Transaction Account Guarantee Program paid an increased assessment rate of 15 basis points for transaction account balances in excess of $250,000. QNB continued to participate in the Transaction Account Guarantee Program, but opted out of participation in the Debt Guarantee Program. Although the Transaction Account Guarantee Program was originally scheduled to expire on December 31, 2009, the FDIC implemented a final rule, effective as of October 1, 2009, extending the Transaction Account Guarantee Program by six months until June 30, 2010 (subject to the option of participating institutions to opt out of such six-month extension). QNB did not choose to opt out of the six-month extension. On April 19, 2010, the FDIC further extended the Transaction Account Guarantee Program through December 31, 2010. QNB continued to participate in the program throughout 2010. Included in the FDIC insurance premium expense noted above are premiums related to this program of $10,000 for 2010 and $7,000 for 2009.

Federal Home Loan Bank System

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB), which is one of 12 regional Federal Home Loan Banks. Each Federal Home Loan Bank serves as a reserve or central bank for members within its assigned

region. It is funded primarily from funds deposited by member institutions and proceeds from the sale of consolidated obligations of the Federal Home Loan Bank System. It makes loans to members (i.e. advances) in accordance with policies and procedures established by the board of directors of the Federal Home Loan Bank. At December 31, 2010, the Bank had no FHLB advances outstanding.

As a member, the Bank is required to purchase and maintain stock in the FHLB in an amount equal to the greater of 1% of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year or 5% of its outstanding advances from the FHLB. On October 28, 2010 the FHLB announced their decision to have a limited excess capital stock repurchase. QNB received $115,000 on October 29, 2010. Further repurchases will be evaluated quarterly by the FHLB. At December 31, 2010, the Bank had $2,164,000 in stock of the FHLB which was well in excess of the amount needed to be in compliance with this requirement.

In December 2008, the FHLB notified member banks that it was suspending dividend payments and the repurchase of capital stock to preserve capital. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the FHLB restricted stock as of December 31, 2010.

Emergency Economic Stabilization Act of 2008

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law. EESA, among other measures, authorizes the U.S. Treasury to purchase from financial institutions and their holding companies up to $700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies, under a troubled asset relief program, or "TARP." The purpose of TARP is to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. Under the TARP Capital Purchase Program, the U.S. Treasury purchased equity securities from participating institutions. EESA also temporarily increased federal deposit insurance on most deposit accounts from $100,000 to $250,000. This temporary increase was scheduled to expire on December 31, 2013; however, has been extended indefinitely due to the passage of the Dodd-Frank Act.

Community Reinvestment Act

Under the Community Reinvestment Act (CRA), as amended, the FDIC is required to assess all financial institutions that it regulates to determine whether these institutions are meeting the credit needs of the communities that they serve. The act focuses specifically on low and moderate income neighborhoods. An institution's record is considered during the evaluation of any application made by such institutions for, among other things:

- Approval of a branch or other deposit facility;
- An office relocation or a merger; and
- Any acquisition of bank shares.

The CRA, as amended, also requires that the regulatory agency make publicly available the evaluation of the Bank's record of meeting the credit needs of its entire community, including low and moderate income neighborhoods. This evaluation includes a descriptive rating of either outstanding, satisfactory, needs to improve, or substantial noncompliance, and a statement describing the basis for the rating. The Bank's most recent CRA rating was satisfactory.

USA Patriot Act

The USA Patriot Act strengthens the anti-money laundering provisions of the Bank Secrecy Act. The Act requires financial institutions to establish certain procedures to be able to identify and verify the identity of its customers. Specifically the Bank must have procedures in place to:

- Verify the identity of persons applying to open an account;
- Ensure adequate maintenance of the records used to verify a person's identity; and
- Determine whether a person is on any U.S. government agency list of known or suspected terrorists or a terrorist organization.

Check 21

In October 2003, the Check Clearing for the 21st Century Act, also known as Check 21, became law. Check 21 gives "substitute checks," such as a digital image of a check and copies made from that image, the same legal standing as the original paper check. Some major provisions of Check 21 include:

- Allowing check truncation without making it mandatory;
- Demanding that every financial institution communicate to account holders in writing a description of its substitute check processing program and their rights under the law;
- Legalizing substitutions for and replacements of paper checks without agreement from consumers;
- Retaining in place the previously mandated electronic collection and return of checks between financial institutions only when individual agreements are in place;
- Requiring that when account holders request verification, financial institutions produce the original check (or a copy that accurately represents the original) and demonstrate that the account debit was accurate and valid; and
-

Requiring recrediting of funds to an individual’s account on the next business day after a consumer proves the financial institution has erred.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act is intended to bolster public confidence in the nation’s capital markets by imposing new duties and penalties for non-compliance on public companies and their executives, directors, auditors, attorneys and securities analysts. Some of the more significant aspects of the Act include:

- Corporate Responsibility for Financial Reports - requires Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) to certify certain matters relating to a company’s financial records and accounting and internal controls.
- Management Assessment of Internal Controls - requires auditors to certify the company’s underlying controls and processes that are used to compile the financial results for companies that are accelerated filers.
- Real-time Issuer Disclosures - requires that companies provide real-time disclosures of any events that may affect its stock price or financial performance, generally within a 48-hour period.
- Criminal Penalties for Altering Documents - provides severe penalties for “whoever knowingly alters, destroys, mutilates” any record or document with intent to impede an investigation. Penalties include monetary fines and prison time.

The Act also imposes requirements for corporate governance, auditor independence, accounting standards, audit committee member independence and increased authority, executive compensation, insider loans and whistleblower protection. As a result of the Act, QNB adopted a Code of Business Conduct and Ethics applicable to its CEO, CFO and Controller, which meets the requirements of the Act, to supplement its long-standing Code of Ethics, which applies to all directors and employees.

QNB's Code of Business Conduct and Ethics can be found on the Bank's website at www.qnb.com.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)
The Dodd-Frank Act was enacted on July 21, 2010. This new law will significantly change the current bank regulatory structure and affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies.

The Dodd-Frank Act requires various Federal agencies to adopt a broad range of new rules and regulations, and to prepare various studies and reports for Congress. The Federal agencies are given significant discretion in drafting such rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for some time.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on the Company. For example, effective July 21, 2011, a provision of the Dodd-Frank Act eliminates the Federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on the Company's interest expense.

The Dodd-Frank Act also broadens the base for Federal Deposit Insurance Corporation insurance assessments. Under the Act, the assessment base will no longer be an institution's deposit base, but rather its average consolidated total assets less its average tangible equity during the assessment period. The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2013.

Bank and thrift holding companies with assets of less than $15 billion as of December 31, 2009, such as the Company, will be permitted to include trust preferred securities that were issued before May 19, 2010, as Tier 1 capital; however, trust preferred securities issued by a bank or thrift holding company (other than those with assets of less than $500 million) after May 19, 2010, will no longer count as Tier 1 capital. Trust preferred securities still will be entitled to be treated as Tier 2 capital.

The Dodd-Frank Act will require publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" arrangements, and may allow greater access by shareholders to the company's proxy material by authorizing the SEC to promulgate rules that would allow stockholders to nominate their own candidates using a company's proxy materials. The legislation also directs the Federal Reserve Board to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.

The Dodd-Frank Act creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets such as the Bank will continue to be examined for compliance with the consumer laws by their primary bank regulators. The Dodd-Frank Act also weakens the Federal preemption rules that have been applicable for national banks and Federal savings associations, and gives state attorneys general the ability to enforce Federal consumer protection laws.

At this time it is difficult to predict the specific impact the Dodd-Frank Act and the yet-to-be written implementing rules and regulations will have on community banks at this time. Given the uncertainty associated with the manner in

which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on financial institutions' operations is presently unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Possible Future Legislation

Congress is often considering some financial industry legislation, and the Federal banking agencies routinely propose new regulations. The Company cannot predict the future effect any new legislation, or new rules adopted by Federal or state banking agencies will have on the business of the Company and its subsidiaries. Given that the financial industry remains under stress and severe scrutiny, and given that the U.S. economy has not yet fully recovered to pre-crisis levels of activity, the Company expects that there will be significant legislation and regulatory actions that may materially effect the banking industry for the foreseeable future.

Additional Information
QNB's principal executive offices are located at 320 West Broad Street, Quakertown, Pennsylvania. Its telephone number is (215) 538-5600.

This annual report, including the exhibits and schedules filed as part of the annual report on Form 10-K, may be inspected at the public reference facility maintained by the Securities and Exchange Commission (SEC) at its public reference room at 100 F Street, NE, Washington, DC 20549 and copies of all, or any part thereof, may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room, and you can request copies of the documents upon payment of a duplicating fee by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including QNB, that file electronically with the SEC which can be accessed at www.sec.gov.

QNB also makes its periodic and current reports available, free of charge, on its website, www.qnb.com, as soon as reasonably practicable after such material is electronically filed with the SEC. Information available on the website is not a part of, and should not be incorporated into, this annual report on Form 10-K.

ITEM 1A. RISK FACTORS

The following discusses risks that management believes are specific to our business and could have a negative impact on QNB's financial performance. When analyzing an investment in QNB, the risks and uncertainties described below, together with all of the other information included or incorporated by reference in this report, should be carefully considered. This list should not be viewed as comprehensive and may not include all risks that may affect the financial performance of QNB.

Economic and Market Risk

As discussed in the section "Supervision and Regulation," the Board of Governors of the Federal Reserve System, the U.S. Congress, the U.S. Treasury, the FDIC, the SEC and others have taken numerous actions to address the liquidity and credit crisis that has followed the subprime mortgage meltdown that commenced in 2007. These measures include homeowner relief that encourage loan restructuring and modification; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the Federal funds rate; significant purchases of longer-term Treasury securities; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector.

The purpose of these legislative and regulatory actions is to stabilize the U.S. banking system. EESA and the other regulatory initiatives described above may not have their desired effects. If the volatility in the markets continues and economic conditions fail to improve or worsen, our business, financial condition, results of operations and cash flows could be materially and adversely affected.

Dramatic declines in the U.S. housing market over the past several years, with decreasing home prices and increasing delinquencies and foreclosures, may have a negative impact on the credit performance of mortgage, consumer, commercial and construction loan portfolios resulting in significant write-downs of assets by many financial institutions. In addition, the values of real estate collateral supporting many loans have declined and may continue to decline. General downward economic trends, reduced availability of commercial credit and increasing unemployment may negatively impact the credit performance of commercial and consumer credit, resulting in additional write-downs.

Concerns over the stability of the financial markets and the economy have resulted in decreased lending by some financial institutions to their customers and to each other. This market turmoil and tightening of credit has led to increased commercial and consumer deficiencies, lack of customer confidence, increased market volatility and widespread reduction in general business activity. The resulting economic pressure on consumers and businesses and the lack of confidence in the financial markets may adversely affect our business, financial condition, results of operations and stock price. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the industry. In particular, we may face the following risks in connection with these events:

- We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs and limit our ability to pursue business opportunities.
- Our ability to assess the creditworthiness of customers and to estimate the losses inherent in our credit exposure is made more complex by these difficult market and economic conditions.
- We also may be required to pay higher FDIC premiums because financial institution failures resulting from the depressed market conditions have depleted and may continue to deplete the deposit insurance fund and reduce its ratio of reserves to insured deposits.
- Our ability to borrow from other financial institutions or the FHLB could be adversely affected by disruptions in the capital markets or other events.
- We may experience increases in foreclosures, delinquencies and customer bankruptcies.

Interest Rate Risk

QNB's profitability is largely a function of the spread between the interest rates earned on earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Like most financial institutions, QNB's net interest income and margin will be affected by general economic conditions and other factors, including fiscal and monetary policies of the Federal government, that influence market interest rates and QNB's ability to respond to changes in such rates. At any given time, QNB's assets and liabilities may be such that they are affected differently by a change in interest rates. As a result, an increase or decrease in rates, the length of loan terms or the mix of adjustable- and fixed-rate loans or investment securities in QNB's portfolio could have a positive or negative effect on its net income, capital and liquidity. Although management believes it has implemented strategies and guidelines to reduce the potential effects of adverse changes in interest rates on results of operations, any substantial and prolonged change in market interest rates could affect operating results negatively.

The yield curve for the various maturities of U.S. Treasury securities provides a fundamental barometer that gauges the prevailing interest rate profile and, simultaneously, acts as a guidepost for current loan and deposit pricing constraints. The slope of the yield curve is driven primarily by expectations for future interest rate increases and inflationary trends. A normal yield curve has a slope that reflects lower costs for shorter-term financial instruments, accompanied by increases in costs for longer term instruments all along the maturity continuum.

Short-term interest rates are highly influenced by the monetary policy of the Federal Reserve. The Federal Open Market Committee, a committee of the Federal Reserve, targets the Federal funds rate, the overnight rate at which banks borrow or lend excess funds between financial institutions. This rate serves as a benchmark for the overnight money costs, and correspondingly influences the pricing of a significant portion of a bank's deposit funding sources. Intermediate and longer-term interest rates, unlike the Federal funds rate, are more directly influenced by external market forces, including perceptions about future interest rates and inflation. These trends, in turn, influence the pricing on mid- and long-term loan commitments as well as deposits and bank borrowings that have scheduled maturities.

Generally speaking, a yield curve with a higher degree of slope provides more opportunity to increase the spread between earning asset yields and funding costs. It should be emphasized that while the yield curve is a critical benchmark in setting prices for various monetary assets and liabilities in banks, its influence is not exerted in a vacuum. Credit risk, market risk, competitive issues, and other factors must all be considered in the pricing of financial instruments.

A steep or highly-sloped yield curve may be a precursor of higher interest rates or elevated inflation in the future, while a flat yield curve may be characteristic of a Federal Reserve policy designed to calm an overheated economy by tightening credit availability via increases in short-term rates. If other rates along the maturity spectrum do not rise correspondingly, the yield curve can be expected to flatten. This scenario may reflect an economic outlook that has little or no expectation of higher future interest rates or higher rates of inflation. For banks, the presence of a flat yield curve for a prolonged or sustained period could measurably lower expectations for expanding the net interest margin.

An inverted yield curve is the opposite of a normal yield curve and is characterized by short-term rates that are higher than longer-term rates. The presence of an inverted yield curve is considered to be an anomaly that is almost counterintuitive to the core business of banking. Inverted yield curves do not typically exist for more than a short period of time. In past economic cycles, the presence of an inverted yield curve has frequently foreshadowed a recession. The recent recession may suppress future asset growth trends and/or increase the influence of other forms of risk, such as credit risk, which could hamper opportunities for revenue expansion and earnings growth in the near term.

Credit Risk

As a lender, QNB is exposed to the risk that its borrowers may be unable to repay their loans and that the current market value of any collateral securing the payment of their loans may not be sufficient to assure repayment in full. Credit losses are inherent in the lending business and could have a material adverse effect on the operating results of QNB. Adverse changes in the economy or business conditions, either nationally or in QNB's market areas, could increase credit-related losses and expenses and/or limit growth. Substantially all of QNB's loans are to businesses and individuals in its limited geographic area and any economic decline in this market could impact QNB adversely. QNB makes various assumptions and judgments about the collectability of its loan portfolio and provides an allowance for loan losses based on a number of factors. If these assumptions are incorrect, the allowance for loan losses may not be sufficient to cover losses and may cause QNB to increase the allowance in the future by increasing the provision for loan losses, thereby having an adverse effect on operating results. QNB has adopted underwriting and credit monitoring procedures and credit policies that management believes are appropriate to control these risks; however, such policies and procedures may not prevent unexpected losses that could have a material adverse effect on QNB's financial condition or results of operations.

Competition

The financial services industry is highly competitive with competition for attracting and retaining deposits and making loans coming from other banks and savings institutions, credit unions, mutual fund companies, insurance companies and other non-bank businesses. Many of QNB's competitors are much larger in terms of total assets and market capitalization, have a higher lending limit, have greater access to capital and funding, and offer a broader array of financial products and services. In light of this, QNB's ability to continue to compete effectively is dependent upon its ability to maintain and build relationships by delivering top quality service.

At December 31, 2010, our lending limit per borrower was approximately $9,720,000. Accordingly, the size of loans that we may offer to potential borrowers (without participation by other lenders) is less than the size of loans that many of our competitors with larger capitalization are able to offer. Our legal lending limit also impacts the efficiency of our lending operation because it tends to lower our average loan size, which means we have to generate a higher number of transactions to achieve the same portfolio volume. We may engage in loan participations with other banks for loans in excess of our legal lending limit. However, there can be no assurance that such participations will be available or on terms which are favorable to us and our customers.

Impairment Risk

QNB purchases U.S. Government and U.S. Government agency debt securities, U.S. Government agency issued mortgage-backed securities or collateralized mortgage obligation securities, corporate debt securities and equity securities. QNB is exposed to the risk that the issuers of these securities may experience significant deterioration in credit quality which could impact the market value of the issue. QNB periodically evaluates its investments to determine if market value declines are other-than-temporary. Once a decline is determined to be other-than-temporary, the value of the security is reduced and a corresponding charge to earnings is recognized for the credit related portion of the impairment.

The Bank holds eight pooled trust preferred securities with an amortized cost of $3,640,000 and a fair value as of December 31, 2010 of $1,866,000. All of the trust preferred securities are available-for-sale securities and are carried at fair value. Currently, the market for these securities is not active and markets for similar securities also are not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which pooled trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. There are currently very few market participants who are willing and or able to transact for these securities. The market values for these securities are very depressed relative to historical levels. These securities are comprised mainly of securities issued by banks, and to a lesser degree, insurance companies. The Bank owns the mezzanine tranches of these securities.

On a quarterly basis, we evaluate our debt securities for other-than-temporary impairment (OTTI), which involves the use of a third-party valuation firm to assist management with the valuation. When evaluating these investments a credit related portion and a non-credit related portion of OTTI are determined. All of the pooled trust preferred collateralized debt obligations held by QNB are rated lower than AA and are measured for OTTI within the scope of The FASB Accounting Standards Codification (ASC) 325 (formerly known as EITF 99-20-1). QNB performs a discounted cash flow analysis on all of its impaired debt securities to determine if the amortized cost basis of an impaired security will be recovered. In determining whether a credit loss exists, QNB uses its best estimate of the present value of cash flows expected to be collected from the debt security and discounts them at the effective yield implicit in the security at the date of acquisition or the prospective yield for those securities with prior OTTI charges. The discounted cash flow analysis is considered to be the primary evidence when determining whether credit related other-than-temporary impairment exists. The credit related portion is recognized in earnings and represents the expected shortfall in future cash flows. The non-credit related portion is recognized in other comprehensive income and represents the difference between the fair value of the security and the amount of credit related impairment. During 2010 and 2009, charges representing credit impairment were recognized on our investment in pooled trust preferred collateralized debt obligations of $277,000 and $1,002,000, respectively.

The Company’s investment in marketable equity securities primarily consists of investments in large cap stock companies. These equity securities are analyzed for impairment on an ongoing basis. As a result of declines in some equity values, $33,000 and $521,000 of other-than-temporary impairment charges were taken in 2010 and 2009, respectively. QNB had five equity securities with unrealized losses of $43,000 at December 31, 2010. The severity and duration of the impairment is consistent with current stock market developments. Management believes these equity securities in an unrealized loss position will recover in the foreseeable future. QNB evaluated the near-term

prospects of the issuers in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold those securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider these equity securities to be other-than-temporarily impaired.

The Bank is a member of the FHLB and is required to purchase and maintain stock in the FHLB in an amount equal to the greater of 1% of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year or 5% of its outstanding advances from the FHLB. At December 31, 2010, the Bank had $2,164,000 in stock of the FHLB which was in compliance with this requirement. These equity securities are restricted in that they can only be sold back to the respective institutions or another member institution at par. Therefore, they are less liquid than other tradable equity securities, their fair value is equal to amortized cost, and no impairment write-downs have been recorded on these securities.

Third-Party Risk

Third parties provide key components of the business infrastructure such as Internet connections and network access. Any disruption in Internet, network access or other voice or data communication services provided by these third parties or any failure of these third parties to handle current or higher volumes of use could affect adversely the ability to deliver products and services to clients and otherwise to conduct business. Technological or financial difficulties of a third-party service provider could affect adversely the business to the extent those difficulties result in the interruption or discontinuation of services provided by that party.

Technology Risk

The market for financial services is increasingly affected by advances in technology, including developments in telecommunications, data processing, computers, automation, Internet-based banking and mobile banking. Our ability to compete successfully in our markets may depend on the extent to which we are able to exploit such technological changes. However, we can provide no assurance that we will be able to properly or timely anticipate or implement such technologies or properly train our staff to use such technologies. Any failure to adapt to new technologies could adversely affect our business, financial condition or operating results.

Changes in accounting standards

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time the Financial Accounting Standards Board (FASB) changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in our restating prior period financial statements. Management believes the current financial statements are prepared in accordance with U.S. generally accepted accounting principles.

Government Regulation and Supervision

The banking industry is heavily regulated under both Federal and state law. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors, by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, expansion of branch offices and the offering of securities. QNB is also subject to capitalization guidelines established by Federal law and could be subject to enforcement actions to the extent that its subsidiary bank is found, by regulatory examiners, to be undercapitalized. It is difficult to predict what changes, if any, will be made to existing Federal and state legislation and regulations or the effect that such changes may have on QNB's future business and earnings prospects.

In response to the financial crisis that commenced in 2008, Congress has taken actions that are intended to strengthen confidence and encourage liquidity in financial institutions, and the FDIC has taken actions to increase insurance coverage on deposit accounts. The recently enacted Dodd-Frank Act provides for the creation of a consumer protection division at the Board of Governors of the Federal Reserve System that will have broad authority to issue regulations governing the services and products we provide consumers. This additional regulation could increase our compliance costs and otherwise adversely impact our operations. That legislation also contains provisions that, over time, could result in higher regulatory capital requirements and loan loss provisions for the Bank, and may increase interest expense due to the ability in July 2011 to pay interest on all demand deposits. In addition, there have been proposals made by members of Congress and others that would reduce the amount delinquent borrowers are otherwise contractually obligated to pay under their mortgage loans and limit an institution's ability to foreclose on mortgage collateral. These proposals could result in credit losses or increased expense in pursuing our remedies as a creditor. Recent regulatory changes impose limits on our ability to charge overdraft fees, which may decrease our non-interest income as compared to recent prior periods.

The potential exists for additional Federal or state laws and regulations, or changes in policy, affecting many aspects of our operations, including capital levels, lending and funding practices, and liquidity standards. New laws and regulations may increase our costs of regulatory compliance and of doing business and otherwise affect our operations, and may significantly affect the markets in which we do business, the markets for and value of our loans and investments, the fees we can charge and our ongoing operations, costs and profitability.

FDIC Insurance Premiums

Since 2008, higher levels of bank failures have dramatically increased the claims against the deposit insurance fund. In addition, the FDIC instituted two temporary programs to further insure customer deposits at FDIC insured banks:

deposit accounts are now insured up to $250,000 per customer (up from $100,000) and noninterest-bearing transactional accounts are fully insured (unlimited coverage). These programs have placed additional stress on the deposit insurance fund. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, the FDIC has increased assessment rates of insured institutions. In addition, on November 12, 2009, the FDIC adopted a rule requiring banks to prepay three years of estimated deposit insurance premiums. The Company is generally unable to control the amount of premiums that the Bank is required to pay for FDIC insurance. If there are additional bank failures, or the cost of resolving prior failures exceeds expectations, the Bank may be required to pay even higher FDIC premiums than the recently increased levels. These announced increases and any future increases or required prepayments of FDIC insurance premiums may adversely impact the Company's earnings and financial condition.

Internal Controls and Procedures

Management diligently reviews and updates its internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Our disclosure controls and procedures are designed to reasonably assure that information required to be disclosed by QNB in reports filed or submitted under the Exchange Act is accumulated and communicated to management, and recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Management believes that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Any undetected circumvention of these controls could have a material adverse impact on QNB's financial condition and results of operations.

These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by an unauthorized override of the controls. Accordingly, because of the inherent limitations in our control system, misstatements due to error or fraud may occur and not be detected.

Attracting and Retaining Skilled Personnel

Our success depends upon the ability to attract and retain highly motivated, well-qualified personnel. We face significant competition in the recruitment of qualified employees. Our ability to execute our business strategy and provide high quality service may suffer if we are unable to recruit or retain a sufficient number of qualified employees or if the costs of employee compensation or benefits increase substantially. QNB currently has employment agreements and change of control agreements with three of its senior officers.

ITEM 1B. UNRESOLVED STAFF COMMENTS

As a "smaller reporting company" as defined in Item 10 of Regulation S-K, the Company is not required to respond to this item.

ITEM 2. PROPERTIES

QNB Bank and QNB Corp.'s principal office is located at 15 North Third Street, Quakertown, Pennsylvania. QNB Bank conducts business from its principal office and eight other retail offices located in upper Bucks, southern Lehigh, and northern Montgomery counties in Pennsylvania. QNB Bank owns its principal office, two retail locations, its operations facility and a computer facility. QNB Bank leases its remaining six retail properties. The leases on the properties generally contain renewal options. In management's opinion, these properties are in good condition and are currently adequate for QNB's purposes.

The following table details QNB Bank's properties:

Location			
Quakertown, PA	-	Downtown Office 15 North Third Street	Owned
Quakertown, PA	-	Towne Bank Center 320-322 West Broad Street	Owned
Quakertown, PA	-	Computer Center 121 West Broad Street	Owned
Quakertown, PA	-	Country Square Office 240 South West End Boulevard	Leased
Quakertown, PA	-	Quakertown Commons Branch 901 South West End Boulevard	Leased
Dublin, PA	-	Dublin Branch 161 North Main Street	Leased
Pennsburg, PA	-	Pennsburg Square Branch 410-420 Pottstown Avenue	Leased
Coopersburg, PA	-	Coopersburg Branch 51 South Third Street	Owned
Perkasie, PA	-	Perkasie Branch 607 Chestnut Street	Owned
Souderton, PA	-	Souderton Branch 750 Route 113	Leased
Wescosville, PA	-	Wescosville Branch 950 Mill Creek Road	Leased

ITEM 3. LEGAL PROCEEDINGS

Although there is currently no material proceedings to which QNB is the subject, future litigation that arises during the normal course of QNB's business could be material and have a negative impact on QNB's earnings. Future litigation also could adversely impact the reputation of QNB in the communities that it serves.

ITEM 4. [REMOVED AND RESERVED]

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Stock Information
QNB common stock is quoted on the over-the-counter bulletin board (OTCBB). QNB had approximately 1,350 shareholders of record as of February 28, 2011.

The following table sets forth the high and low bid and ask stock prices for QNB common stock on a quarterly basis during 2010 and 2009. These prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	High		Low		Cash Dividend
	Bid	Ask	Bid	Ask	Per Share
2010					
First Quarter	$ 18.90	$ 19.03	$ 16.75	$ 17.05	$ 0.24
Second Quarter	20.55	21.20	17.80	19.00	0.24
Third Quarter	20.50	21.30	19.35	19.70	0.24
Fourth Quarter	21.00	22.00	19.60	20.00	0.24
2009					
First Quarter	$ 18.00	$ 20.00	$ 15.55	$ 16.00	$ 0.24
Second Quarter	18.40	19.30	16.25	16.85	0.24
Third Quarter	17.06	18.25	16.05	16.15	0.24
Fourth Quarter	18.00	18.90	16.20	16.50	0.24

QNB has traditionally paid quarterly cash dividends on the last Friday of each quarter. The Company expects to continue the practice of paying quarterly cash dividends to its shareholders; however, future dividends are dependent upon future earnings, financial condition, appropriate legal restrictions, and other factors relevant at the time the board of directors considers declaring a dividend. Certain laws restrict the amount of dividends that may be paid to shareholders in any given year. See "Capital Adequacy" section of this Form 10-K filing, and Note 19 of the Notes to Consolidated Financial Statements of this Form 10-K filing, for the information that discusses and quantifies this regulatory restriction.

The following table provides information on repurchases by QNB of its common stock in each month of the quarter ended December 31, 2010.

	Total Number of Shares	Average Price Paid	Total Number of Shares Purchased as Part of Publicly Announced	Maximum Number of Shares that may yet be Purchased

Period	Purchased	per Share	Plan	Under the Plan
October 1, 2010 through October 31, 2010	–	N/A	–	42,117
November 1, 2010 through November 30, 2010	–	N/A	–	42,117
December 1, 2010 through December 31, 2010	–	N/A	–	42,117

(1) Transactions are reported as of settlement dates.

(2) QNB’s current stock repurchase plan was approved by its Board of Directors and announced on January 24, 2008 and subsequently increased on February 9, 2009.

(3) The number of shares approved for repurchase under QNB’s current stock repurchase plan is 100,000 as of the filing of this Form 10-K.

(4) QNB’s current stock repurchase plan has no expiration date.

(5) QNB has no stock repurchase plan that it has determined to terminate or under which it does not intend to make further purchases.

Stock Performance Graph

Set forth below is a performance graph comparing the yearly cumulative total shareholder return on QNB's common stock with:

- the yearly cumulative total shareholder return on stocks included in the NASDAQ Market Index, a broad market index;
- the yearly cumulative total shareholder return on the SNL $500M to $1B Bank Index, a group encompassing publicly traded banking companies trading on the NYSE, AMEX, or NASDAQ with assets between $500 million and $1 billion;
- the yearly cumulative total shareholder return on the SNL Mid-Atlantic Bank Index, a group encompassing publicly traded banking companies trading on the NYSE, AMEX, or NASDAQ headquartered in Delaware, District of Columbia, Maryland, New Jersey, New York, Pennsylvania, and Puerto Rico.

All of these cumulative total returns are computed assuming the reinvestment of dividends at the frequency with which dividends were paid during the applicable years.

QNB Corp.

	Period Ending					
Index	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
QNB Corp.	100.00	97.49	97.16	72.84	74.77	92.39
NASDAQ Composite	100.00	110.39	122.15	73.32	106.57	125.91
SNL $500M-$1B Bank Index	100.00	113.73	91.14	58.40	55.62	60.72
SNL Mid-Atlantic Bank Index	100.00	120.02	90.76	50.00	52.63	61.40

Source : SNL Financial LC, Charlottesville, VA

ITEM 6. SELECTED FINANCIAL DATA (in thousands, except share and per share data)

Year Ended December 31,	2010	2009	2008	2007	2006
Income and Expense					
Interest income	$ 36,183	$ 35,368	$ 35,285	$ 35,305	$ 32,002
Interest expense	10,270	13,667	15,319	17,738	15,906
Net interest income	25,913	21,701	19,966	17,567	16,096
Provision for loan losses	3,800	4,150	1,325	700	345
Non-interest income	4,339	3,885	3,300	907	3,937
Non-interest expense	17,401	16,586	14,628	14,441	13,234
Income before income taxes	9,051	4,850	7,313	3,333	6,454
Provision for income taxes	1,834	623	1,560	286	1,034
Net income	$ 7,217	$ 4,227	$ 5,753	$ 3,047	$ 5,420
Share and Per Share Data					
Net income - basic	$ 2.32	$ 1.37	$ 1.83	$ 0.97	$ 1.73
Net income - diluted	2.32	1.36	1.82	0.96	1.71
Book value	19.52	18.24	17.21	16.99	16.11
Cash dividends	0.96	0.96	0.92	0.88	0.84
Average common shares outstanding - basic	3,105,565	3,094,624	3,135,608	3,130,179	3,124,724
Average common shares outstanding - diluted	3,114,722	3,103,433	3,161,326	3,174,873	3,176,710
Balance Sheet at Year-end					
Federal funds sold	–	–	$ 4,541	–	$ 11,664
Investment securities available-for-sale	$ 290,564	$ 256,862	219,597	$ 191,552	219,818
Investment securities held-to-maturity	2,667	3,347	3,598	3,981	5,021
Restricted investment in bank stocks	2,176	2,291	2,291	954	3,465
Loans held-for-sale	228	534	120	688	170
Loans receivable	482,182	449,421	403,579	381,016	343,496
Allowance for loan losses	(8,955)	(6,217)	(3,836)	(3,279)	(2,729)
Other earning assets	6,414	22,158	1,314	579	778
Total assets	809,260	762,426	664,394	609,813	614,539
Deposits	694,977	634,103	549,790	494,124	478,922
Borrowed funds	50,094	63,433	56,663	58,990	82,113
Shareholders' equity	61,090	56,426	53,909	53,251	50,410
Selected Financial Ratios					
Net interest margin	3.72 %	3.42 %	3.56 %	3.32 %	3.12 %
Net income as a percentage of:					
Average total assets	0.93	0.59	0.91	0.51	0.91
Average shareholders' equity	12.53	7.73	10.76	5.94	10.89
Average shareholders' equity to average total assets	7.42	7.70	8.47	8.51	8.37
Dividend payout ratio	41.32	70.31	50.17	90.42	48.45

ITEM 7.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations – Overview
QNB Corp. (QNB or the Company) earns its net income primarily through its subsidiary, QNB Bank (the Bank). Net interest income, or the spread between the interest, dividends and fees earned on loans and investment securities and the expense incurred on deposits and other interest-bearing liabilities, is the primary source of operating income for QNB. QNB seeks to achieve sustainable and consistent earnings growth while maintaining adequate levels of capital and liquidity and limiting its exposure to credit and interest rate risk levels approved by the Board of Directors. Due to its limited geographic area, comprised principally of upper Bucks, southern Lehigh and northern Montgomery counties, growth is pursued through expansion of existing customer relationships and building new relationships by stressing a consistent high level of service at all points of contact.

Tabular information, other than share and per share data, is presented in thousands of dollars.

Net income for the year ended December 31, 2010 was $7,217,000, or $2.32 per share on a diluted basis, and represents a record year for the Company. In 2009, the Company reported net income of $4,227,000, or $1.36 per share on a diluted basis.

Two important measures of profitability in the banking industry are an institution's return on average assets and return on average shareholders' equity. Return on average assets was 0.93% and 0.59% in 2010 and 2009, respectively, and return on average shareholders' equity was 12.53% and 7.73% during those same periods.

The core functions of the Bank, gathering deposits and making loans, continued to show strength and contributed positively to the results for both 2010 and 2009. QNB took advantage of disruptions in its local banking market to grow both loans and deposits. This growth when combined with a declining cost of funds resulted in significant improvement in net interest income and the net interest margin and helped the Company to achieve record net income for 2010. However, the challenging economic environment and the continued uncertainty in the financial markets negatively impacted QNB's earnings performance during these same periods as QNB had to record a higher than normal level of provision for loan losses and recognize credit related other-than-temporary impairment charges (OTTI) on investment securities. In addition, the results for 2009 were impacted by higher industry-wide FDIC insurance premiums plus a special industry-wide FDIC assessment. These FDIC actions were a result of bank failures which significantly impacted the level of the Deposit Insurance Fund.

2010 versus 2009

The results for 2010 include the following significant components:

Net interest income increased $4,212,000, or 19.4%, to $25,913,000 for 2010.

- Average earning assets increased $64,261,000, or 9.4%, to $747,453,000 for 2010 with average loans increasing $39,139,000, or 9.1%, to $467,063,000, and average investment securities increasing $20,203,000, or 8.3%, to $263,307,000. The growth in loans was primarily real estate secured commercial loans and to a lesser degree commercial and industrial loans and tax-exempt state and municipal loans.
- Funding the growth in earning assets was an increase in average total deposits of $71,585,000, or 12.0%, to $665,913,000 for 2010. The growth is a result of increases in core deposits, including checking, savings and money market accounts. The growth in deposit balances reflects the positive response to two of QNB's high yielding deposit products, QNB Rewards Checking and Online eSavings, as well as customer's desire to do business with a strong institution that believes in community bank principles.
- While the economy has shown signs of improvement, issues in the residential and commercial real estate markets persist as do high levels of unemployment and low levels of inflation. In response to these factors the Federal Reserve Open Market Committee maintained its position of an exceptionally low level for the Federal funds rate throughout 2010. As detailed below, Treasury yields were volatile during 2010 and declined to historically low levels in the fourth quarter of 2010 before rebounding towards the end of the year. A low level of interest rates have been in place since 2008 and have resulted in lower yields earned on both loans and investment securities as well as lower rates paid on deposits and borrowed funds.

	December 31, 2009	2010	Low during 2010	High during 2010
3 month Treasury	0.07 %	0.12 %	0.03 %	0.18 %
2 year Treasury	1.15	0.60	0.33	1.17
5 year Treasury	2.69	2.01	1.03	2.74
10 year Treasury	3.88	3.30	2.39	3.99

- The net interest margin for 2010 was 3.72% compared to 3.42% for 2009 with lower deposit costs being a significant factor in the improvement. The interest rate paid on interest-bearing deposits declined by 73 basis points from 2.20% for 2009 to 1.47% for 2010. The decline in the rate paid on deposits largely resulted from the repricing of time deposits at lower market rates. The average rate paid on time deposits declined from 3.15% for 2009 to 2.12% for 2010.
- Lower interest rates also had a negative impact on the yields on earning assets, especially investment securities. The average rate on earning assets declined 32 basis points when comparing the two years with the average rate earned on investment securities falling 73 basis points from 4.80% for 2009 to 4.07% for 2010. The extended period of low interest rates resulted in an increase in the amount of cash flow that was reinvested into lower yielding securities.

Helping to minimize the impact of lower securities yields on the yield on earning assets was the minimal decline in the average rate earned on the loan portfolio. The average rate earning on loans declined only seven basis points from 5.92% for 2009 to 5.85% for 2010.

•Contributing to the increase in both net interest income and the net interest margin was a reduction in interest expense on long-term debt resulting from the maturity and repayment of $15,000,000 in borrowings at an average cost of 3.61%.

QNB recorded a provision for loan losses of $3,800,000 for 2010, a slight decrease from the $4,150,000 recorded in 2009. As a result of an increase in specific reserves for impaired loans, loan growth, increases in non-performing, delinquent and classified loans and continued concerns related to current economic conditions, QNB increased the allowance for loan losses to reflect these conditions.

•The allowance for loan losses of $8,955,000 represents 1.86% of total loans at December 31, 2010 compared to $6,217,000, or 1.38% of total loans at December 31, 2009.

•Net charge-offs for 2010 were $1,062,000, or 0.23% of average total loans, as compared with $1,769,000, or 0.41% of average total loans for 2009.

•Total non-performing loans, which represent loans on non-accrual status, loans past due more than 90 days and still accruing interest, and restructured loans, were $9,872,000, or 2.05% of total loans at December 31, 2010, compared to $6,102,000, or 1.36% of total loans at December 31, 2009.

•Total delinquent loans, which includes loans past due more than 30 days, increased to 2.82% of total loans at December 31, 2010 compared with 2.17% of total loans at December 31, 2009.

•QNB's non-performing loan ratio of 2.05%, while elevated, continues to compare favorably with the average for Pennsylvania commercial banks with assets between $500 million and $1 billion, as reported by the FDIC. The total non-performing loan ratio for these Pennsylvania commercial banks was 3.14% of total loans as of December 31, 2010.

Non-interest income increased $454,000 to $4,339,000 for 2010

•Net losses on investment securities were $1,000 in 2010 compared with net losses of $454,000 in 2009. The net loss on investment securities for 2010 was comprised of credit related OTTI charges of $310,000 which was almost entirely offset by net gains on the sale of securities of $309,000. The net loss for 2009 was comprised of credit related OTTI charges on pooled trust preferred securities and equity securities of $1,523,000 and net gains on the sales of securities of $1,069,000.

- •Gains on the sale of residential mortgages decreased from $633,000 in 2009 to $494,000 in 2010, largely a result of a decline in mortgage activity and the volume of mortgages sold.
- •Fees for services to customers declined $172,000 when comparing the two years. Overdraft income, which represents approximately 73% of total fees for services to customers in 2010, declined by $217,000, or 16.0%, when comparing 2010 to 2009. The decline in overdraft income is a result of the implementation of new rules under Regulation E and a reduction in the per item fee charged to customers.
- •ATM and debit card income increased $212,000, or 20.9%, to $1,228,000 for 2010 as a result of the continued acceptance and use by consumers and business cardholders.
- •Net losses on other real estate owned and repossessed assets declined from $134,000 in 2009 to $2,000 for 2010.

Non-interest expense increased $815,000, or 4.9%, to $17,401,000 for 2010.

- •Salary and benefit expense increased $474,000, or 5.6%, when comparing 2010 and 2009. A company-wide incentive compensation expense contributed $211,000 to the increase. There was no incentive compensation expense in 2009. Payroll tax and retirement plan expense increased $56,000, principally a function of higher salary expense, while medical and dental premiums increased $44,000 compared to 2009.
- •Net occupancy expense increased $192,000 with the majority of the increase related to lease expense for the new permanent Wescosville branch as well as increased expenses for utilities, building repairs and maintenance and security.
- •Marketing expense increased $90,000 to $737,000 for 2010. The majority of the increase relates to a $56,000 increase in donations and a $15,000 increase in public relations expense.
- •FDIC insurance premiums decreased $170,000, or 14.0%, to $1,041,000 for 2010. The 2009 expense included a special assessment levied on all insured institutions by the FDIC during the second quarter of 2009. The special assessment contributed $332,000 to the total FDIC costs in 2009. There was no similar special assessment in 2010. Partially offsetting this reduction in 2010 was the impact on the premiums resulting from significant growth in deposits combined with a slightly higher assessment rate in 2010 compared with 2009.
- •Expenses in connection with foreclosed real estate and repossessed assets increased $89,000, with the majority of the increase related to costs associated with maintaining a property the Bank owns that is classified as other real estate owned (OREO).

These items, as well as others, will be explained more thoroughly in the next sections.

Net Interest Income

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the years ended December 31, 2010 and 2009.

Net Interest Income

Year Ended December 31,	2010	2009
Total interest income	$36,183	$35,368
Total interest expense	10,270	13,667
Net interest income	25,913	21,701
Tax-equivalent adjustment	1,907	1,658
Net interest income (tax-equivalent basis)	$27,820	$23,359

Net interest income is the primary source of operating income for QNB. Net interest income is interest income, dividends, and fees on earning assets, less interest expense incurred for funding sources. Earning assets primarily include loans, investment securities, interest bearing balances at the Federal Reserve Bank (Fed) and Federal funds sold. Sources used to fund these assets include deposits and borrowed funds. Net interest income is affected by changes in interest rates, the volume and mix of earning assets and interest-bearing liabilities, and the amount of earning assets funded by non-interest bearing deposits.

For purposes of this discussion, interest income and the average yield earned on loans and investment securities are adjusted to a tax-equivalent basis as detailed in the table that appears above. This adjustment to interest income is made for analysis purposes only. Interest income is increased by the amount of savings of Federal income taxes, which QNB realizes by investing in certain tax-exempt state and municipal securities and by making loans to certain tax-exempt organizations. In this way, the ultimate economic impact of earnings from various assets can be more easily compared.

The net interest rate spread is the difference between average rates received on earning assets and average rates paid on interest-bearing liabilities, while the net interest margin, which includes interest-free sources of funds, is net interest income expressed as a percentage of average interest-earning assets.

Net interest income increased $4,212,000, or 19.4%, to $25,913,000 for 2010. On a tax-equivalent basis, net interest income for 2010 increased $4,461,000, or 19.1%, to $27,820,000. Several factors contributed to the significant increase in net interest income. Continued strong growth in deposits and the deployment of these deposits into loans and investment securities was one contributing factor. Total average deposits increased $71,585,000, or 12.0%, to $665,913,000 when comparing 2010 and 2009. Over this same time period total average loans increased $39,139,000, or 9.2%, and total average investment securities increased $20,203,000, or 8.3%. An even more significant factor was the decrease in interest expense resulting from a change in the mix of deposit types, the pricing of new and reinvested time deposits and money market accounts at lower market rates and a reduction in higher cost long-term debt. As a result of these factors the net interest margin improved to 3.72% for 2010 compared with 3.42% for 2009.

While the economy has shown signs of improvement, issues in the residential and commercial real estate markets persist as do high levels of unemployment and extremely low levels of inflation. As a result of these factors, as well as actions by the Fed, both actual and anticipated, interest rates on Treasury securities declined during 2010 to historically low levels. These low levels of interest rates have been in place since 2008 and have resulted in lower yields earned on both loans and investment securities as well as lower rates paid on deposits and borrowed funds.

Average Balances, Rates, and Interest Income and Expense Summary (Tax-Equivalent Basis)

	2010			2009			2008		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
Assets									
Federal funds sold	–	–	–	$992	0.15 %	$2	$6,281	2.20 %	$138
Investment securities:									
U.S. Treasury	$3,924	0.56 %	$22	5,075	1.41	71	5,152	3.46	178
U.S. Government agencies	58,050	2.88	1,671	47,717	3.97	1,892	37,391	5.03	1,881
State and municipal	59,141	6.22	3,676	50,921	6.50	3,308	43,394	6.51	2,826
Mortgage-backed and CMOs	134,859	3.85	5,192	126,883	4.89	6,200	107,069	5.50	5,894
Corporate bonds (fixed and variable)	4,313	1.24	54	5,839	1.36	79	12,689	6.11	776
Money market mutual funds	–	–	–	3,461	0.68	23	865	2.62	23
Equities	3,020	3.66	111	3,208	3.15	101	4,177	2.57	107
Total investment securities	263,307	4.07	10,726	243,104	4.80	11,674	210,737	5.54	11,685
Loans:									
Commercial real estate	252,604	5.95	15,041	219,991	6.16	13,544	183,212	6.68	12,242
Residential real estate*	24,468	5.74	1,405	24,710	5.95	1,471	21,737	6.13	1,332
Home equity loans	60,192	5.02	3,023	64,918	5.14	3,338	68,249	5.83	3,977
Commercial and industrial	82,074	5.27	4,327	74,343	5.09	3,786	67,542	5.98	4,042
Indirect lease financing	13,910	8.97	1,248	14,735	8.62	1,270	13,372	9.79	1,309
Consumer loans	3,163	13.78	436	3,986	10.71	427	4,524	11.49	520
Tax-exempt loans	30,652	6.02	1,844	25,241	5.91	1,491	24,362	6.05	1,475
Total loans, net of unearned income	467,063	5.85	27,324	427,924	5.92	25,327	382,998	6.50	24,897
Other earning assets	17,083	0.23	40	11,172	0.21	23	2,430	2.33	56
Total earning assets	747,453	5.10	38,090	683,192	5.42	37,026	602,446	6.10	36,776
Cash and due from banks	10,157			9,815			10,716		
Allowance for loan losses	(7,129)			(4,668)			(3,425)		
Other assets	26,118			22,241			21,955		

Total assets	$776,599			$ 710,580			$631,692		
Liabilities and Shareholders' Equity									
Interest-bearing deposits:									
Interest-bearing demand	$83,546	0.65 %	545	$ 70,398	0.57 %	403	$57,883	0.27 %	156
Municipals	40,242	0.91	366	33,077	1.08	357	39,738	2.06	818
Money market	75,128	0.76	568	60,535	1.16	703	48,027	1.83	879
Savings	93,576	0.79	739	51,245	0.37	189	43,859	0.39	169
Time	211,867	2.09	4,420	218,047	3.13	6,829	198,500	4.10	8,143
Time of $100,000 or more	105,482	2.19	2,306	107,764	3.18	3,424	77,765	4.09	3,179
Total interest-bearing deposits	609,841	1.47	8,944	541,066	2.20	11,905	465,772	2.86	13,344
Short-term borrowings	27,658	0.97	269	21,817	1.14	248	22,197	2.12	471
Long-term debt	22,077	4.72	1,057	35,000	4.27	1,514	34,535	4.28	1,504
Total interest-bearing liabilities	659,576	1.56	10,270	597,883	2.29	13,667	522,504	2.93	15,319
Non-interest bearing deposits	56,072			53,262			51,170		
Other liabilities	3,362			4,725			4,532		
Shareholders' equity	57,589			54,710			53,486		
Total liabilities and shareholders' equity	$776,599			$ 710,580			$631,692		
Net interest rate spread		3.54 %			3.13 %			3.17 %	
Margin/net interest income		3.72 %	$27,820		3.42 %	$23,359		3.56 %	$21,457

Tax-exempt securities and loans were adjusted to a tax-equivalent basis and are based on the marginal Federal corporate tax rate of 34 percent.

Non-accrual loans and investment securities are included in earning assets.

* Includes loans held-for-sale.

Rate-Volume Analysis of Changes in Net Interest Income (1) (2) (3)

	2010 vs. 2009			2009 vs. 2008		
	Change due to		Total	Change due to		Total
	Volume	Rate	Change	Volume	Rate	Change
Interest income:						
Federal funds sold	$ (2)	–	$ (2)	$ (116)	$ (20)	$ (136)
Investment securities:						
U.S. Treasury	(16)	$ (33)	(49)	(3)	(104)	(107)
U.S. Government agencies	410	(631)	(221)	519	(508)	11
State and municipal	533	(165)	368	490	(8)	482
Mortgage-backed and CMOs	390	(1,398)	(1,008)	1,090	(784)	306
Corporate bonds (fixed and variable)	(20)	(5)	(25)	(419)	(278)	(697)
Money market mutual funds	(23)	–	(23)	67	(67)	–
Equities	(6)	16	10	(24)	18	(6)
Loans:						
Commercial real estate	2,008	(511)	1,497	2,457	(1,155)	1,302
Residential real estate	(14)	(52)	(66)	182	(43)	139
Home equity loans	(243)	(72)	(315)	(194)	(445)	(639)
Commercial and industrial	394	147	541	407	(663)	(256)
Indirect lease financing	(71)	49	(22)	134	(173)	(39)
Consumer loans	(88)	97	9	(62)	(31)	(93)
Tax-exempt loans	319	34	353	53	(37)	16
Other earning assets	13	4	17	203	(236)	(33)
Total interest income	3,584	(2,520)	1,064	4,784	(4,534)	250
Interest expense:						
Interest-bearing demand	76	66	142	34	213	247
Municipals	77	(68)	9	(138)	(323)	(461)
Money market	170	(305)	(135)	229	(405)	(176)
Savings	156	394	550	29	(9)	20
Time	(194)	(2,215)	(2,409)	802	(2,116)	(1,314)
Time of $100,000 or more	(73)	(1,045)	(1,118)	1,227	(982)	245
Short-term borrowings	67	(46)	21	(8)	(215)	(223)
Long-term debt	(559)	102	(457)	16	(6)	10
Total interest expense	(280)	(3,117)	(3,397)	2,191	(3,843)	(1,652)
Net interest income	$ 3,864	$ 597	$ 4,461	$ 2,593	$ (691)	$ 1,902

(1) Loan fees have been included in the change in interest income totals presented. Non-accrual loans and investment securities have been included in average balances.
(2) Changes due to both volume and rates have been allocated in proportion to the relationship of the dollar amount change in each.
(3) Interest income on loans and securities is presented on a tax-equivalent basis.

The Rate-Volume Analysis table, as presented on a tax-equivalent basis, highlights the impact of changing rates and volumes on interest income and interest expense. Total interest income on a tax-equivalent basis increased $1,064,000, or 2.9%, in 2010, to $38,090,000, while total interest expense decreased $3,397,000, or 24.9%, to $10,270,000. The increase in interest income was the result of the growth in earning assets outpacing the impact of the decline in interest rates. Volume growth contributed an additional $3,584,000 of interest income offsetting the decline in interest income of $2,520,000 resulting from lower interest rates. With regard to interest expense, lower funding costs resulted in a decline in interest expense of $3,117,000.

The yield on earning assets on a tax-equivalent basis decreased 32 basis points from 5.42% for 2009 to 5.10% for 2010. The yield on earning assets has held up fairly well as a result of the ability to grow loans at reasonable returns. This has been offset in part by the decline in the yield on the investment portfolio due to the call or prepayment of a significant amount of higher yielding securities the proceeds of which were reinvested at much lower rates. In comparison, the rate paid on interest-bearing liabilities decreased 73 basis points from 2.29% for 2009 to 1.56% for 2010.

Interest income on investment securities decreased $948,000 when comparing the two years as the $20,203,000, or 8.3%, increase in average balances could only partially offset the 73 basis point decline in the average yield of the portfolio. The average yield on the investment portfolio was 4.07% for 2010 compared with 4.80% for 2009. As noted previously, the decline in the yield on the investment portfolio is primarily the result of the extended period of low interest rates which has resulted in an increase in cash flow from the investment portfolio as prepayment speeds on mortgage-backed securities and CMOs ramped-up as did the amount of calls of agency and municipal securities. The reinvestment of these funds was generally in securities that had lower yields than what they replaced. The growth in the investment portfolio was primarily in high quality U.S. Government agency issued mortgage-backed and CMO securities as well as in tax-exempt state and municipal bonds.

Income on Government agency securities decreased $221,000, as the yield declined 109 basis points from 3.97% for 2009 to 2.88% for 2010, with lower yields reducing interest income by $631,000. Most of the bonds in the agency portfolio have call features ranging from three months to five years, many of which were exercised as a result of the low interest rate environment. The proceeds from these called bonds were reinvested in securities with significantly lower yields. The average balance of Government agency securities increased $10,333,000, or 21.7% and contributed $410,000 in additional income. The growth in this sector is primarily the result of an increase in deposits of a local school district. Agency bonds were purchased to match the cash flow needs of the school district over the course of the year. Since these bonds were very short-term their average yields were low, also contributing to the decline in the overall yield of the agency portfolio.

Interest income on mortgage-backed securities and CMOs decreased $1,008,000 with lower yields being the primary factor. The yield on the mortgage-backed portfolio decreased 104 basis points from 4.89% to 3.85% when comparing 2009 and 2010. With the historically low interest rate environment mortgage refinancing activity was significant resulting in an increase in prepayments on these securities. Since most of these securities were purchased at a premium, prepayments result in a shorter amortization period of this premium and therefore a reduction in income. The impact on income of lower yields was partially offset by a $7,976,000, or 6.3%, increase in average balances which resulted in additional income of $390,000.

Interest on tax-exempt municipal securities increased $368,000 with higher balances accounting for $533,000 of additional income. Average balances of tax-exempt municipal securities increased $8,220,000, or 16.1%, to $59,141,000 for 2010. As a result of credit concerns in the municipal market arising from issues with the insurance companies that insure the bonds during 2009 and concerns over the general health of state and municipal governments because of declining revenues and budget issues resulting from economic conditions in 2010, municipal bond yields declined but not to the same degree as yields on other types of securities. As a result QNB expanded its purchase of municipal bonds, primarily general obligation bonds of issuers with strong underlying credit ratings. The yield on the state and municipal portfolio decreased 28 basis points from 6.50% for 2009 to 6.22% for 2010. As of December 31, 2010 the balance in this category was $66,255,000 with a tax-equivalent yield of 5.84%.

With the issues in the economy and low levels of inflation the Federal Reserve Open Market Committee has indicated it will continue to keep its target rate at between 0.0% and 0.25% for an extended period of time and will continue its purchases of Treasury securities through its quantitative easing program. Therefore, Treasury yields, despite coming off their historic lows at the end of 2010 will likely remain at fairly low levels. When combined with spread tightening on agency bonds, mortgage securities and municipal securities, yields on investment securities are anemic. As a result the yield on the total investment portfolio is anticipated to continue to decline as cash flow from the portfolio, as well as excess liquidity, is invested at current market rates which are significantly below the projected portfolio yield at December 31, 2010 of 3.79%.

Income on loans increased $1,997,000 to $27,324,000 comparing 2010 to 2009 as the impact of declining interest rates was offset by the growth in the portfolio. Average loans increased $39,139,000, or 9.1%, and this volume

increase contributed an additional $2,305,000 in interest income. The yield on loans decreased only seven basis points, to 5.85% when comparing the same periods, resulting in a reduction in interest income of $308,000. Reducing the impact of the decline in interest rates on loans is the structure of the loan portfolio, which has a significant portion of fixed-rate and adjustable-rate loans with fixed-rate terms for three to ten years. Also helping to stabilize the yield was the implementation of interest rate floors on some variable-rate commercial loans and home equity lines of credit. The rate earned on loans has not fallen to the degree that the rate earned on investment securities, which are more closely tied to the Treasury yield curve. Most variable-rate loans are indexed to the Prime lending rate which did not change during 2010.

QNB took advantage of disruptions in its local banking market during 2009 and 2010 to grow its loan portfolio, particularly the commercial loan portfolio. Most of the growth in the loan portfolio, both in terms of balances and interest income, was in the category of commercial real estate loans. This category of loans includes commercial purpose loans secured by either commercial properties such as office buildings, factories, warehouses, medical facilities and retail establishments, or residential real estate, usually the residence of the business owner. This category also includes construction and land development loans. Income on commercial real estate loans increased $1,497,000, with average balances increasing $32,613,000, or 14.8%, to $252,604,000, for 2010. The growth in this category resulted in an additional $2,008,000 in interest income. The yield on commercial real estate loans was 5.95% for 2010, a decline of 21 basis points from the 6.16% reported for 2009. The decline in the yield on the portfolio reduced interest income by $511,000.

Interest on commercial and industrial loans, the second largest category, increased $541,000 with a positive impact from both the growth in balances and the increase in the yield. Average commercial and industrial loans increased $7,731,000, or 10.4%, to $82,074,000 for 2010, contributing an additional $394,000 in interest income. The average yield on these loans increased 18 basis points to 5.27% resulting in an increase in interest income of $147,000. The implementation of interest rate floors on some loans in this category, primarily lines of credit indexed to the Prime lending rate, was a major factor in the improvement in the yield.

Another strong growth area has been loans to tax-exempt municipalities and organizations. This category of loans increased $5,411,000, or 21.4%, when comparing the average balances for 2010 and 2009. This growth in balances along with an increase in the yield on the portfolio from 5.91% for 2009 to 6.02% for 2010 resulted in an increase in interest income of $353,000.

Income on home equity loans declined by $315,000 when comparing the two years. During this same time period average home equity loans decreased $4,726,000, or 7.3%, to $60,192,000, while the yield on the home equity portfolio decreased 12 basis points to 5.02%. The demand for home equity loans has declined as home values have fallen eliminating some homeowners' equity in their homes while others have taken advantage of the low interest rates on mortgages and refinanced their home equity loans into a new mortgage. Included in the home equity portfolio are floating rate home equity lines tied to the Prime lending rate. The average balance of these loans increased by $3,102,000, or 14.2%, to $24,992,000 for 2010. In contrast, average fixed-rate home equity loans declined by $7,828,000, or 18.1%, to $35,200,000. Customers who are opening home equity loans are choosing the floating rate option indexed to Prime even with a rate floor because the rate is currently significantly lower than a fixed rate home equity loan. In an attempt to boost demand, QNB has been offering an attractive fixed rate home equity loan promotion. This promotion which began during the second quarter of 2010 has had limited success, an indication of lack of demand by homeowners.

Income on other earning assets is comprised of interest on deposits in correspondent banks, primarily the Fed and dividends on restricted investments in bank stocks, primarily the Federal Home Loan Bank of Pittsburgh (FHLB). Income on other earning assets increased from $23,000 for 2009 to $40,000 for 2010. Beginning in December 2008, the Fed began paying 0.25% on balances in excess of required reserves. With this rate being above what could be earned on selling Federal funds or investing in AAA rated money market mutual funds excess liquidity was housed at the Fed. The average balance held at the Federal Reserve Bank was $14,671,000 for 2010 compared with $8,385,000 for 2009. In December 2008, the FHLB notified member banks that it was suspending dividend payments to preserve capital. There was no dividend income from the FHLB in either 2010 or 2009.

For the most part, earning assets are funded by deposits, which increased on average by $71,585,000, or 12.0%, to $665,913,000, when comparing 2010 and 2009. This follows an increase of $77,386,000, or 15.0% between 2008 and 2009. It appears that customers continue to be attracted to the safety of FDIC insured deposits and the stability of a strong local community bank as opposed to the volatility of the equity markets and the uncertainty of the larger regional and national banks. On October 3, 2008, in response to the ongoing economic crisis affecting the financial services industry, the Emergency Economic Stabilization Act of 2008 was enacted which temporarily raised the basic limit on FDIC coverage from $100,000 to $250,000 per depositor until December 31, 2009. However, legislation was passed during the second quarter of 2009 that extended the higher coverage through December 31, 2013. The recently enacted Dodd-Frank Act made the $250,000 coverage permanent. In addition, on October 13, 2008, the FDIC established a program under which the FDIC fully guaranteed all non-interest bearing transaction accounts until December 31, 2009 (the "Transaction Account Guarantee Program"). On August 26, 2009 the FDIC amended the program to extend the date six months until June 30, 2010 to those institutions that do not opt out of participating. On April 19, 2010 the program was extended again until December 31, 2010. QNB participated in the Transaction

Account Guarantee Program. To participate in this program QNB paid a fee of 15 basis points in 2010. These programs likely contributed to the growth in deposits.

While total income on earning assets on a tax-equivalent basis increased $1,064,000 when comparing 2010 to 2009, total interest expense declined $3,397,000. Interest expense on total deposits decreased $2,961,000 while interest expense on borrowed funds decreased $436,000 when comparing the two years. The rate paid on interest-bearing liabilities decreased 73 basis points from 2.29% for 2009 to 1.56% for 2010. During this same period, the rate paid on interest-bearing deposits decreased 73 basis points from 2.20% to 1.47%.

All categories of average deposits, except for time deposits, increased when comparing 2010 to the same period in 2009. Unlike prior years the growth was not centered in time deposits but in accounts with greater liquidity, such as interest-bearing demand, interest-bearing municipal accounts, money market and savings deposits. Average interest-bearing demand accounts increased $13,148,000, or 18.7%, to $83,546,000 for 2010 compared to 2009. Interest expense on interest-bearing demand accounts increased from $403,000 for 2009 to $545,000 for 2010 while the average rate paid increased from 0.57% to 0.65%. The increase in the average rate paid reflects a change in the mix of accounts included in interest-bearing demand accounts. Included in this category is QNB Rewards checking, a high rate checking account. For most of 2009 the product paid a yield of 3.25% on balances up to $25,000. This yield was reduced on February 10, 2010 to 2.75% and again on August 18, 2010 to 2.05% as Treasury rates declined to historic lows. In order to receive the high rate a customer must receive an electronic statement, have one direct deposit or other ACH transaction and have at least 12 check card purchase transactions post per statement cycle. For 2010, the average balance in this product was $25,885,000 and the related interest expense was $512,000 for an average yield of 1.98%. This lower rate reflects the lower rate paid on accounts that do not meet the qualifications or on balances in excess of $25,000 which paid 1.01% until August 18, 2010 and 0.75% thereafter. In comparison the average balance for 2009 was $14,056,000 with a related interest expense of $373,000 and an average rate paid of 2.65%. This product also generates fee income through the use of the check card. The average balance of other interest-bearing demand accounts included in this category increased from $56,342,000 for 2009 to $57,661,000 for 2010 while the average rate paid on these balances was 0.06% for both years.

Interest expense on municipal interest-bearing demand accounts increased from $357,000 for 2009 to $366,000 for 2010. The increase in interest expense was the result of an increase in average balances offsetting a slight decline in the rate paid. The average balance of municipal interest-bearing demand accounts increased $7,165,000, or 21.7%, while the average interest rate paid on these accounts decreased from 1.08% for 2009 to 0.91% for 2010. Most of these accounts are tied directly to the Federal funds rate with most having rate floors between 0.25% and 1.00%. The balances in many of these accounts are seasonal in nature and are dependent upon the timing of the receipt of taxes and the disbursement by the schools and municipalities.

Average money market accounts increased $14,593,000, or 24.1%, to $75,128,000 for 2010 compared with 2009. The growth in balances in money market accounts was centered primarily in business accounts. Despite the significant increase in balances, interest expense on money market accounts decreased $135,000 to $568,000 for 2010 compared to 2009. The average interest rate paid on money market accounts was 1.16% for 2009 and 0.76% for 2010, a decline of 40 basis points. Included in total money market balances is the Select money market account, a higher yielding money market product that pays a tiered rate based on account balances. With the sharp decline in short-term interest rates, the rates paid on the Select money market account have declined as well. The average rate paid on Select money market accounts in 2010 was 0.85% a decline of 48 basis points from the average rate of 1.33% paid in 2009.

During the second quarter of 2009, QNB introduced an online eSavings account to compete with other online savings accounts. This product was introduced at a yield of 1.85% and has been extremely successful having grown to balances of $67,435,000 at December 31, 2010. The eSavings yield was reduced to 1.60% on March 17, 2010 and to 1.30% on August 6, 2010. The average balance of this product was $42,582,000 for 2010 compared with $3,874,000 for 2009 and contributed to the $42,331,000, or 82.6%, increase in total average savings accounts when comparing the two years. Average statement savings accounts also increased $3,819,000, or 8.2%, when comparing the same periods. As a result of the eSavings product the average rate paid on savings accounts increased 42 basis points from 0.37% for 2009 to 0.79% for 2010 and interest expense increased $550,000 from $189,000 for 2009 to $739,000 for 2010. The growth in balances appears to reflect the desire for safety, liquidity and a better rate than short-term time deposits.

The repricing of time deposits at lower rates over the past couple of years has had the greatest impact on total interest expense when comparing the two years. Total interest expense on time deposits decreased $3,527,000, or 34.4%, to $6,726,000 for 2010. Average total time deposits decreased by $8,462,000, or 2.6%, to $317,349,000 for 2010. Similar to fixed-rate loans and investment securities, time deposits reprice over time and, therefore, have less of an immediate impact on costs in either a rising or falling rate environment. Unlike loans and investment securities, however, the maturity and repricing characteristics of time deposits tend to be shorter. Over the course of 2009 and 2010 a significant amount of time deposits have repriced lower as market rates have declined. The average rate paid on time deposits decreased from 3.15% to 2.12% when comparing 2009 to 2010.

Approximately $232,201,000, or 74.8%, of time deposits at December 31, 2010 will reprice or mature over the next 12 months. The average rate paid on these time deposits is approximately 1.76%. During the first quarter of 2011 approximately $104,417,000 of time deposits yielding 2.19% will reprice or mature. Given the short-term nature of QNB’s time deposit portfolio and the current rates being offered, it is likely that the average rate paid on time deposits should continue to decline during 2011 as higher costing time deposits are repriced lower. However, given the short-term nature of these deposits interest expense could increase if short-term time deposit rates were to increase suddenly. It is anticipated, given recent history, that some of these maturing time deposits will migrate to the online savings or money market accounts or be withdrawn.

Short-term borrowings are primarily comprised of sweep accounts structured as repurchase agreements with our commercial customers. Interest expense on short-term borrowings increased by $21,000 to $269,000 when comparing the two years. During this period average balances increased $5,841,000 to $27,658,000 while the average rate paid

declined from 1.14% to 0.97%.

Contributing to the decrease in total interest expense was a reduction in interest expense on long-term debt of $457,000. In January 2010, $10,000,000 in FHLB advances at a rate of 2.97% matured and were repaid. In addition, in April 2010 another $5,000,000 of debt at a rate of 4.90% matured and was repaid resulting in the reduction in expense. The average balance of long-term debt for 2010 was $22,077,000 compared with $35,000,000 in 2009. Since the average rate paid on the debt that was repaid was lower than the remaining debt the average rate paid increased from 4.27% for 2009 to 4.72% for 2010.

Provision For Loan Losses

The provision for loan losses represents management's determination of the amount necessary to be charged to operations to bring the allowance for loan losses to a level that represents management's best estimate of the known and inherent losses in the existing loan portfolio. Actual loan losses, net of recoveries, serve to reduce the allowance. Recent economic conditions contributed to high rates of unemployment and a softening of the residential and commercial real estate markets. These factors have had a negative impact on both consumers and small businesses and have contributed to higher than historical levels of net charge-offs and non-performing, impaired and classified loans over the past two years. These results when combined with the inherent risk related to the significant growth in the loan portfolio, contributed to QNB recording provision for loan losses of $3,800,000 in 2010, a slight decrease from the $4,150,000 recorded in 2009. Further deterioration in credit quality could result in a continuation of an elevated provision for loan losses in 2011.

Non-Interest Income Comparison

			Change from Prior Year	
Year Ended December 31,	2010	2009	Amount	Percent
Fees for services to customers	$1,571	$1,743	$(172)	(9.9)%
ATM and debit card	1,228	1,016	212	20.9
Bank-owned life insurance	314	309	5	1.6
Merchant income	278	243	35	14.4
Net loss on investment securities	(1)	(454)	453	99.8
Net gain on sale of loans	494	633	(139)	(22.0)
Other	455	395	60	15.2
Total	$4,339	$3,885	$454	11.7 %

Non-Interest Income

QNB, through its core banking business, generates various fees and service charges. Total non-interest income is composed of service charges on deposit accounts, ATM and check card income, income on bank-owned life insurance, merchant income and gains and losses on investment securities and residential mortgage loans. Total non-interest income was $4,339,000 in 2010 compared with $3,885,000 in 2009, an increase of $454,000, or 11.7%.

Fees for services to customers, the largest component of non-interest income, are primarily comprised of service charges on deposit accounts. These fees were $1,571,000 for 2010, a $172,000, or 9.9%, decline from 2009. Overdraft income, which represents approximately 73% of total fees for services to customers in 2010, declined by $217,000, or 16.0%, when comparing 2010 to 2009. The decline in overdraft income is a result of the implementation of new rules under Regulation E and a reduction in the per item fee charged to customers. In March 2010, QNB reduced the per item charge for overdrafts by $2 to $35. Offsetting a portion of the decline in overdraft income was an increase in fees on business checking accounts of $35,000 when comparing 2010 to 2009. This increase reflects the impact of a lower earnings credit rate in 2010 compared to 2009, resulting from the decline in short-term interest rates. These earnings credits are applied against service charges to reduce the costs paid by the customer. Fees charged to commercial customers for the use of internet banking increased from $19,000 for 2009 to $32,000 in 2010 as more customers enrolled in the service.

ATM and debit card income is primarily comprised of transaction income on debit cards and ATM cards and ATM surcharge income for the use of QNB's ATM machines by non-QNB customers. ATM and debit card income was $1,228,000 in 2010, an increase of $212,000, or 20.9%, from the amount recorded in 2009. Debit card income increased $130,000, or 18.0%, to $851,000 in 2010, while ATM interchange income increased $101,000, or 54.1%, to $290,000. The increase in debit and ATM card income was a result of the continuing increased reliance on the card as a means of paying for goods and services by both consumers and business cardholders. The higher rate of increase in ATM PIN-based transactions is a function of some merchants recommending lower costing PIN based transactions

over higher costing signature debit transactions as well as an increase in the amount QNB receives per transaction. Helping to contribute to the growth in debit card transactions is the growth in the QNB Rewards checking product, a high-yield checking account which requires, among other terms, the posting of a minimum of twelve debit card purchase transactions per statement cycle to receive the high interest rate. The passage of the Dodd-Frank Act could have negative implications on the amount of interchange income earned by QNB in the future. The impact at this time is unknown. Partially offsetting these increases was a decline in ATM surcharge income of $15,000. Fewer non-customers are making cash withdrawals at QNB machines because they are finding machines without a surcharge, are getting cash back on PIN-based card transactions or are using less cash.

Income on bank-owned life insurance (BOLI) represents the earnings and death benefits on life insurance policies in which the Bank is the beneficiary. Income on these policies was $314,000 and $309,000 in 2010 and 2009, respectively. The insurance carriers reset the rates on these policies annually taking into consideration the interest rate environment as well as mortality costs. The existing policies have rate floors which minimize how low the earnings rate can go. Some of these policies are currently at their floor.

Merchant income represents fees charged to merchants for the bank’s handling of credit card or charge sales. Merchant income was $278,000 for 2010, an increase of $35,000, or 14.4%, from the amount reported in 2009. The increase in merchant income is primarily a result of an increase in the number of merchant’s QNB services.

The fixed-income securities portfolio represents a significant portion of QNB's earning assets and is also a primary tool in liquidity and asset/liability management. QNB actively manages its fixed-income portfolio in an effort to take advantage of changes in the shape of the yield curve, changes in spread relationships in different sectors, and for liquidity purposes. Management continually reviews strategies that will result in an increase in the yield or improvement in the structure of the investment portfolio, including monitoring credit and concentration risk in the portfolio.

QNB recorded net losses on investment securities of $1,000 in 2010 compared with net losses of $454,000 in 2009. Net securities losses of $1,000 for 2010 include credit related OTTI charges of $277,000 on three pooled trust preferred securities and OTTI charges of $33,000 on an equity security. These OTTI charges were almost entirely offset by net gains on the sales of securities, primarily equity securities of $309,000. The net loss for 2009 included credit related OTTI charges on pooled trust preferred securities of $1,002,000. The impairment charges on the pooled trust preferred securities for the past two years resulted from a valuation performed by an independent third party that included a review of all eight pooled trust preferred securities owned by the Bank. A description of the valuation methodology used can be found in Footnotes 4 and 17. The net loss for 2009 also included OTTI charges on equity securities of $521,000, net gains on the sale of debt securities of $660,000 and net gains on the sale of equity securities of $409,000. During 2009, in an effort to reduce credit risk QNB sold $6,000,000 in corporate bonds issued by financial institutions and $3,347,000 of non-agency issued collateralized mortgage backed securities. In addition, $14,345,000 of higher coupon faster paying mortgage-backed securities were sold in the fourth quarter of 2009 to reposition the cash-flow of the portfolio.

When QNB sells its residential mortgages in the secondary market, it retains servicing rights. A normal servicing fee is retained on all mortgage loans sold and serviced. QNB recognizes its obligation to service financial assets that are retained in a transfer of assets in the form of a servicing asset. The servicing asset is amortized in proportion to, and over, the period of net servicing income or loss. On a quarterly basis, servicing assets are assessed for impairment based on their fair value. The timing of mortgage payments and delinquencies also impacts the amount of servicing fees recorded.

The net gain on residential mortgage sales is directly related to the volume of mortgages sold and the timing of the sales relative to the interest rate environment. Residential mortgage loans to be sold are identified at origination. The net gain on the sale of residential mortgage loans was $494,000 and $633,000 for 2010 and 2009, respectively. This $139,000 decrease in the net gain on sale of loans was primarily a result of decreased refinancing activity. Many customers who were able to refinance have already done so due to the low interest rate environment that has existed for the past two years. Included in the gains on the sale of residential mortgages in 2010 and 2009 are $89,000 and $189,000, respectively, related to the recognition of mortgage servicing assets. Proceeds from the sale of residential mortgages were $12,124,000 and $25,400,000 for 2010 and 2009, respectively. While the total gains on the sale of mortgages has declined as a result of reduced volume, the amount of gain recognized on each sale has increased because of the historically low level of mortgage rates.

Other income increased by $60,000 when comparing the $455,000 recorded in 2010 to the $395,000 recorded in 2009. The majority of the difference was a result of the following:

- Losses on the sale of other real estate owned and repossessed assets were $2,000 in 2010 compared with losses of $134,000 in 2009. Approximately half the loss in 2009 relate to the sale of two foreclosed residential properties while the other half relates to the sale of repossessed vehicles and equipment from the indirect lease portfolio.
- Income from an investment in a title insurance company decreased by $30,000 as a result of a decline in mortgage activity compared to the prior year.
- Other income in 2009 included the recognition of income related to the reversal of a $44,000 accrual recorded in prior years as a result of a decision to amend the terms of a group term life plan.
- Other income in 2010 includes a sales and use tax refund of $22,000.

Non-Interest Expense Comparison

Year Ended December 31,	2010	2009	Change from Prior Year Amount	Percent
Salaries and employee benefits	$8,999	$8,525	$474	5.6 %
Net occupancy	1,535	1,343	192	14.3
Furniture and equipment	1,202	1,220	(18)	(1.5)
Marketing	737	647	90	13.9
Third party services	1,116	1,075	41	3.8
Telephone, postage and supplies	612	609	3	0.5
State taxes	561	539	22	4.1
FDIC insurance premiums	1,041	1,211	(170)	(14.0)
Other	1,598	1,417	181	12.8
Total	$17,401	$16,586	$815	4.9 %

Non-Interest Expense

Non-interest expense is comprised of costs related to salaries and employee benefits, net occupancy, furniture and equipment, marketing, third party services, FDIC insurance premiums, regulatory assessments and taxes and various other operating expenses. Total non-interest expense was $17,401,000 in 2010, an increase of $815,000, or 4.9%, from the $16,586,000 recorded in 2009. QNB's overhead efficiency ratio, which represents the percentage of each dollar of revenue that is used for non-interest expense, is calculated by taking non-interest expense divided by net operating revenue on a tax-equivalent basis. QNB's efficiency ratios for 2010 and 2009 were 54.1% and 60.9%, respectively.

Salaries and benefits expense is the largest component of non-interest expense. QNB monitors, through the use of various surveys, the competitive salary and benefit information in its markets and makes adjustments where appropriate. Salaries and benefits expense for 2010 was $8,999,000, an increase of $474,000, or 5.6%, over the $8,525,000 reported in 2009. Salary expense for 2010 was $7,208,000, an increase of $365,000, or 5.3%, over the $6,843,000 reported in 2009. Included in salary expense in 2010 was an accrual for incentive compensation of $211,000. There was no incentive compensation expense in 2009. Also included in salary expense for 2010 and 2009 was $130,000 and $109,000, respectively, in severance expense for former executives of the Company. Excluding the cost of incentive compensation and severance pay, salary expense increased $133,000, or 2.0%, when comparing 2010 to 2009. Merit increases, as well as an increase in the average number of full-time equivalent employees by three contributed to the higher salary expense. Included in salary expense for most of 2009 were costs associated with the Chief Operating Officer position. This position was vacant for the first eight months of 2010.

Benefit expense for 2010 was $1,791,000, an increase of $109,000, or 6.5%, from the amount recorded in 2009. Payroll tax and retirement plan expense increased $42,000 and $14,000, respectively, principally a function of higher salary expense, while medical and dental premiums increased $44,000 compared to 2009, an 8.9% increase.

Net occupancy expense for 2010 was $1,535,000, an increase of $192,000, or 14.3%, from the amount reported in 2009. Branch rent expense accounted for $101,000 of the increase with the lease on the permanent Wescosville branch being the most significant contributor to this increase. Also contributing to the higher net occupancy cost in 2010 were increases in utilities expense of $31,000, building repairs and maintenance expense of $32,000 and building security expense of $20,000. Some of these increases also relate to the new branch. Rate increases by the utility companies as well as an increase in usage also contributed to the increase in utilities expense. The increase in security expense also relates to the ongoing expense of tracking devices in the branches added over the past two years.

Furniture and equipment expense decreased $18,000, or 1.5%, to $1,202,000, when comparing 2010 to 2009. Depreciation expense declined by $40,000 while equipment maintenance costs increased by $25,000 when comparing the two years.

Marketing expense was $737,000 for 2010, an increase of $90,000, or 13.9%, from the $647,000 recorded in 2009. The majority of the increase relates to a $56,000 increase in donations and a $15,000 increase in public relations expense. QNB contributes to many not-for-profit organizations and clubs and sponsors many local events in the Bank's communities it serves. Marketing costs also increased in 2010 as a result of the opening of the permanent Wescosville branch and the launching of the new marketing campaign, "Always You, Always QNB. Yesterday, Today, Tomorrow."

Third-party services are comprised of professional services including legal, accounting and auditing, and consulting services, as well as fees paid to outside vendors for services in support of day-to-day operations. These support services include correspondent banking services, statement printing and mailing, investment security safekeeping and supply management services. Third-party services expense was $1,116,000 in 2010, compared to $1,075,000 in 2009, an increase of $41,000, or 3.8%. The largest portion of the increase relate to the following third party services:

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Audit and accounting cost increased $50,000 compared to the prior year. The main contributors are costs associated with complying with the upcoming XBRL requirements as well as additional services related to Sarbanes-Oxley documentation and testing contracted with the Company's outsourced internal audit firm.

- Consultant expense decreased by $42,000 to $91,000 in 2010. Included in 2009 were expenses associated with an executive search consultant used to fill the open Chief Operating Officer position.
- Costs associated with the registration, printing and mailing and ongoing expenses of the Dividend Reinvestment and Stock Purchase Plan contributed approximately $17,000 to the increase in 2010.

State tax expense represents the payment of the Pennsylvania Shares Tax, which is based primarily on the equity of the Bank, Pennsylvania sales and use tax and the Pennsylvania capital stock tax. State tax expense was $561,000 and $539,000 for the years 2010 and 2009, respectively. The Pennsylvania Shares Tax was $557,000 in 2010, an increase of $26,000 reflecting higher equity levels.

FDIC insurance premiums decreased $170,000, or 14.0%, to $1,041,000 for 2010. The lower expense is a result of a special assessment levied on all insured institutions by the FDIC during the second quarter of 2009. These actions were taken by the FDIC in order to replenish the Deposit Insurance Fund which was reduced as a result of bank failures. The special assessment contributed $332,000 to the total FDIC costs in 2009. There was no similar special assessment in 2010. Partially offsetting this reduction in 2010 was the impact on FDIC premiums resulting from the significant growth in deposits combined with a slightly higher assessment rate in 2010 compared with 2009.

Other expense increased $181,000, or 12.8%, to $1,598,000 for the year ended December 31, 2010. The majority of the difference was a result of the following:

- Costs related to appraisals and title searches on loans, particularly classified loans, increased $60,000 when comparing 2010 to 2009. These expenses are a result of the Company's ongoing efforts to obtain the most recent and relevant information to analyze classified loans in connection with the calculation of the allowance for loan losses.
- Directors' fees increased $31,000 for 2010 when compared to 2009. This was partly attributable to an increase in the number of meetings held and a portion of the increase is a result of deferred loan fees decreasing by $18,000. These fees have the impact of offsetting a portion of the directors' fees related to meetings for loans that require director approval. These fees were lower than the prior year due to a reduction in the number of loans requiring director approval in 2010 as commercial loan demand softened due to the economy.
- Expenses in connection with foreclosed real estate and repossessed assets increased $89,000, with the majority of the increase related to costs associated with maintaining a property the Bank owns that is classified as OREO. Also contributing to the increase in foreclosed real estate expense is the payment of past due real estate taxes in order to preserve the Bank's lien position on several mortgages.
- Refund of ATM fees related to the QNB Rewards product increased $20,000.
- Charge-offs related to fraudulent ATM and checkcard transactions increased $15,000.
- Employee training expenses decreased $16,000. Prior year included higher costs for service and sales training for branch and call center personnel.

Income Taxes

Applicable income taxes and effective tax rates were $1,834,000, or 20.3%, for 2010 compared to $623,000, or 12.8%, for 2009. The higher effective tax rate for 2010 is predominately a result of tax-exempt income from loans and securities comprising a lower proportion of pre-tax income. For a more comprehensive analysis of income tax expense and deferred taxes, refer to Note 11 in the Notes to Consolidated Financial Statements.

Financial Condition

Financial service organizations are challenged to demonstrate they can generate sustainable and consistent earnings growth in a dynamic operating environment. This challenge was evident in 2010 and 2009 as financial institutions, including QNB, had to operate in an unprecedented economic environment which included a global recession, the freeze up in credit markets, the bursting of the housing bubble, significant volatility in the equity markets and historically low interest rates. While the economy is showing signs of improvement, a challenging economic environment is anticipated to continue in 2011. QNB operates in an attractive but highly competitive market for financial services. Competition comes in many forms including other local community banks, regional banks, national financial institutions and credit unions, all with a physical presence in the markets we serve. In addition, other strong forms of competition have emerged, such as internet banks. The internet has enabled customers to "rate shop" financial institutions throughout the nation, both for deposits and retail loans. QNB has been able to compete effectively by emphasizing a consistently high level of customer service, including local decision-making on loans and by providing a broad range of high quality financial products designed to address the specific needs of our customers. The establishment of long-term customer relationships and customer loyalty remain our primary focus.

Total assets at December 31, 2010 were $809,260,000, an increase of $46,834,000, or 6.1%, when compared with total assets of $762,426,000 at December 31, 2009. The growth in total assets since December 31, 2009 was centered in loans receivable and investment securities which increased $32,761,000 and $33,022,000, respectively. Partially offsetting these increases was a $15,744,000 decrease in interest-bearing deposits in banks, primarily deposits at the Fed. Higher balances were maintained at the Fed at December 31, 2009 compared to December 31, 2010 in anticipation of paying down FHLB advances in January 2010 and for the payment of $4,998,000 of unsettled investment trades. The category of other assets decreased $477,000 from December 31, 2009 to December 31, 2010. Contributing to the decrease in other assets was a reduction in the prepaid FDIC assessment account of $973,000 to $2,236,000 at December 31, 2010 compared to $3,209,000 at December 31, 2009. On September 29, 2009, the FDIC adopted an Amended Restoration Plan. Pursuant to this Plan, the FDIC amended its assessment regulations to require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, as estimated by the FDIC. The assessment paid by the Bank was $3,407,000 and the amount related to 2010 through 2012 was recorded in a prepaid asset account. The remaining prepaid asset will be expensed monthly during the years 2011 and 2012 based on actual FDIC assessment rate calculations. Also included in other assets is a net deferred tax asset of $2,572,000 at December 31, 2010 compared to $1,610,000 at December 31, 2009. The detail of the net deferred tax asset can be found in Footnote 11 in the Notes to the Consolidated Financial Statements.

Funding the growth in assets was an increase in total deposits of $60,874,000, or 9.6%, to $694,977,000 at December 31, 2010. The growth in total deposits reflects increases in core deposits, including interest-bearing demand, money market and savings accounts. Offsetting some of the growth in funding sources from deposits was a reduction in long-term debt of $14,692,000. As noted above $10,000,000 in FHLB borrowings matured and were repaid in January 2010 and in April 2010, $5,000,000 of repurchase agreements matured and were repaid. The category of other liabilities decreased $4,889,000 from December 31, 2009 to December 31, 2010. Included in the December 31, 2009 balance of other liabilities were $4,998,000 of unsettled trades of investment securities. These trades settled in January 2010.

The following discussion will further detail QNB's financial condition during 2010 and 2009.

Investment Portfolio History

December 31,	2010	2009	2008
Investment Securities Available-for-Sale			
U.S. Treasuries	–	$5,013	$5,124
U.S. Government agencies	$66,448	69,731	44,194
State and municipal securities	63,588	54,160	42,300
U.S. Government agencies and sponsored enterprises (GSEs) - residential:			
Mortgage-backed securities	78,801	61,649	67,347
Collateralized mortgage obligations (CMOs)	75,573	61,317	49,067
Other debt securities	2,384	1,533	8,476
Equity securities	3,770	3,459	3,089
Total investment securities available-for-sale	$290,564	$256,862	$219,597
Investment Securities Held-to-Maturity			
State and municipal securities	$2,667	$3,347	$3,598
Total investment securities held-to-maturity	$2,667	$3,347	$3,598
Total investment securities	$293,231	$260,209	$223,195

Investment Securities and Other Short-Term Investments

QNB had interest bearing balances at the Federal Reserve Bank of $6,405,000 at December 31, 2010 compared with $22,125,000 at December 31, 2009. These balances are included in the category of interest bearing deposits in banks. At December 31, 2010 and 2009 QNB had no Federal funds sold. With the decline in the Federal funds rate to between 0.0% and 0.25% the decision was made to maintain excess funds for liquidity purposes at the Fed which was paying 0.25% and carries a 0% risk weighting for risk-based capital calculation purposes. Higher balances were maintained at the Fed at December 31, 2009 compared to December 31, 2010 in anticipation of paying down $10,000,000 in FHLB advances in January 2010 and for the payment of the unsettled investment trades, noted previously.

The total carrying amount of investment securities at December 31, 2010 and 2009 were $293,231,000 and $260,209,000, respectively. For the same periods, approximately 75.3% and 76.0%, respectively, of QNB's investment securities were either U.S. Government, U.S. Government agency debt securities, U.S. Government agency issued mortgage-backed securities or collateralized mortgage obligation securities (CMOs). As of December 31, 2010, QNB held no securities of any one issue or any one issuer (excluding the U.S. Government and its agencies) that were in excess of 10% of shareholders' equity.

In light of the fact that QNB's investment portfolio represents a significant portion of earning assets and interest income, QNB actively manages the portfolio in an attempt to maximize earnings, while considering liquidity needs, interest rate risk and credit risk. Proceeds from the sale of investments were $7,490,000 in 2010 compared to $26,006,000 during 2009. To reduce credit risk in the portfolio QNB has proactively sold over the past two years corporate bonds issued by financial institutions, nonagency issued CMOs and noninvestment grade and nonrated state and municipal bonds. These sales generally resulted in the recording of gains but usually also resulted in the selling of some higher yielding bonds. In addition to the proceeds from the sale of investment securities, proceeds from maturities, calls and prepayments of securities were $131,527,000 in 2010, compared with $88,575,000 in 2009. The significant amount of proceeds in both years reflects the low interest rate environment that has existed for the past two years which resulted in an increase in the amount of bonds called as well as the amount of prepayments on mortgage-backed securities and CMOs. The 2010 and 2009 proceeds along with the increase in deposits were used primarily to fund loan growth and purchase replacement securities. During 2010, $178,411,000 of investment securities were purchased compared with $144,365,000 during 2009.

As a result of this activity and the effort to manage cash flow in the low interest rate environment, the composition of the portfolio changed over the past year. While the portfolio is fairly even split between the four main sectors at December 31, 2010, an effort was made to increase the amount of amortizing securities in anticipation of rising rates. To accomplish this goal the percentage of mortgage-backed securities and CMO's was increased. The balance of mortgage-backed securities increased by $17,152,000 to $78,801,000 at December 31, 2010 and represent 26.9% of the portfolio at December 31, 2010 compared with 23.7% of balances at the end of 2009. The balance of CMOs increased by $14,256,000 to $75,573,000 at December 31, 2010 and represent 25.8% of the portfolio at December 31, 2010, compared with 23.6% at December 31, 2009. QNB continues to purchase Government National Mortgage Association (GNMA) CMOs as these securities qualify for 0% risk-weighting for capital purposes. Municipal bond yields did not decline to the same degree as yields on other types of securities. To take advantage of these higher yields QNB expanded its purchase of tax-exempt state and municipal securities, increasing its holdings by $8,748,000 to represent 22.6% of the portfolio at December 31, 2010, compared with 22.1% at December 31, 2009. When QNB purchases a municipal security it focuses on the credit rating of the underlying issuer not the rating of bond insurer, if present. In contrast to the other three sectors, the balance of U.S. Government agency securities, primarily callable agency bonds decreased from $69,731,000, or 26.8% of the portfolio at the end of 2009, to $66,448,000, or 22.7% of the portfolio at December 31, 2010. With the significant decline in Treasury rates during 2010 and the tightening of spreads, on agency, mortgage and municipal securities, yields on investment securities were anemic during most of 2010. The weighted average yield on the portfolio declined from 4.43% as of December 31, 2009 to 3.79% at December 31, 2010. The decline in yield is the result of an increase in liquidity resulting from deposit growth and a significant increase in cash flow from the investment portfolio as prepayment speeds on mortgage-backed securities and CMOs ramped-up as did the amount of calls of agency and municipal securities. The reinvestment of these funds was generally in securities that had lower yields than what they replaced. It is anticipated that the yield will continue to decline in 2011 as the proceeds from the call and maturity of investment securities continues to be reinvested at lower rates.

Collateralized debt obligations (CDO) are securities derived from the packaging of various assets with many backed by subprime mortgages. These instruments are complex and difficult to value. QNB did a review of its mortgage related securities and concluded that it has minimal exposure to subprime mortgages within its U.S. government sponsored agency (GNMA, FHLMC and FNMA) mortgage-backed and CMO investment portfolio. QNB does not own any non-agency mortgage security or CDO backed by subprime mortgages.

QNB does own CDOs in the form of pooled trust preferred securities. These securities are comprised mainly of securities issued by financial institutions, and to a lesser degree, insurance companies. QNB owns the mezzanine tranches of these securities. These securities are structured so that the senior and mezzanine tranches are protected from defaults by over-collateralization and cash flow default protection provided by subordinated tranches. QNB holds eight of these securities with an amortized cost of $3,640,000 and a fair value of $1,866,000. All of the trust preferred securities are available-for-sale securities and are carried at fair value. During 2010 and 2009, QNB took credit related OTTI charges through the income statement of $277,000 and $1,002,000, respectively. For additional detail on these securities see Note 4 Investment Securities and Note 17 Fair Value Measurements and Fair Values of Financial Instruments.

QNB accounts for its investments by classifying its securities into three categories. Securities that QNB has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses, net of tax, excluded from earnings and reported as a separate component of shareholders' equity. Management determines the appropriate classification of securities at the time of purchase. QNB held no trading securities at December 31, 2010 or 2009.

At December 31, 2010 and 2009, investment securities totaling $133,446,000 and $133,136,000, respectively, were pledged as collateral for repurchase agreements and public deposits.

Investment Portfolio Maturities and Weighted Average Yields

December 31, 2010	Under 1 Year	1-5 Years	5-10 Years	Over 10 Years	Total
Investment Securities Available-for-Sale					
U.S. Government agencies:					
Fair value	–	$ 38,847	$ 27,601	–	$ 66,448
Weighted average yield	–	1.95 %	2.24 %	–	2.07 %
State and municipal securities:					
Fair value	$ 2,937	$ 3,792	$ 14,897	$ 41,962	$ 63,588
Weighted average yield	8.05 %	6.53 %	5.95 %	5.51 %	5.79 %
Mortgage-backed securities:					
Fair value	–	$ 75,664	$ 3,137	–	$ 78,801
Weighted average yield	–	3.80 %	2.93 %	–	3.77 %
Collateralized mortgage obligations (CMOs):					
Fair value	$ 1,960				