QNB CORP
Form 10-Q
November 14, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

OR

¨ 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

QNB Corp.
(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, P.O. Box 9005 Quakertown, PA	18951-9005
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code (215) 538-5600

Not Applicable
Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report.

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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at November 7, 2011
Common Stock, par value $0.625	3,163,304

QNB CORP. AND SUBSIDIARY
FORM 10-Q
QUARTER ENDED SEPTEMBER 30, 2011

INDEX

QNB Corp. and Subsidiary
CONSOLIDATED BALANCE SHEETS

	(in thousands, except share data)	
	(unaudited)	
	September 30, 2011	December 31, 2010
Assets		
Cash and due from banks	$ 10,725	$ 8,498
Interest-bearing deposits in banks	21,711	6,414
Total cash and cash equivalents	32,436	14,912
Investment securities		
Available-for-sale (amortized cost $343,382 and $288,232)	350,410	290,564
Held-to-maturity (fair value $1,897 and $2,729)	1,841	2,667
Restricted investment in bank stocks	1,868	2,176
Loans held-for-sale	-	228
Total loans, net of unearned fees and costs	472,978	482,182
Allowance for loan losses	(8,867)	(8,955)
Net loans	464,111	473,227
Bank-owned life insurance	9,627	9,439
Premises and equipment, net	6,523	6,552
Accrued interest receivable	2,930	2,988
Other assets	5,465	6,507
Total assets	$ 875,211	$ 809,260
Liabilities		
Deposits		
Demand, non-interest bearing	$ 63,674	$ 55,377
Interest-bearing demand	160,911	132,500
Money market	82,442	78,802
Savings	157,880	118,066
Time	187,848	206,629
Time of $100,000 or more	104,385	103,603
Total deposits	757,140	694,977
Short-term borrowings	25,806	29,786
Long-term debt	20,301	20,308
Accrued interest payable	748	1,089
Other liabilities	1,771	2,010
Total liabilities	805,766	748,170
Shareholders' Equity		
Common stock, par value $0.625 per share; authorized 10,000,000 shares; 3,327,873 shares and 3,293,687 shares issued; 3,163,304 and 3,129,118 shares outstanding	2,080	2,059
Surplus	11,437	10,811
Retained earnings	53,766	49,157
Accumulated other comprehensive income, net of tax	4,638	1,539

Treasury stock, at cost; 164,569 shares	(2,476)	(2,476)
Total shareholders' equity	69,445	61,090
Total liabilities and shareholders' equity	$ 875,211	$ 809,260

The accompanying notes are an integral part of the unaudited consolidated financial statements

QNB Corp. and Subsidiary
CONSOLIDATED STATEMENTS OF INCOME

	(in thousands, except share data) (unaudited)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest Income				
Interest and fees on loans	$6,567	$6,847	$19,974	$19,841
Interest and dividends on investment securities:				
Taxable	1,807	1,641	5,341	5,330
Tax-exempt	697	619	2,022	1,794
Interest on interest-bearing balances and other interest income	14	10	31	29
Total interest income	9,085	9,117	27,368	26,994
Interest Expense				
Interest on deposits				
Interest-bearing demand	217	242	613	709
Money market	67	128	245	455
Savings	299	197	881	518
Time	722	1,033	2,306	3,427
Time of $100,000 or more	404	548	1,241	1,771
Interest on short-term borrowings	50	84	163	204
Interest on long-term debt	246	244	731	810
Total interest expense	2,005	2,476	6,180	7,894
Net interest income	7,080	6,641	21,188	19,100
Provision for loan losses	650	1,200	1,750	2,600
Net interest income after provision for loan losses	6,430	5,441	19,438	16,500
Non-Interest Income				
Total other-than-temporary impairment loss on investment securities	(97)	(51)	(97)	(304)
Less: Portion of loss recognized in other comprehensive income (before taxes)	-	-	-	27
Net other-than temporary impairment losses on investment securities	(97)	(51)	(97)	(277)
Net gain on sale of investment securities	65	4	76	299
Net (loss) gain on investment securities	(32)	(47)	(21)	22
Fees for services to customers	363	392	1,037	1,203
ATM and debit card	359	317	1,053	902
Bank-owned life insurance	80	67	270	199
Merchant	85	73	229	205
Net gain on sale of loans	124	81	181	298
Other	103	121	343	334
Total non-interest income	1,082	1,004	3,092	3,163
Non-Interest Expense				

Salaries and employee benefits	2,522	2,409	7,317	6,713
Net occupancy	386	386	1,153	1,115
Furniture and equipment	319	295	942	865
Marketing	165	155	546	515
Third party services	342	263	930	826
Telephone, postage and supplies	141	157	447	456
State taxes	152	143	452	422
FDIC insurance premiums	41	268	579	779
Other	446	402	1,152	1,146
Total non-interest expense	4,514	4,478	13,518	12,837
Income before income taxes	2,998	1,967	9,012	6,826
Provision for income taxes	676	349	2,044	1,419
Net Income	$2,322	$1,618	$6,968	$5,407
Earnings Per Share - Basic	$0.74	$0.52	$2.22	$1.74
Earnings Per Share - Diluted	$0.73	$0.52	$2.21	$1.74
Cash Dividends Per Share	$0.25	$0.24	$0.75	$0.72

The accompanying notes are an integral part of the unaudited consolidated financial statements

QNB Corp. and Subsidiary
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(in thousands, except share data) (unaudited)	Number of Shares Outstanding	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance, December 31, 2010	3,129,118	$ 2,059	$ 10,811	$ 49,157	$ 1,539	$ (2,476)	$ 61,090
Comprehensive income:							
Net income	-	-	-	6,968		-	6,968
Other comprehensive income, net of tax	-	-	-	-	3,099	-	3,099
Total comprehensive income, net of tax							10,067
Cash dividends declared ($0.75 per share)	-	-	-	(2,359)	-	-	(2,359)
Stock issued in connection with dividend reinvestment and stock purchase plan	24,706	15	514	-	-	-	529
Stock issued for employee stock purchase plan	1,971	1	35				36
Stock issued for options exercised	7,509	5	12	-	-	-	17
Tax benefit of stock options exercised	-	-	23	-	-	-	23
Stock-based compensation expense	-	-	42	-	-	-	42
Balance, September 30, 2011	3,163,304	$ 2,080	$ 11,437	$ 53,766	$ 4,638	$ (2,476)	$ 69,445

The accompanying notes are an integral part of the unaudited consolidated financial statements

QNB Corp. and Subsidiary
CONSOLIDATED STATEMENTS OF CASH FLOWS

	(in thousands) (unaudited)	
Nine Months Ended September 30,	2011	2010
Operating Activities		
Net income	$6,968	$5,407
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	609	606
Provision for loan losses	1,750	2,600
Net losses (gains) on investment securities available-for-sale	21	(22)
Net loss on sale of repossessed assets	3	6
Net gain on sale of loans	(181)	(298)
Loss on disposal of premises and equipment	2	1
Proceeds from sales of residential mortgages held-for-sale	5,915	7,057
Origination of residential mortgages held-for-sale	(5,506)	(7,193)
Income on bank-owned life insurance	(270)	(199)
Stock-based compensation expense	42	36
Deferred income tax provision (benefit)	107	(707)
Net (decrease) increase in income taxes payable	(2)	85
Net decrease (increase) in accrued interest receivable	58	(120)
Amortization of mortgage servicing rights and change in valuation allowance	84	73
Net amortization of premiums and discounts on investment securities	1,070	756
Net decrease in accrued interest payable	(341)	(391)
Decrease in other assets	39	892
Decrease in other liabilities	(240)	(271)
Net cash provided by operating activities	10,128	8,318
Investing Activities		
Proceeds from maturities and calls of investment securities		
available-for-sale	92,427	99,037
held-to-maturity	825	500
Proceeds from the sale of investment securities		
available-for-sale	28,272	3,476
Purchases of investment securities		
available-for-sale	(176,940)	(126,568)
Proceeds from redemption of investment in restricted bank stock	308	-
Net decrease (increase) in loans	6,452	(29,338)
Redemption of Bank Owned Life Insurance investment	95	-
Net purchases of premises and equipment	(582)	(865)
Proceeds from sales of repossessed assets	117	183
Net cash used by investing activities	(49,026)	(53,575)
Financing Activities		
Net increase (decrease) in non-interest bearing deposits	8,297	(830)
Net increase in interest-bearing deposits	53,866	40,974
Net (decrease) increase in short-term borrowings	(3,980)	2,740
Proceeds from issuance of long-term debt	-	311
Repayments of long-term debt	(7)	(15,000)
Tax benefit from exercise of stock options	23	-

Cash dividends paid, net of reinvestment	(2,172)	(2,119)
Proceeds from issuance of common stock	395	248
Net cash provided by financing activities	56,422	26,324
Increase (decrease) in cash and cash equivalents	17,524	(18,933)
Cash and cash equivalents at beginning of year	14,912	30,999
Cash and cash equivalents at end of period	$32,436	$12,066
Supplemental Cash Flow Disclosures		
Interest paid	$6,521	$9,777
Income taxes paid	1,915	909
Non-cash transactions		
Transfer of loans to repossessed assets or other real estate owned	914	615

The accompanying notes are an integral part of the unaudited consolidated financial statements

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements include the accounts of QNB Corp. and its wholly-owned subsidiary, QNB Bank (the Bank). The consolidated entity is referred to herein as “QNB” or the “Company”. All significant intercompany accounts and transactions are eliminated in the consolidated financial statements.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in QNB's 2010 Annual Report incorporated in the Form 10-K. Operating results for the three and nine-month periods ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The unaudited consolidated financial statements reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the results of operations for the interim periods and are of a normal and recurring nature. Certain items in the 2010 consolidated financial statements have been reclassified to conform to the 2011 financial statement presentation format.

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

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from such estimates.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2011, for items that should potentially be recognized or disclosed in these financial statements.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In April 2011, the FASB issued ASU No. 2011-02 Receivables (Topic 310) — A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring. The troubled debt restructuring (TDR) guidance clarifies whether loan modifications constitute TDRs, includes factors and examples for creditors to consider in evaluating whether a restructuring results in a delay in payment that is insignificant, prohibits creditors from using the borrower’s effective rate test to evaluate whether a concession has been granted to the borrower, and adds factors for creditors to use in determining whether a borrower is experiencing financial difficulties. A provision in the guidance also ends the FASB’s deferral of the additional disclosures about TDRs. The provisions of this guidance are effective for the first interim and annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The adoption of the guidance did not have a material impact on the consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-03 Transfers and Servicing (Topic 860) — Reconsideration of Effective Control for Repurchase Agreements. Under the amended guidance, a transferor maintains effective control over transferred financial assets if there is an agreement that both entitles and obligates the transferor to repurchase the financial assets before maturity. In addition, the following requirements must be met: (a) the financial asset to be repurchased or redeemed is the same or substantially the same as those transferred, (b) the agreement is to repurchase or redeem the transferred financial asset before maturity at a fixed or determinable price, and (c) the agreement is entered into contemporaneously with, or in contemplation of the transfer. This guidance is effective prospectively for transactions, or modifications of existing transactions, that occur on or after the first interim or annual period beginning on or after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company's consolidated financial statements.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

2. RECENT ACCOUNTING PRONOUNCEMENTS (Continued)

In May 2011, the FASB issued ASU 2011-04 Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU amends FASB ASC Topic 820, Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The ASU clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholders' equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The ASU also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The ASU also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. This ASU is effective for the Company for interim and annual periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05 Presentation of Comprehensive Income. The provisions of this ASU amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The ASU prohibits the presentation of the components of comprehensive income in the statement of stockholders' equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate statements of net income and other comprehensive income. Under previous GAAP, all three presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this ASU are effective for the Company for fiscal years and interim periods beginning after December 31, 2011 and the required presentation will be included in those filings.

3. STOCK-BASED COMPENSATION AND SHAREHOLDERS' EQUITY

QNB sponsors stock-based compensation plans, administered by a committee, under which both qualified and non-qualified stock options may be granted periodically to certain employees. Compensation cost has been measured using the fair value of an award on the grant date and is recognized over the service period, which is usually the vesting period.

Stock-based compensation expense was approximately $13,000 and $11,000 for the three months ended September 30, 2011 and 2010, respectively, and $42,000 and $36,000 for the nine months ended September 30, 2011 and 2010, respectively. As of September 30, 2011, there was approximately $78,000 of unrecognized compensation cost related to unvested share-based compensation award grants that is expected to be recognized over the next 35 months.

Options are granted to certain employees at prices equal to the market value of the stock on the date the options are granted. The 1998 Plan authorized the issuance of 220,500 shares. The time period during which any option is exercisable under the Plan is determined by the committee but shall not commence before the expiration of six months after the date of grant or continue beyond the expiration of ten years after the date the option is awarded. The granted options vest ratably over a three-year period. As of September 30, 2011, there were 225,058 options granted, 28,444 options forfeited, 114,414 options exercised and 82,200 options outstanding under this Plan. The 1998 Plan expired on March 10, 2008, therefore no further options can be granted under this Plan.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

3. STOCK-BASED COMPENSATION AND SHAREHOLDERS' EQUITY (Continued)

The 2005 Plan authorizes the issuance of 200,000 shares. The terms of the 2005 Plan are identical to the 1998 Plan, except options expire five years after the grant date. As of September 30, 2011, there were 103,200 options granted, 29,125 options forfeited and 74,075 options outstanding under this Plan. The 2005 Plan expires March 15, 2015.

The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the option and each vesting date. QNB estimated the fair value of stock options on the date of the grant using the Black-Scholes option pricing model. The model requires the use of numerous assumptions, many of which are highly subjective in nature.

The following assumptions were used in the option pricing model in determining the fair value of options granted during the nine months ended September 30:

Options granted	2011	2010
Risk-free interest rate	1.84 %	2.19 %
Dividend yield	4.96	5.26
Volatility	30.04	27.77
Expected life (years)	5.00	5.00

The risk-free interest rate was selected based upon yields of U.S. Treasury issues with a term equal to the expected life of the option being valued. Historical information was the primary basis for the selection of the expected dividend yield, expected volatility and expected lives of the options.

The fair market value of options granted in the first nine months of 2011 and 2010 was $3.31 and $2.55, respectively.

Stock option activity during the nine months ended September 30, 2011 is as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in yrs.)	Aggregate intrinsic value
Outstanding at January 1, 2011	170,515	$ 21.60		
Exercised	(18,940)	14.12		
Forfeited	(14,800)	26.00		
Granted	19,500	20.27		
Outstanding at September 30, 2011	156,275	$ 21.93	2.1	$ 316
Exercisable at September 30, 2011	105,725	$ 23.55	1.5	$ 165

4. SHARE REPURCHASE PLAN

The Board of Directors has authorized the repurchase of up to 100,000 shares of its common stock in open market or privately negotiated transactions. The repurchase authorization does not bear a termination date. There were no shares repurchased during the nine months ended September 30, 2011. As of September 30, 2011, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. EARNINGS PER SHARE

The following sets forth the computation of basic and diluted earnings per share:

	For the Three Months Ended September 30, 2011	2010	For the Nine Months Ended September 30, 2011	2010
Numerator for basic and diluted earnings per share - net income	$ 2,322	$ 1,618	$ 6,968	$ 5,407
Denominator for basic earnings per share - weighted average shares outstanding	3,154,529	3,108,535	3,144,711	3,101,025
Effect of dilutive securities - employee stock options	14,402	14,727	14,109	11,714
Denominator for diluted earnings per share – adjusted weighted average shares outstanding	3,168,931	3,123,262	3,158,820	3,112,739
Earnings per share-basic	$ 0.74	$ 0.52	$ 2.22	$ 1.74
Earnings per share-diluted	$ 0.73	$ 0.52	$ 2.21	$ 1.74

There were 61,350 stock options that were anti-dilutive for both the three and nine-month periods ended September 30, 2011. There were 113,700 and 128,100 stock options that were anti-dilutive for the three and nine-month periods ended September 30 2010, respectively. These stock options were not included in the above calculation.

6. COMPREHENSIVE INCOME

For QNB, the sole component of other comprehensive income is the unrealized holding gains and losses on available-for-sale investment securities.

The following shows the components and activity of comprehensive income during the periods ended September 30, 2011 and 2010:

Three Months Ended	September 30, 2011	September 30, 2010
Unrealized holding gains arising during the period	$ 2,281	$ 789
Reclassification adjustment for gains included in net income	(65)	(4)
Reclassification adjustment for OTTI losses included in net income	97	51
Net unrealized gains	2,313	836
Tax effect	(787)	(284)
Other comprehensive income, net of tax	1,526	552
Net income	2,322	1,618
Total comprehensive income, net of tax	$ 3,848	$ 2,170

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

6. COMPREHENSIVE INCOME (Continued)

Nine Months Ended	September 30, 2011	September 30, 2010
Unrealized holding gains arising during the period	$ 4,675	$ 4,088
Unrealized losses related to factors other than credit arising during the period	-	(27)
Reclassification adjustment for gains included in net income	(76)	(299)
Reclassification adjustment for OTTI losses included in net income	97	304
Net unrealized gains	4,696	4,066
Tax effect	(1,597)	(1,382)
Other comprehensive income, net of tax	3,099	2,684
Net income	6,968	5,407
Total comprehensive income, net of tax	$ 10,067	$ 8,091

7. INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities available-for-sale at September 30, 2011 and December 31, 2010 were as follows:

Available-for-Sale
September 30, 2011

	Fair value	Gross unrealized holding gains	Gross unrealized holding losses	Amortized cost
U.S. Government agency securities	$64,512	$672	$44	$63,884
State and municipal securities	78,330	2,208	62	76,184
U.S. Government agencies and sponsored enterprises (GSEs) - residential:				
Mortgage-backed securities	111,586	3,587	24	108,023
Collateralized mortgage obligations (CMOs)	89,162	2,211	-	86,951
Other debt securities	3,378	50	1,763	5,091
Equity securities	3,442	349	156	3,249
Total investment securities available-for-sale	$350,410	$9,077	$2,049	$343,382

December 31, 2010

	Fair value	Gross unrealized holding gains	Gross unrealized holding losses	Amortized cost
U.S. Government agency securities	$66,448	$241	$869	$67,076

State and municipal securities	63,588	675	514	63,427
U.S. Government agencies and sponsored enterprises (GSEs) - residential:				
Mortgage-backed securities	78,801	2,438	311	76,674
Collateralized mortgage obligations (CMOs)	75,573	1,890	137	73,820
Other debt securities	2,384	69	1,774	4,089
Equity securities	3,770	667	43	3,146
Total investment securities available-for-sale	$290,564	$5,980	$3,648	$288,232

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at September 30, 2011 are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities are assigned to categories based on contractual maturity except for mortgage-backed securities and CMOs which are based on the estimated average life of these securities.

	Fair value	Amortized cost
Due in one year or less	$ 17,313	$ 16,891
Due after one year through five years	228,690	222,889
Due after five years through ten years	46,789	45,959
Due after ten years	54,176	54,394
Equity securities	3,442	3,249
Total investment securities available-for-sale	$ 350,410	$ 343,382

Proceeds from sales of investment securities available-for-sale were $28,272,000 and $3,476,000 for the nine months ended September 30, 2011 and 2010, respectively.

At September 30, 2011 and December 31, 2010, investment securities available-for-sale totaling $173,095,000 and $133,446,000, respectively, were pledged as collateral for repurchase agreements and deposits of public funds.

The following table presents information related to the Company's gains and losses on the sales of equity and debt securities, and losses recognized for the other-than-temporary impairment of these investments. Gains and losses on available-for-sale securities are computed on the specific identification method and included in non-interest income. Gross realized losses on equity and debt securities are net of other-than-temporary impairment charges:

Nine months ended September 30, 2011:

	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Net gains (losses)
Equity securities	$ 140	$ -	$ (97)	$ 43
Debt securities	314	(378)	-	(64)
Total	$ 454	$ (378)	$ (97)	$ (21)

Nine months ended September 30, 2010:

	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Net gains (losses)

Equity securities	$ 287	$ -	$ -	$ 287
Debt securities	14	(2)	(277)	(265)
Total	$ 301	$ (2)	$ (277)	$ 22

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

All other-than-temporary impairment (OTTI) writedowns on debt securities were on pooled trust preferred securities, which are included in the other debt securities category, held at the Bank.

The tax benefit applicable to the net realized losses was $7,000 for the nine months ended September 30, 2011. The tax expense applicable to the net realized gains was $7,000 for the nine months ended September 30, 2010.

QNB recognizes OTTI for debt securities classified as available-for-sale in accordance with FASB ASC 320, Investments – Debt and Equity Securities, which requires that we assess whether we intend to sell or it is more likely than not that the Company will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell prior to recovery of our amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows discounted at the security's effective yield. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and, therefore, is not required to be recognized as a loss in the income statement, but is recognized in other comprehensive income. For equity securities, once a decline in value is determined to be other-than-temporary, the value of the equity security is reduced to fair value and a corresponding charge to earnings is recognized. QNB believes that we will fully collect the carrying value of securities on which we have recorded a non-credit related impairment in other comprehensive income.

The table below presents a rollforward of the credit loss component recognized in earnings. The credit loss component of the amortized cost represents the difference between the present value of expected future cash flows and the amortized cost basis of the security prior to considering credit losses. The beginning balance represents the credit loss component for debt securities for which OTTI occurred prior to January 1, 2011. Credit-impaired debt securities must be presented in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). No credit impairments were recognized in 2011. If we sell, intend to sell or believe we will be required to sell previously credit-impaired debt securities, the credit loss component would be reduced. The following table presents a summary of the cumulative credit-related other-than-temporary impairment charges recognized as components of earnings for debt securities still held by QNB:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Balance, beginning of period	$ 1,279	$ 1,279
Additions:		
Initial credit impairments	-	-
Subsequent credit impairments	-	-
Balance, end of period	$ 1,279	$ 1,279

The amortized cost and estimated fair values of investment securities held-to-maturity at September 30, 2011 and December 31, 2010 were as follows:

Held-To-Maturity

	September 30, 2011				December 31, 2010			
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
State and municipal securities	$1,841	$ 56	-	$1,897	$2,667	$ 62	-	$2,729

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

The amortized cost and estimated fair value of securities held-to-maturity by contractual maturity at September 30, 2011 are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Fair value	Amortized cost
Due in one year or less	$ 510	$ 501
Due after one year through five years	-	-
Due after five years through ten years	1,387	1,340
Due after ten years	-	-
Total investment securities held-to-maturity	$ 1,897	$ 1,841

There were no sales of investment securities classified as held-to-maturity during the nine months ended September 30, 2011 or 2010.

The following table indicates the length of time individual securities have been in a continuous unrealized loss position at September 30, 2011 and December 31, 2010:

September 30, 2011

		Less than 12 months		12 months or longer		Total	
	No. of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government agency securities	6	$ 7,954	$ 44	-	-	$ 7,954	$ 44
State and municipal securities	14	7,561	62	-	-	7,561	62
Mortgage-backed securities	5	9,078	24	-	-	9,078	24
Other debt securities	6	-	-	$ 1,576	$ 1,763	1,576	1,763
Equity	11	1,153	131	131	25	1,284	156
Total	42	$ 25,746	$ 261	$ 1,707	$ 1,788	$ 27,453	$ 2,049

December 31, 2010

		Less than 12 months		12 months or longer		Total	
	No. of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government agency securities	30	$ 40,179	$ 869	-	-	$ 40,179	$ 869
State and municipal securities	40	19,207	482	$ 468	$ 32	19,675	514

Mortgage-backed securities	19	21,999	311	-	-	21,999	311
Collateralized mortgage obligations (CMOs)	7	6,918	137	-	-	6,918	137
Other debt securities	7	-	-	1,866	1,774	1,866	1,774
Equity securities	5	740	43	-	-	740	43
Total	108	$ 89,043	$ 1,842	$ 2,334	$ 1,806	$ 91,377	$ 3,648

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

Management evaluates debt securities, which are comprised of U.S. Government Agencies, state and municipalities, mortgage-backed securities, CMOs and other issuers, for other-than-temporary impairment and considers the current economic conditions, the length of time and the extent to which the fair value has been less than cost, interest rates and the bond rating of each security. The unrealized losses at September 30, 2011 in U.S. Government securities, state and municipal securities, mortgage-backed securities and CMOs are primarily the result of interest rate fluctuations. If held to maturity, these bonds will mature at par, and QNB will not realize a loss. The Company has the intent to hold the securities and does not believe it will be required to sell the securities before recovery occurs.

All of the securities in the other debt securities category with unrealized losses longer than twelve months as of September 30, 2011 are pooled trust preferred security issues. QNB holds eight of these securities with an amortized cost of $3,640,000 and a fair value of $1,878,000. All of the pooled trust preferred securities are available-for-sale securities and are carried at fair value.

The following table provides additional information related to pooled trust preferred securities (PreTSLs) as of September 30, 2011:

Deal	Class	Book value	Fair value	Unrealized gains (losses)	Realized OTTI credit loss (YTD 2011)	Total Recognized OTTI Credit Loss	Moody's /Fitch ratings	Current number of performing banks	Current number of performing insurance companies	Actual deferrals and defaults as a % of total collateral	Total performing collateral as a % of outstanding bonds
PreTSL IV	Mezzanine*	$ 243	$ 204	$ (39)	$ -	$ (1)	Ca/CCC	4	-	27.1 %	124.2 %
PreTSL V	Mezzanine*	-	-	-	-	(118)	Ba3/D	-	-	100.0 %	11.9 %
PreTSL VI	Mezzanine*	121	110	(11)	-	(8)	Ca/D	3	-	73.6 %	62.3 %
PreTSL XVII	Mezzanine	752	258	(494)	-	(222)	Ca/C	31	4	40.4 %	71.8 %
PreTSL XIX	Mezzanine	988	443	(545)	-	-	C/C	38	13	27.5 %	81.7 %
PreTSL XXV	Mezzanine	766	333	(433)	-	(222)	C/C	40	8	34.1 %	75.3 %
PreTSL XXVI	Mezzanine	469	228	(241)	-	(270)	C/C	38	10	28.3 %	82.4 %
PreTSL XXVI	Mezzanine	301	302	1	-	(438)	C/C	38	10	28.3 %	82.4 %
		$ 3,640	$ 1,878	$ (1,762)	$ -	$ (1,279)					

Mezzanine* - only class of bonds still outstanding (represents the senior-most obligation of the trust)

The market for these securities at September 30, 2011 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. The new issue market is also inactive and the market values for these securities (and any securities other than those issued or guaranteed by U.S. Government agencies) are depressed relative to historical levels. In today's market, a low market price for a particular bond may only provide evidence of a recent widening of corporate spreads in general versus being an indicator of credit problems with a particular issuer. Lack of liquidity in the market for trust preferred collateralized debt obligations, credit rating downgrades and market uncertainties related to the financial industry are all factors contributing to the temporary impairment of these securities. Although these securities are classified as available-for-sale, the Company has the intent to hold the securities and does not believe it will be required to sell the securities before recovery occurs. As illustrated in the table above, these securities are comprised mainly of securities issued by banks, and to a lesser degree, insurance companies. QNB owns the mezzanine tranches of these securities.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

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. 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. In the nine months ended September 30, 2011, no other-than-temporary impairment charges representing credit impairment were recognized on our pooled trust preferred collateralized debt obligations. A discounted cash flow analysis provides the best estimate of credit related OTTI for these securities. Additional information related to this analysis follows:

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 ASC 325 (formerly known as EITF 99-20), Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to be Held by a Transferor in Securitized Financial Assets, and Amendments to the Impairment Guidance of EITF Issue No. 99-20 (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.

Results of a discounted cash flow test are significantly affected by other variables such as the estimate of future cash flows (including prepayments), credit worthiness of the underlying banks and insurance companies and determination of probability and severity of default of the underlying collateral. The following provides additional information for each of these variables:

- Estimate of Future Cash Flows – Cash flows are constructed in an INTEX desktop valuation model. INTEX is a proprietary cash flow model recognized as the industry standard for analyzing all types of structured debt products. It includes each deal’s structural features updated with trustee information, including asset-by-asset detail, as it becomes available. The modeled cash flows are then used to determine if all the scheduled principal and interest payments of the investments will be returned. For purposes of the cash flow analysis, relatively modest rates of prepayment were forecasted (ranging from 0-2%). In addition to the base prepayment assumption, due to the recent enactment of the Dodd-Frank financial legislation additional prepayment analysis was performed. First, all fixed-rate trust preferred securities issued by banks with more than $15 billion in total assets at December 31, 2009 were identified. Next the holding companies’ approximate cost of long-term funding given their rating and marketplace interest rates was estimated. The following assumption was made; any holding company that could refinance for a cost savings of more than 2% will refinance and will do so on January 1, 2013, or July 1, 2015 for bank holding company subsidiaries of foreign banking organizations that have relied on Supervision and Regulation Letter SR-01-1.
- Credit Analysis – A quarterly credit evaluation is performed for the companies comprising the collateral across the various pooled trust preferred securities. This credit evaluation considers all available evidence and focuses on

capitalization, asset quality, profitability, liquidity, stock price performance, whether the institution has received TARP funding and whether the institution has shown the ability to raise capital.

- Probability of Default – A near-term probability of default is determined for each issuer based on its financial condition and is used to calculate the expected impact of future deferrals and defaults on the expected cash flows. Each issuer in the collateral pool is assigned a near-term probability of default based on individual performance and financial characteristics. Various studies suggest that the rate of bank failures between 1934 and 2008 were approximately 0.36%. Thus, in addition to the specific bank default assumptions used for the near term, future defaults on the individual banks in the analysis are assumed at 0.75% for 2012 (approximately two times historical levels) and for 2013 and beyond the rate used is calculated using the above mentioned thirty-six basis points and factoring that number based on a comparison of key financial ratios of active individual issuers without a short-term probability of default compared to all FDIC insured banks.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. INVESTMENT SECURITIES (Continued)

- Severity of Loss – In addition to the probability of default discussed above, a severity of loss (projected recovery) is determined in all cases. In the current analysis, the severity of loss ranges from 0% to 100% depending on the estimated credit worthiness of the individual issuer, with a 95% severity of loss utilized for defaults projected in 2012 and thereafter.

In addition to the above factors, the evaluation of impairment also includes a stress test analysis which provides an estimate of future risk for each tranche. This stressed breakpoint is then compared to the level of assets with credit concerns in each tranche. This comparison allows management to identify those pools that are at a greater risk for a future adverse change in cash flows so the asset quality in those pools can be monitored more closely for potential deterioration of credit quality.

Based upon the analysis performed by management as of September 30, 2011, it is probable that we will collect all contractual principal and interest payments on one of our eight pooled trust preferred securities, PreTSL XIX. The expected principal shortfall on the remaining pooled trust preferred securities has resulted in credit related other-than-temporary impairment charges in previous years. All of these pooled trust preferred securities held by QNB could be subject to additional writedowns in the future if additional deferrals and defaults occur.

8. LOANS & ALLOWANCE FOR LOAN LOSSES

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at the principal amount outstanding, net of deferred loan fees and costs. Interest income is accrued on the principal amount outstanding. Loan origination and commitment fees and related direct costs are deferred and amortized to income over the term of the respective loan and loan commitment period as a yield adjustment.

Loans held-for-sale consist of residential mortgage loans and are carried at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recognized through a valuation allowance charged to income. Gains and losses on residential mortgages held-for-sale are included in non-interest income.

QNB maintains an allowance for loan losses, which is intended to absorb probable known and inherent losses in the outstanding loan portfolio. The allowance is reduced by actual credit losses and is increased by the provision for loan losses and recoveries of previous losses. The provisions for loan losses are charged to earnings to bring the total allowance for loan losses to a level considered necessary by management.

The allowance for loan losses is based on management’s continuing review and evaluation of the loan portfolio. The level of the allowance is determined by assigning specific reserves to individually identified problem credits and general reserves to all other loans. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value) of the impaired loan is lower than the carrying value of that loan. The portion of the allowance that is allocated to internally criticized and non-accrual loans is determined by estimating the inherent loss on each credit after giving consideration to the value of underlying collateral. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates. These loss rates are based on a three year history of charge-offs and are more heavily weighted for recent experience for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

1. Lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices. Effect of external factors, such as legal and regulatory requirements.
2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.
3. Nature and volume of the portfolio including growth.
4. Experience, ability, and depth of lending management and staff.
5. Volume and severity of past due, classified and nonaccrual loans.
6. Quality of the Company's loan review system, and the degree of oversight by the Company's Board of Directors.
7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized in order to assess and monitor the degree of risk in the loan portfolio. QNB's lending and credit administration staff are charged with reviewing the loan portfolio and identifying changes in the economy or in a borrower's circumstances which may affect the ability to repay debt or the value of pledged collateral. A loan classification and review system exists that identifies those loans with a higher than normal risk of uncollectibility. Each commercial loan is assigned a grade based upon an assessment of the borrower's financial capacity to service the debt and the presence and value of collateral for the loan. An independent loan review group tests risk assessments and evaluates the adequacy of the allowance for loan losses. Management meets monthly to review the credit quality of the loan portfolio and quarterly to review the allowance for loan losses.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review QNB's allowance for loan losses. Such agencies may require QNB to recognize additions to the allowance based on their judgments using information available to them at the time of their examination.

Management believes that it uses the best information available to make determinations about the adequacy of the allowance and that it has established its existing allowance for loan losses in accordance with GAAP. If circumstances differ substantially from the assumptions used in making determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be affected. Because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that increases to the allowance will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

Major classes of loans are as follows:

	September 30, 2011	December 31, 2010
Commercial:		
Commercial and industrial	$ 85,104	$ 86,628
Construction	14,925	18,611
Secured by commercial real estate	196,952	199,874
Secured by residential real estate	45,690	44,444
State and political subdivisions	31,519	31,053
Indirect lease financing	12,029	12,995
Retail:		
1-4 family residential mortgages	25,050	23,127
Home equity loans and lines	59,274	62,726
Consumer	2,468	2,751
Total loans	473,011	482,209
Net unearned fees	(33)	(27)
Loans receivable	$ 472,978	$ 482,182

Loans secured by commercial real estate include all loans collateralized at least in part by commercial real estate. These loans may not be for the expressed purpose of conducting commercial real estate transactions.

Overdrafts are reclassified as loans and are included in consumer loans above and total loans on the balance sheet. At September 30, 2011 and December 31, 2010, overdrafts were $127,000 and $93,000, respectively.

QNB generally lends in its trade area which is comprised of Quakertown and the surrounding communities. To a large extent, QNB makes loans collateralized at least in part by real estate. Its lending activities could be affected by changes in the general economy, the regional economy, or real estate values. Other than disclosed in the table above, at September 30, 2011, there were no concentrations of loans exceeding 10% of total loans.

The Company engages in a variety of lending activities, including commercial, residential real estate and consumer transactions. The Company focuses its lending activities on individuals, professionals and small to medium sized businesses. Risks associated with lending activities include economic conditions and changes in interest rates, which can adversely impact both the ability of borrowers to repay their loans and the value of the associated collateral.

Commercial and industrial loans, commercial real estate loans, construction loans and residential real estate loans with a business purpose are generally perceived as having more risk of default than residential real estate loans with a personal purpose and consumer loans. These types of loans involve larger loan balances to a single borrower or groups of related borrowers and are more susceptible to a risk of loss during a downturn in the business cycle. These loans may involve greater risk because the availability of funds to repay these loans depends on the successful operation of the borrower’s business. The assets financed are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets, such as accounts receivable and inventory, to cash. Typical collateral for commercial and industrial loans includes the borrower’s accounts receivable, inventory and machinery and equipment. Commercial real estate and residential real estate loans secured for a business purpose are originated primarily within the eastern Pennsylvania market area at conservative loan-to-value ratios and often backed by the individual guarantees of the borrowers or owners. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. Commercial real estate loans may be affected to a greater extent than residential loans by adverse conditions in real estate markets or the economy because commercial real estate borrowers’ ability to repay their loans depends on successful development of their properties, as well as the factors affecting residential real estate borrowers.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

Loans to state and political subdivisions are tax-exempt or taxable loans to municipalities, school districts and housing and industrial development authorities. These loans can be general obligations of the municipality or school district repaid through their taxing authority, revenue obligations repaid through the income generated by the operations of the authority, such as a water or sewer authority, or loans issued to a housing and industrial development agency, for which a private corporation is responsible for payments on the loans.

Indirect lease financing receivables represent loans to small businesses that are collateralized by equipment. These loans tend to have higher risk characteristics but generally provide higher rates of return. These loans are originated by a third party and purchased by QNB based on criteria specified by QNB. The criteria include minimum credit scores of the borrower, term of the lease, type and age of equipment financed and geographic area. The geographic area primarily represents states contiguous to Pennsylvania. QNB is not the lessor and does not service these loans.

The Company originates fixed-rate and adjustable-rate real estate-residential mortgage loans for personal purposes that are secured by first liens on the underlying 1-4 family residential properties. Credit risk exposure in this area of lending is minimized by the evaluation of the credit worthiness of the borrower, including debt-to-income ratios, credit scores and adherence to underwriting policies that emphasize conservative loan-to-value ratios of generally no more than 80%. Residential mortgage loans granted in excess of the 80% loan-to-value ratio criterion are generally insured by private mortgage insurance.

The real estate-home equity portfolio consists of fixed-rate home equity loans and variable-rate home equity lines of credit. Risks associated with loans secured by residential properties are generally lower than commercial loans and include general economic risks, such as the strength of the job market, employment stability and the strength of the housing market. Since most loans are secured by a primary or secondary residence, the borrower's continued employment is the greatest risk to repayment.

The Company offers a variety of loans to individuals for personal and household purposes. Consumer loans are generally considered to have greater risk than first or second mortgages on real estate because they may be unsecured, or, if they are secured, the value of the collateral may be difficult to assess and is more likely to decrease in value than real estate. Credit risk in this portfolio is controlled by conservative underwriting standards that consider debt-to-income levels and the creditworthiness of the borrower and, if secured, collateral values.

The Company employs an eight (8) grade risk rating system related to the credit quality of commercial loans, loans to state and political subdivisions and indirect lease financing of which the first four categories are pass categories (credits not adversely rated). The following is a description of the internal risk ratings and the likelihood of loss related to each risk rating.
1 - Excellent - no apparent risk
2 - Good - minimal risk
3 - Acceptable - average risk
4 - Watch List - greater than average risk
5 - Special Mention - potential weaknesses
6 - Substandard - well defined weaknesses
7 - Doubtful - full collection unlikely

8 - Loss - considered uncollectible

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

The Company maintains a loan review system, which allows for a periodic review of our loan portfolio and the early identification of potential problem loans. Each loan officer assigns a rating to all loans in the portfolio at the time the loan is originated. Loans with risk ratings of one through three are reviewed annually based on the borrower's fiscal year. Loans with risk ratings of four are reviewed every six to twelve months based on the dollar amount of the relationship with the borrower. Loans with risk ratings of five through eight are reviewed at least quarterly, and as often as monthly, at management's discretion. The Company also utilizes an outside loan review firm to review the portfolio on a semi-annual basis to provide the Board of Directors and senior management an independent review of the Bank's loan portfolio on an ongoing basis. These reviews are designed to recognize deteriorating credits in their earliest stages in an effort to reduce and control risk in the lending function as well as identifying potential shifts in the quality of the loan portfolio. The examinations by the outside loan review firm include the review of lending activities with respect to underwriting and processing new loans, monitoring the risk of existing loans and to provide timely follow-up and corrective action for loans showing signs of deterioration in quality. In addition, the outside firm reviews the methodology for the allowance for loan losses to determine compliance to policy and regulatory guidance.

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of September 30, 2011 and December 31, 2010:

September 30, 2011	Pass	Special mention	Substandard	Doubtful	Total
Commercial:					
Commercial and industrial	$ 71,362	$ 1,565	$ 12,134	$ 43	$ 85,104
Construction	6,151	4,073	4,701	-	14,925
Secured by commercial real estate	154,354	6,282	35,865	451	196,952
Secured by residential real estate	40,847	1,185	3,658	-	45,690
State and political subdivisions	29,087	2,280	152	-	31,519
Indirect lease financing	11,609	-	420	-	12,029
	$ 313,410	$ 15,385	$ 56,930	$ 494	$ 386,219

December 31, 2010	Pass	Special mention	Substandard	Doubtful	Total
Commercial:					
Commercial and industrial	$ 74,315	$ 1,378	$ 10,878	$ 57	$ 86,628
Construction	9,888	5,993	2,730	-	18,611
Secured by commercial real estate	154,697	6,537	37,942	698	199,874
Secured by residential real estate	39,823	1,038	3,583	-	44,444
State and political subdivisions	28,649	2,338	66	-	31,053
Indirect lease financing	12,460	-	535	-	12,995
	$ 319,832	$ 17,284	$ 55,734	$ 755	$ 393,605

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

For retail loans, the Company evaluates credit quality based on the performance of the individual credits. The following tables present the recorded investment in the retail classes of the loan portfolio based on payment activity as of September 30, 2011 and December 31, 2010:

September 30, 2011	Performing	Non-performing	Total
Retail:			
1-4 family residential mortgages	$ 24,518	$ 532	$ 25,050
Home equity loans and lines	58,905	369	59,274
Consumer	2,468	-	2,468
	$ 85,891	$ 901	$ 86,792

December 31, 2010	Performing	Non-performing	Total
Retail:			
1-4 family residential mortgages	$ 22,694	$ 433	$ 23,127
Home equity loans and lines	62,581	145	62,726
Consumer	2,751	-	2,751
	$ 88,026	$ 578	$ 88,604

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of September 30, 2011 and December 31, 2010:

September 30, 2011	30-59 days past due	60-89 days past due	>90 days past due	Total past due loans	Current	Total loans receivable
Commercial:						
Commercial and industrial	$ 28	$ 13	$ -	$ 41	$ 85,063	$ 85,104
Construction	1,448	-	-	1,448	13,477	14,925
Secured by commercial real estate	2,052	34	3,513	5,599	191,353	196,952
Secured by residential real estate	463	395	-	858	44,832	45,690
State and political subdivisions	51	-	-	51	31,468	31,519
Indirect lease financing	80	218	47	345	11,684	12,029
Retail:						
1-4 family residential mortgages	-	-	-	-	25,050	25,050
Home equity loans and lines	230	187	186	603	58,671	59,274
Consumer	17	3	-	20	2,448	2,468

$ 4,369	$ 850	$ 3,746	$ 8,965	$ 464,046	$ 473,011

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

December 31, 2010	30-59 days past due	60-89 days past due	>90 days past due	Total past due loans	Current	Total loans receivable
Commercial:						
Commercial and industrial	$ 228	$ 66	$ 197	$ 491	$ 86,137	$ 86,628
Construction	39	-	1,334	1,373	17,238	18,611
Secured by commercial real estate	527	4,517	3,257	8,301	191,573	199,874
Secured by residential real estate	857	125	54	1,036	43,408	44,444
State and political subdivisions	-	8	9	17	31,036	31,053
Indirect lease financing	495	244	72	811	12,184	12,995
Retail:						
1-4 family residential mortgages	668	-	433	1,101	22,026	23,127
Home equity loans and lines	220	203	29	452	62,274	62,726
Consumer	32	-	-	32	2,719	2,751
	$ 3,066	$ 5,163	$ 5,385	$ 13,614	$ 468,595	$ 482,209

The following tables disclose the recorded investment in loans receivable that are either on non-accrual status or past due more than 90 days and still accruing interest as of September 30, 2011 and December 31, 2010:

September 30, 2011	>90 days past due (still accruing)	Non-accrual
Commercial:		
Commercial and industrial	-	$ 6,060
Construction	-	3,500
Secured by commercial real estate	-	7,410
Secured by residential real estate	-	1,269
State and political subdivisions	-	4
Indirect lease financing	-	162
Retail:		
1-4 family residential mortgages	-	532
Home equity loans and lines	$ 87	282
Consumer	-	-
	$ 87	$ 19,219

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

December 31, 2010	>90 Days Past Due (still accruing)	Non-accrual
Commercial:		
Commercial and industrial	-	$ 1,082
Construction	-	1,334
Secured by commercial real estate	$ 259	3,837
Secured by residential real estate	-	97
State and political subdivisions	9	-
Indirect lease financing	-	255
Retail:		
1-4 family residential mortgages	-	433
Home equity loans and lines	-	145
Consumer	-	-
	$ 268	$ 7,183

Activity in the allowance for loan losses is shown below:

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Balance at beginning of period	$ 8,850	$ 7,009	$ 8,955	$ 6,217
Charge-offs	(650)	(139)	(1,890)	(917)
Recoveries	17	62	52	232
Net charge-offs	(633)	(77)	(1,838)	(685)
Provision for loan losses	650	1,200	1,750	2,600
Balance at end of period	$ 8,867	$ 8,132	$ 8,867	$ 8,132

Additional details for changes in the allowance for loan losses for the three and nine months ended September 30, 2011 and the year December 31, 2010 are as follows:

For the Three Months Ended September 30, 2011	Balance, beginning of period	Provision for (credit to) loan losses	Charge-offs	Recoveries	Balance, end of period
Commercial:					
Commercial and industrial	$ 2,826	$ (121)	$ (90)	$ 9	$ 2,624
Construction	608	(12)	(237)	-	359
Secured by commercial real estate	3,119	569	(300)	6	3,394
Secured by residential real estate	687	6	-	-	693
State and political subdivisions	151	7	-	-	158
Indirect lease financing	376	33	-	-	409
Retail:					
1-4 family residential mortgages	234	(39)	-	-	195

Home equity loans and lines		616		72		(13	)	-		675
Consumer		19		15		(10	)	2		26
Unallocated		214		120		N/A		N/A		334
	$	8,850	$	650	$	(650	) $	17	$	8,867

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

For the Nine Months Ended September 30, 2011	Balance, beginning of period	Provision for (credit to) loan losses	Charge-offs	Recoveries	Balance, end of period
Commercial:					
Commercial and industrial	$ 2,136	$ 648	$ (179)	$ 19	$ 2,624
Construction	633	360	(634)	-	359
Secured by commercial real estate	3,875	450	(941)	10	3,394
Secured by residential real estate	676	71	(54)	-	693
State and political subdivisions	108	50	-	-	158
Indirect lease financing	496	(96)	-	9	409
Retail:					
1-4 family residential mortgages	212	(17)	-	-	195
Home equity loans and lines	646	92	(66)	3	675
Consumer	32	(1)	(16)	11	26
Unallocated	141	193	N/A	N/A	334
	$ 8,955	$ 1,750	$ (1,890)	$ 52	$ 8,867

As previously discussed, the Company maintains a loan review system, which includes a continuous review of the loan portfolio by internal and external parties to aid in the early identification of potential impaired loans. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans, loans to state and political subdivisions and indirect lease financing loans by using either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are part of a larger relationship that is impaired, or are classified as a troubled debt restructuring.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of the majority of the Company's impaired loans are measured based on the estimated fair value of the loan's collateral.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable agings or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

From time to time, QNB may extend, restructure, or otherwise modify the terms of existing loans, on a case-by-case basis, to remain competitive and retain certain customers, as well as assist other customers who maybe experiencing financial difficulties. A loan is considered to be a troubled debt restructuring ("TDR") loan when the Company grants a concession to the borrower because of the borrower's financial condition that it would not otherwise consider. Such concessions include the reduction of interest rates, forgiveness of principal or interest, or other modifications of interest rates to less than the current market rate for new obligations with similar risk. Loans classified as TDRs are also designated as impaired.

The concessions made for TDRs involve lowering the monthly payments on loans through periods of interest only payments, a reduction in interest rate below a market rate or an extension of the term of the loan without a corresponding adjustment to the risk premium reflected in the interest rate, or a combination of these three methods. The restructurings rarely result in the forgiveness of principal or accrued interest. If the borrower has demonstrated performance under the previous terms and our underwriting process shows the borrower has the capacity to continue to perform under the restructured terms, the loan will continue to accrue interest. Non-accruing restructured loans may be returned to accrual status when there has been a sustained period of repayment performance (generally six consecutive months of payments) and both principal and interest are deemed collectible. TDR loans that are in compliance with their modified terms and that yield a market rate may be removed from the TDR status after a period of performance.

As a result of the adoption of ASU 2011-02, QNB reassessed all loan restructurings that occurred on or after January 1, 2011 for potential identification as TDRs and has concluded that the adoption of ASU 2011-02 did not impact the number of TDRs identified, or the specific reserves for such loans included in our allowance for loan losses at September 30, 2011. Performing TDRs (not reported as non-accrual loans) totaled $2,650,000 and $2,421,000 as of September 30, 2011 and December 31, 2010, respectively. Non-performing TDRs totaled $2,027,000 and $1,838,000 as of September 30, 2011 and December 31, 2010, respectively. All TDRs are included in impaired loans presented in the section above.

The following tables present loans by loan class modified as TDRs during the three and nine months ended September 30, 2011. The pre-modification and post-modification outstanding recorded investments disclosed in the tables below, represent carrying amounts immediately prior to the modification and at September 30, 2011, respectively.

Three Months Ended September 30, 2011	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment

Commercial:			
Commercial and industrial	1	$ 29	$ 28
Secured by residential real estate	2	168	168
	3	$ 197	$ 196

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

Three Months Ended September 30, 2011	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial:			
Commercial and industrial	1	$ 29	$ 28
Secured by commercial real estate	4	580	553
Secured by residential real estate	2	168	168
	7	$ 777	$ 749

The majority of the TDR concessions made during the three and nine months ended September 30, 2011 involved a period of interest only. The specific reserve for loan losses allocated to loans modified as TDRs during the three and nine months ended September 30, 2011 totaled $23,000. These specific reserves are included in the allowance for loan losses for loans individually evaluated for impairment. There were no charge-offs resulting from loans modified as TDRs during the three and nine months ended September 30, 2011.

The following table presents loans modified as TDRs within the previous 12 months from September 30, 2011, and for which there was a payment default (90 days or more past due or on non-accrual) during the three and nine months ended September 30, 2011:

	Three Months Ended		Nine Months Ended	
TDRs Subsequently Defaulted	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Commercial:				
Commercial and industrial	-	$ -	1	$ 28
Secured by residential real estate	-	-	2	168
	-	$ -	3	$ 196

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables present the balance in the allowance of loan losses at September 30, 2011 and December 31, 2010 disaggregated on the basis of the Company's impairment method by class of loans receivable along with the balance of loans receivable by class, excluding unearned fees and costs, disaggregated on the basis of the Company's impairment methodology:

	Allowance for Loan Losses			Loans Receivable		
September 30, 2011	Balance	Balance related to loans individually evaluated for impairment	Balance related to loans collectively evaluated for impairment	Balance	Balance individually evaluated for impairment	Balance collectively evaluated for impairment
Commercial:						
Commercial and industrial	$2,624	$ 1,383	$ 1,241	$85,104	$ 9,677	$ 75,427
Construction	359	-	359	14,925	4,701	10,224
Secured by commercial real estate	3,394	237	3,157	196,952	16,647	180,305
Secured by residential real estate	693	199	494	45,690	2,748	42,942
State and political subdivisions	158	-	158	31,519	-	31,519
Indirect lease financing	409	28	381	12,029	167	11,862
Retail:						
1-4 family residential mortgages	195	72	123	25,050	532	24,518
Home equity loans and lines	675	89	586	59,274	741	58,533
Consumer	26	-	26	2,468	-	2,468
Unallocated	334	N/A	N/A	N/A	N/A	N/A
	$8,867	$ 2,008	$ 6,525	$473,011	$ 35,213	$ 437,798

	Allowance for Loan Losses			Loans Receivable		
December 31, 2010	Balance	Balance related to loans individually evaluated for impairment	Balance related to loans collectively evaluated for impairment	Balance	Balance individually evaluated for impairment	Balance collectively evaluated for impairment
Commercial:						
Commercial and industrial	$2,136	$ 878	$ 1,258	$86,628	$ 4,710	$ 81,918
Construction	633	370	263	18,611	2,650	15,961
Secured by commercial real estate	3,875	687	3,188	199,874	9,213	190,661
	676	179	497	44,444	2,624	41,820

Secured by residential real estate						
State and political subdivisions	108	-	108	31,053	-	31,053
Indirect lease financing	496	64	432	12,995	275	12,720
Retail:						
1-4 family residential mortgages	212	41	171	23,127	606	22,521
Home equity loans and lines	646	62	584	62,726	785	61,941
Consumer	32	-	32	2,751	-	2,751
Unallocated	141	N/A	N/A	N/A	N/A	N/A
	$8,955	$ 2,281	$ 6,533	$482,209	$ 20,863	$ 461,346

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables summarize additional information in regards to impaired loans by loan portfolio class as of September 30, 2011 and December 31, 2010:

September 30, 2011	Recorded investment (after charge-offs)	Unpaid principal balance	Related allowance	Average recorded investment	Interest income recognized
With no specific allowance recorded:					
Commercial:					
Commercial and industrial	$ 6,332	$ 6,375	$ -		
Construction	4,701	4,701	-		
Secured by commercial real estate	13,564	13,910	-		
Secured by residential real estate	2,134	2,149	-		
State and political subdivisions	-	-	-		
Indirect lease financing	81	111	-		
Retail:					
1-4 family residential mortgages	366	394	-		
Home equity loans and lines	516	521	-		
Consumer	-	-	-		
	$ 27,694	$ 28,161	$ -		
With an allowance recorded:					
Commercial:					
Commercial and industrial	$ 3,345	$ 3,375	$ 1,383		
Construction	-	-	-		
Secured by commercial real estate	3,083	3,635	237		
Secured by residential real estate	614	621	199		
State and political subdivisions	-	-	-		
Indirect lease financing	86	94	28		
Retail:					
1-4 family residential mortgages	166	170	72		
Home equity loans and lines	225	227	89		
Consumer	-	-	-		
	$ 7,519	$ 8,122	$ 2,008		
Total:					
Commercial:					
Commercial and industrial	$ 9,677	$ 9,750	$ 1,383	$ 8,125	$ 215

Construction	4,701	4,701	-	2,808	57
Secured by commercial real estate	16,647	17,545	237	12,901	393
Secured by residential real estate	2,748	2,770	199	2,005	67
State and political subdivisions	-	-	-	-	-
Indirect lease financing	167	205	28	227	3
Retail:					
1-4 family residential mortgages	532	564	72	489	-
Home equity loans and lines	741	748	89	1,406	53
Consumer	-	-	-	-	-
	$ 35,213	$ 36,283	$ 2,008	$ 27,961	$ 788

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (Continued)

December 31, 2010	Recorded investment (after charge-offs)	Unpaid principal balance	Related allowance
With no specific allowance recorded:			
Commercial:			
Commercial and industrial	$ 3,218	$ 3,225	$ -
Construction	1,316	1,316	-
Secured by commercial real estate	5,495	5,497	-
Secured by residential real estate	1,558	1,558	-
State and political subdivisions	-	-	-
Indirect lease financing	55	60	-
Retail:			
1-4 family residential mortgages	434	436	-
Home equity loans and lines	492	492	-
Consumer	-	-	-
	$ 12,568	$ 12,584	$ -
With an allowance recorded:			
Commercial:			
Commercial and industrial	$ 1,492	$ 1,492	$ 878
Construction	1,334	1,340	370
Secured by commercial real estate	3,718	3,821	687
Secured by residential real estate	1,066	1,066	179
State and political subdivisions	-	-	-
Indirect lease financing	220	239	64
Retail:			
1-4 family residential mortgages	172	172	41
Home equity loans and lines	293	293	62
Consumer	-	-	-
	$ 8,295	$ 8,423	$ 2,281
Total:			
Commercial:			
Commercial and industrial	$ 4,710	$ 4,717	$ 878
Construction	2,650	2,656	370
Secured by commercial real estate	9,213	9,318	687
Secured by residential real estate	2,624	2,624	179
State and political subdivisions	-	-	-
Indirect lease financing	275	299	64
Retail:			

1-4 family residential mortgages	606	608	41
Home equity loans and lines	785	785	62
Consumer	-	-	-
	$ 20,863	$ 21,007	$ 2,281

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES

Financial Accounting Standards Board (FASB) ASC 820, Fair Value Measurements and Disclosures, defines fair value as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (fair values are not adjusted for transaction costs). ASC 820 also establishes a framework (fair value hierarchy) for measuring fair value under GAAP, and expands disclosures about fair value measurements.

ASC 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1:	Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
Level 2:	Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.
Level 3:	Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The measurement of fair value should be consistent with one of the following valuation techniques: market approach, income approach, and/or cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the security's relationship to other benchmark quoted securities.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used were as follows:

September 30, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable input (Level 2)	Significant unobservable inputs (Level 3)	Balance at end of period
Securities available-for-sale				
U.S. Government agency securities	-	$ 64,512	-	$ 64,512
State and municipal securities	-	78,330	-	78,330

U.S. Government agencies and sponsored enterprises (GSEs) - residential				
Mortgage-backed securities	-	111,586	-	111,586
Collateralized mortgage obligations (CMOs)	-	89,162	-	89,162
Pooled trust preferred securities	-	-	$ 1,878	1,878
Corporate debt securities	-	1,500	-	1,500
Equity securities	$ 3,442	-	-	3,442
Total	$ 3,442	$ 345,090	$ 1,878	$ 350,410

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (Continued)

December 31, 2010	Quoted prices in active markets for identical assets (Level 1)	Significant other observable input (Level 2)	Significant unobservable inputs (Level 3)	Balance at end of period
Securities available-for-sale				
U.S. Government agency securities	-	$ 66,448	-	$ 66,448
State and municipal securities	-	63,588	-	63,588
U.S. Government agencies and sponsored enterprises (GSEs) - residential				
Mortgage-backed securities	-	78,801	-	78,801
Collateralized mortgage obligations (CMOs)	-	75,573	-	75,573
Pooled trust preferred securities	-	-	$ 1,866	1,866
Corporate debt securities	-	518	-	518
Equity securities	$ 3,770	-	-	3,770
Total	$ 3,770	$ 284,928	$ 1,866	$ 290,564

The following table presents additional information about the securities available-for-sale measured at fair value on a recurring basis and for which QNB utilized significant unobservable inputs (Level 3 inputs) to determine fair value for the nine months ended September 30, 2011:

	Fair value measurements using significant unobservable inputs (Level 3)
Balance, beginning of year	$ 1,866
Settlements	-
Total gains or losses (realized/unrealized)	-
Included in earnings	-
Included in other comprehensive income	12
Transfers in and/or out of Level 3	-
Balance, September 30, 2011	$ 1,878

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the period ended September 30, 2011. There were also no transfers in or out of level 3 for the same period. There were $0 and $277,000 of losses included in earnings attributable to the change in unrealized gains or losses relating to the available-for-sale securities above with fair value measurements utilizing significant unobservable inputs for the nine-month periods ended September 30, 2011 and 2010, respectively.

The Level 3 securities consist of eight collateralized debt obligation securities that are backed by trust preferred securities issued by banks, thrifts, and insurance companies (PreTSLs). The market for these securities at September 30, 2011 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 PreTSLs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive and there are currently very few market participants who are willing and or able to transact for these securities.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (Continued)

Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, we determined:

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at September 30, 2011;
- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates; and
- PreTSLs will be classified within Level 3 of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date.

The Bank is aware of several factors indicating that recent transactions of PreTSL securities are not orderly including an increased spread between bid/ask prices, lower sales transaction volumes for these types of securities, and a lack of new issuances. As a result, the Bank engaged an independent third party to value the securities using a discounted cash flow analysis. The estimated cash flows are based on specific assumptions about defaults, deferrals and prepayments of the trust preferred securities underlying each PreTSL. The resulting collateral cash flows are allocated to the bond waterfall using the INTEX desktop valuation model.

The estimates for the conditional default rates (CDR) are based on the payment characteristics of the trust preferred securities themselves (e.g. current, deferred, or defaulted) as well as the financial condition of the trust preferred issuers in the pool. A near-term CDR for each issuer in the pool is estimated based on their financial condition using key financial ratios relating to the financial institution’s capitalization, asset quality, profitability and liquidity. In addition to the specific bank default assumptions, default rates are modeled to approximately two times historic levels throughout 2012. In 2013 and beyond the CDR rate is calculated based upon a comparison of key financial ratios of active individual issuers without a short-term probability of default compared to all FDIC insured banks. To derive this long-term default rate, a comparison of certain key financial ratios of the active issuers in the security to all FDIC insured bank institutions is reviewed. The active issuers are summarized by creating a weighted average based on issue size, then divided into categories based upon their status of deferral and whether or not a specific default assumption has been assigned to the issuer. To ensure an accurate comparison, the standard deviation across the issuers for each ratio is calculated and any issuer that falls more than three standard deviations above or below the average for that ratio is removed.

The base loss severity assumption is 95%. The severity factor for near-term CDRs is vectored to reflect the relative expected performance of the institutions modeled to default, with lower forecasted severities used for the higher quality institutions. The long-term loss severity is modeled at 95%.

Prepayments are modeled to take into account the disruption in the asset-backed securities marketplace and the lack of new pooled trust preferred issuances. For purposes of the cash flow analysis, relatively modest rates of prepayment were forecasted (ranging from 0-2%). In addition to the base prepayment assumption, due to the recent enactment of the Dodd-Frank financial legislation additional prepayment analysis was performed. First, all fixed rate trust preferred securities issued by banks with more than $15 billion in total assets at December 31, 2009 were identified. Next the holding companies’ approximate cost of long-term funding given their rating and marketplace interest rates were estimated. The following assumption was made; any holding company that could refinance for a cost savings of more than 2% will refinance and will do so on January 1, 2013, or July 1, 2015 for bank holding company subsidiaries of foreign banking organizations that have relied on Supervision and Regulation Letter SR-01-1.

The internal rate of return is the pre-tax yield used to discount the best estimate of future cash flows after credit losses. The cash flows have been discounted using estimated market discount rates of 3-month LIBOR plus spreads ranging from 4.04% to 9.39%. The determination of appropriate market discount rates involved the consideration of the following:

- the time value of money
- the price for bearing uncertainty in cash flows

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (Continued)

- other factors that would be considered by market participants

The analysis of discount rates involved the review of corporate bond spreads for banks, U.S. Treasury yields, credit default swap rates for financial companies (utilized as a proxy for credit), the swap/LIBOR yield curve and the characteristics of the individual securities being valued.

For assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

	Quoted prices in active markets for identical assets (Level 1)	Significant other observable input (Level 2)	Significant unobservable inputs (Level 3)	Balance at end of period
September 30, 2011				
Mortgage servicing rights	$ -	$ -	$ 463	$ 463
Impaired loans	-	-	5,511	5,511
Other real estate owned	-	-	864	864
December 31, 2010				
Mortgage servicing rights	$ -	$ -	$ 504	$ 504
Impaired loans	-	-	6,014	6,014

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of QNB's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between QNB's disclosures and those of other companies may not be meaningful.

The following methods and assumptions were used to estimate the fair values of each major classification of financial instrument and non-financial asset at September 30, 2011 and December 31, 2010:

Cash and due from banks, interest-bearing deposits in banks, Federal funds sold, accrued interest receivable and accrued interest payable (carried at cost): The carrying amounts reported in the balance sheet approximate those assets' fair value.

Investment securities available for sale (carried at fair value) and held-to-maturity (carried at amortized cost): The fair value of securities are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

Restricted investment in bank stocks (carried at cost): The fair value of stock in Atlantic Central Bankers Bank and the Federal Home Loan Bank is the carrying amount, based on redemption provisions, and considers the limited marketability of such securities.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (Continued)

Loans Held for Sale (carried at lower of cost or fair value): The fair value of loans held for sale is determined, when possible, using quoted secondary market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan.

Loans Receivable (carried at cost): The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired Loans (generally carried at fair value): Impaired loans are loans, in which the Company has measured impairment generally based on the fair value of the loan’s collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value of impaired loans as of September 30, 2011 consists of loan balances of $7,519,000 less a valuation allowance of $2,008,000. The fair value of impaired loans as of December 31, 2010 consists of loan balances of $8,295,000 less a valuation allowance of $2,281,000.

Mortgage Servicing Rights (carried at lower of cost or fair value): The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The mortgage servicing rights are startified into tranches based on predominant characteristics, such as interest rate, loan type and investor type. The valuation incorporates assumptions that market participants would use in estimating future net servicing income.

Certain tranches of mortgage servicing rights, which are carried at lower of cost or fair value, were written down to fair value during the quarter resulting in a charge to earnings of $15,000. The ending valuation allowance is $31,000 at September 30, 2011.

Foreclosed assets (other real estate owned and repossessed assets): Foreclosed assets are the only non-financial assets valued on a non-recurring basis which are held by the Company at fair value, less cost to sell. At foreclosure or repossession, if the fair value, less estimated costs to sell, of the collateral acquired (real estate, vehicles, equipment) is less than the Company’s recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Additionally, valuations are periodically performed by management and any subsequent reduction in value is recognized by a charge to income. The fair value of foreclosed assets held-for-sale is estimated using Level 3 inputs based on observable market data.

Deposit liabilities (carried at cost): The fair value of deposits with no stated maturity (e.g. demand deposits, interest-bearing demand accounts, money market accounts and savings accounts) are by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). This approach to estimating fair value excludes the significant benefit that results from the low-cost funding provided by such deposit liabilities, as compared to alternative sources of funding. Deposits with a stated maturity (time deposits) have been valued using the present value of cash flows discounted at rates approximating the current market for similar deposits.

Short-term borrowings (carried at cost): The carrying amount of short-term borrowings approximates their fair values.

Long-term debt (carried at cost): The fair values of FHLB advances and securities sold under agreements to repurchase are estimated using discounted cash flow analysis, based on quoted prices for new long-term debt with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a fair value that is deemed to represent the transfer price if the liability were assumed by a third party.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (Continued)

Off-balance-sheet instruments (disclosed at cost): The fair values for the Bank's off-balance sheet instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of the respective period ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

The estimated fair values and carrying amounts of the Company's financial instruments are summarized as follows:

	September 30, 2011		December 31, 2010	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial Assets				
Cash and due from banks	$ 10,725	$ 10,725	$ 8,498	$ 8,498
Interest-bearing deposits in banks	21,711	21,711	6,414	6,414
Investment securities available-for-sale	350,410	350,410	290,564	290,564
Investment securities held-to-maturity	1,841	1,897	2,667	2,729
Restricted investment in bank stocks	1,868	1,868	2,176	2,176
Loans held-for-sale	-	-	228	228
Net loans	464,111	454,306	473,227	458,040
Mortgage servicing rights	463	496	504	620
Accrued interest receivable	2,930	2,930	2,988	2,988
Financial Liabilities				
Deposits with no stated maturities	464,907	464,907	384,745	384,745
Deposits with stated maturities	292,233	293,321	310,232	312,016
Short-term borrowings	25,806	25,806	29,786	29,786
Long-term debt	20,301	21,205	20,308	21,666
Accrued interest payable	748	748	1,089	1,089

The estimated fair value of QNB's off-balance sheet financial instruments is as follows:

	September 30, 2011		December 31, 2010	
	Notional amount	Fair value	Notional amount	Fair value
Commitments to extend credit	$ 111,133	$ -	$ 103,012	$ -
Standby letters of credit	6,510	-	13,519	-

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. OFF-BALANCE-SHEET FINANCIAL INSTRUMENTS AND GUARANTEES

In the normal course of business there are various legal proceedings, commitments, and contingent liabilities which are not reflected in the financial statements. Management does not anticipate any material losses as a result of these transactions and activities. They include, among other things, commitments to extend credit and standby letters of credit. The maximum exposure to credit loss, which represents the possibility of sustaining a loss due to the failure of the other parties to a financial instrument to perform according to the terms of the contract, is represented by the contractual amount of these instruments. QNB uses the same lending standards and policies in making credit commitments as it does for on-balance sheet instruments. The activity is controlled through credit approvals, control limits, and monitoring procedures.

A summary of the Bank's financial instrument commitments is as follows:

	September 30, 2011	December 31, 2010
Commitments to extend credit and unused lines of credit	$ 111,133	$ 103,012
Standby letters of credit	6,510	13,519
	$ 117,643	$ 116,531

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. QNB evaluates each customer’s creditworthiness on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the financial or performance obligation of a customer to a third party. QNB’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making conditional obligations as it does for on-balance sheet instruments. These standby letters of credit expire within three years. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral and personal guarantees supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral and the enforcement of personal guarantees would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2011 and December 31, 2010 for guarantees under standby letters of credit issued is not material.

The amount of collateral obtained for letters of credit and commitments to extend credit is based on management’s credit evaluation of the customer. Collateral varies, but may include real estate, accounts receivable, marketable securities, pledged deposits, inventory or equipment.

11. REGULATORY RESTRICTIONS

Dividends payable by the Company and the Bank are subject to various limitations imposed by statutes, regulations and policies adopted by bank regulatory agencies. Under Pennsylvania banking law, the Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. Under Federal Reserve regulations, the Bank is limited as to the amount it may lend affiliates, including QNB Corp., unless such loans are collateralized by specific obligations.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

11. REGULATORY RESTRICTIONS (Continued)

Both the Company and the Bank are subject to regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can initiate actions by regulators that could have an effect on the financial statements. Under the framework for prompt corrective action, both the Company and the Bank must meet capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items. The capital amounts and classification are also subject to qualitative judgments by the regulators. Management believes, as of September 30, 2011, that the Company and the Bank met capital adequacy requirements to which they were subject.

As of the most recent notification, the primary regulator of the Bank considered it to be “well capitalized” under the regulatory framework. There are no conditions or events since that notification that management believes have changed the classification. To be categorized as well capitalized, the Company and the Bank must maintain minimum ratios as set forth in the table below.

The Company and the Bank’s actual capital amounts and ratios are presented as follows:

	Actual		Capital Levels Adequately Capitalized		Well Capitalized	
As of September 30, 2011	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Risk-Based Capital (to Risk Weighted Assets)						
Consolidated	$71,990	12.72 %	$45,270	8.00 %	N/A	N/A
Bank	67,981	12.09 %	44,973	8.00 %	$56,216	10.00 %
Tier I Capital (to Risk Weighted Assets)						
Consolidated	64,807	11.45 %	22,635	4.00 %	N/A	N/A
Bank	60,931	10.84 %	22,486	4.00 %	33,730	6.00 %
Tier I Capital (to Average Assets)						
Consolidated	64,807	7.54 %	34,377	4.00 %	N/A	N/A
Bank	60,931	7.12 %	34,233	4.00 %	42,792	5.00 %

	Actual		Capital Levels Adequately Capitalized		Well Capitalized	
As of December 31, 2010	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Risk-Based Capital (to Risk Weighted Assets)						
Consolidated	$66,932	11.82 %	$45,289	8.00 %	N/A	N/A
Bank	62,901	11.18 %	44,995	8.00 %	$56,243	10.00 %

Tier I Capital (to Risk Weighted Assets)									
Consolidated	59,551	10.52	%	22,644	4.00	%	N/A	N/A	
Bank	55,847	9.93	%	22,497	4.00	%	33,746	6.00	%
Tier I Capital (to Average Assets)									
Consolidated	59,551	7.42	%	32,086	4.00	%	N/A	N/A	
Bank	55,847	6.99	%	31,947	4.00	%	39,934	5.00	%

QNB CORP. AND SUBSIDIARY

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

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

QNB Corp. (herein referred to as QNB or the Company) is a bank holding company headquartered in Quakertown, Pennsylvania. The Company, through its wholly-owned subsidiary, QNB Bank (the Bank), has been serving the residents and businesses of upper Bucks, northern Montgomery and southern Lehigh counties in Pennsylvania since 1877. The Bank is a locally managed community bank that provides a full range of commercial and retail banking and retail brokerage services.

Tabular information presented throughout management’s discussion and analysis, other than share and per share data, is presented in thousands of dollars.

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 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, and including the risk factors identified in Item 1A of QNB’s 2010 Form 10-K, could affect the future financial results of the Company 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 the Company’s line of business;
- The risk that the Federal Deposit Insurance Corporation (FDIC) could levy additional insurance assessments on all insured institutions in order 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 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 report on Form 10-Q, 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.

QNB CORP. AND SUBSIDIARY

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of the financial condition and results of operations are based on the consolidated financial statements of QNB, which are prepared in accordance with U.S. generally accepted accounting principles (GAAP) and predominant practices within the banking industry. The preparation of these consolidated financial statements requires QNB to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. QNB evaluates estimates on an on-going basis, including those related to the determination of the allowance for loan losses, the determination of the valuation of other real estate owned and foreclosed assets, other-than-temporary impairments on investment securities, the determination of impairment of restricted bank stock, the valuation of deferred tax assets, stock-based compensation and income taxes. QNB bases its estimates on historical experience and various other factors and assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Other-Than-Temporary Investment Security Impairment

Securities are evaluated periodically to determine whether a decline in their value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term “other-than-temporary” is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. For equity securities, once a decline in value is determined to be other-than-temporary, the value of the equity security is reduced and a corresponding charge to earnings is recognized.

The Company follows accounting guidance related to the recognition and presentation of other-than-temporary impairment that specifies (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

During the third quarter of 2011 and 2010 QNB recorded credit related other-than-temporary impairment charges of $97,000 and $51,000, respectively. For the nine-month period ended September 30, 2011 and 2010, the Company recorded $97,000 and $277,000 of credit related other-than-temporary impairment charges. The 2011 charges relate to losses in the equity securities portfolio while the 2010 charges relate to trust preferred securities.

Impairment of Restricted Investment in Bank Stocks

Restricted bank stock is comprised of restricted stock of the Federal Home Loan Bank of Pittsburgh (FHLB) and the Atlantic Central Bankers Bank. Federal law requires a member institution of the FHLB to hold stock of its district bank according to a predetermined formula. These restricted securities are carried at cost.

In December 2008, the FHLB of Pittsburgh 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.

QNB CORP. AND SUBSIDIARY

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES (Continued)

Impairment of Restricted Investment in Bank Stocks (Continued)
Beginning in October 2010, the FHLB announced their decision to have a limited excess capital stock repurchase. There have been several repurchases since that time. The repurchases during the first nine months of 2011 have totaled $308,000. Further repurchases will be evaluated quarterly by the FHLB. Management believes no impairment charge is necessary related to the restricted stock balance as of September 30, 2011.

Allowance for Loan Losses
QNB considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than its other significant accounting policies. The allowance for loan losses is calculated with the objective of maintaining a level believed by management to be sufficient to absorb probable known and inherent losses in the outstanding loan portfolio. The allowance is reduced by actual credit losses and is increased by the provision for loan losses and recoveries of previous losses. The provisions for loan losses are charged to earnings to bring the total allowance for loan losses to a level considered necessary by management.

The allowance for loan losses is based on management’s continual review and evaluation of the loan portfolio. The level of the allowance is determined by assigning specific reserves to individually identified problem credits and general reserves to all other loans. The portion of the allowance that is allocated to impaired loans is determined by estimating the inherent loss on each credit after giving consideration to the value of underlying collateral. The general reserves are based on the composition and risk characteristics of the loan portfolio, including the nature of the loan portfolio, credit concentration trends, delinquency and loss experience, as well as other qualitative factors such as current economic trends.

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized in order to assess and monitor the degree of risk in the loan portfolio. QNB’s lending and credit administration staff are charged with reviewing the loan portfolio and identifying changes in the economy or in a borrower’s circumstances which may affect the ability to repay debt or the value of pledged collateral. A loan classification and review system exists that identifies those loans with a higher than normal risk of uncollectibility. Each commercial loan is assigned a grade based upon an assessment of the borrower’s financial capacity to service the debt and the presence and value of collateral for the loan. An independent loan review group tests risk assessments and evaluates the adequacy of the allowance for loan losses. Management meets monthly to review the credit quality of the loan portfolio and quarterly to review the allowance for loan losses.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review QNB’s allowance for loan losses. Such agencies may require QNB to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Management believes that it uses the best information available to make determinations about the adequacy of the allowance and that it has established its existing allowance for loan losses in accordance with GAAP. If circumstances differ substantially from the assumptions used in making determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be affected. Because future events affecting borrowers and collateral cannot be predicted with certainty, increases to the allowance may be necessary should the quality of any loans deteriorate as a result of the factors discussed above.

Foreclosed Assets

Assets acquired through, or in lieu of, loan foreclosure are held-for-sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses and changes in the valuation allowance are included in net expenses from foreclosed assets.

QNB CORP. AND SUBSIDIARY

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES (Continued)

Stock-Based Compensation
QNB sponsors stock-based compensation plans, administered by a board committee, under which both qualified and non-qualified stock options may be granted periodically to certain employees. QNB accounts for all awards granted under stock-based compensation plans in accordance with ASC 718, Compensation-Stock Compensation. Compensation cost has been measured using the fair value of an award on the grant date and is recognized over the service period, which is usually the vesting period. The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the option and each vesting date. QNB estimates the fair value of stock options on the date of the grant using the Black-Scholes option pricing model. The model requires the use of numerous assumptions, many of which are highly subjective in nature.

Income Taxes
QNB accounts for income taxes under the asset/liability method in accordance with income tax accounting guidance, ASC 740, Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established against deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become available. Because the judgment about the level of future taxable income is dependent to a great extent on matters that may, at least in part, be beyond QNB’s control, it is at least reasonably possible that management’s judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

RESULTS OF OPERATIONS - OVERVIEW

QNB Corp. earns its net income primarily through its subsidiary, QNB 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 to 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 consistently high level of service at all points of contact.

QNB reported net income for the third quarter of 2011 of $2,322,000, or $0.73 per share on a diluted basis. This represents a 43.5% increase compared to net income of $1,618,000, or $0.52 per share on a diluted basis, for the same period in 2010.

For the nine month period ended September 30, 2011, QNB reported net income of $6,968,000, or $2.21 per share on a diluted basis. This represents a 28.9% increase in net income compared to the $5,407,000, or $1.74 per share on a diluted basis, reported for the nine month period ended September 30, 2010.

The results for the nine months ended September 2011 represent record profits for QNB for a nine month period. The results for both the three and nine month periods reflect higher net interest income, resulting from strong growth in deposits and earning assets, primarily investment securities. Also contributing to the increase in net income for both periods were lower provisions for loan losses.

QNB CORP. AND SUBSIDIARY

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

RESULTS OF OPERATIONS – OVERVIEW (Continued)

Net income expressed as an annualized rate of return on average assets and average shareholders' equity was 1.07% and 14.31%, respectively, for the quarter September 30, 2011 compared with 0.82% and 11.01%, respectively for the quarter ended September 30, 2010. For the nine month periods the annualized rate of return on average assets and average shareholders' equity was 1.12% and 14.88%, respectively, for the period ended September 30, 2011 compared with 0.94% and 12.69%, respectively, for the period ended September 30, 2010.

Net Interest Income and Net Interest Margin

Growth in net interest income continues to be a significant contributor to the Company's outstanding performance. Net interest income for the quarter ended September 30, 2011 totaled $7,080,000, an increase of $439,000, or 6.6%, over the same period in 2010. Negatively impacting net interest income in the third quarter of 2011 was the reversal of $70,000 in interest income on loans that were placed on nonaccrual status during the quarter.

Strong growth in deposits and the investment of these deposits into the securities portfolio was the primary contributor to the increase in net interest income when comparing the two quarters. Average earning assets grew by $76,016,000, or 10.1%, when comparing the third quarter of 2011 to the same period in 2010, with average investment securities increasing $70,319,000, or 26.8%. On the funding side, average deposits increased $74,863,000, or 11.2%, with average transaction accounts increasing $94,043,000, or 26.5%. The growth in transaction accounts is largely due to the success of QNB's Online eSavings account and the seasonal tax deposits of several local school districts and municipalities. Offsetting a portion of this growth was a decline in average time deposits of $19,180,000 when comparing the third quarter 2011 with the same period in 2010.

With the growth in earning assets occurring in the investment portfolio, the mix of earning assets changed which contributed to a decline in the net interest margin, as investment securities generally earn a lower yield than loans. In addition, the Federal Open Market Committee's announcement that they were likely to leave the federal funds rate at exceptionally low levels through mid-2013 and their decision to purchase longer term Treasury securities in an effort to further reduce longer term interest rates had the impact of reducing interest rates to historically low levels. As a result, a significant amount of higher yielding bonds with call features were called and prepayments on mortgage-related securities increased, with these proceeds being reinvested in lower yielding investment securities. The net interest margin for the third quarter of 2011 was 3.63% compared to 3.75% for the third quarter of 2010 and 3.84% for the second quarter of 2011. The reversal of interest on loans placed on non-accrual noted above had a negative impact of approximately three basis points on the net interest margin for the third quarter of 2011.

The average rate earned on earning assets declined 46 basis points from 5.05% for the third quarter of 2010 to 4.59% for the third quarter of 2011 with loans and investment securities declining from 5.86% and 3.94%, respectively, for the third quarter of 2010 to 5.61% and 3.45%, respectively, for the third quarter of 2011, a decline of 25 basis points and 49 basis points, respectively. In comparison, the cost of interest-bearing liabilities declined 38 basis points from 1.47% to 1.09% over the same time periods. The interest rate paid on interest-bearing deposits declined by 39 basis points to 1.00% for the third quarter of 2011 compared to the third quarter of 2010. The decline in the rate paid on deposits largely resulted from the repricing of time deposits, interest-bearing transaction accounts and money market accounts at lower market rates. Lower-cost time deposits was the greatest contributor with the average rate paid on time deposits declining 48 basis points from 1.99% for the third quarter of 2010 to 1.51% for the third quarter of 2011.

For the nine-month period ended September 30, 2011 net interest income was $21,188,000, an increase of $2,088,000, or 10.9% over the $19,100,000 reported for the first nine months of 2010. Growth in deposits and earnings assets as well as an increase in the net interest margin contributed to the improvement in net interest income when comparing the nine-month periods. The net interest margin for these same periods was 3.78% and 3.71%, respectively.

For the nine-month period average earning assets increased by $64,631,000, or 8.8%, with average loans increasing $12,352,000, or 2.7%, and average investment securities increasing $51,909,000, or 20.1%. Over this same period average funding sources increased $57,850,000, or 8.2%, with average total deposits increasing $61,246,000, or 9.3%.

QNB CORP. AND SUBSIDIARY

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

RESULTS OF OPERATIONS – OVERVIEW (Continued)

When comparing the nine-month periods ended September 30, 2010 and 2011, the average rate earned on earning assets declined 33 basis points from 5.14% to 4.81%, respectively, with the yield on loans and investment securities declining by 11 basis points and 55 basis points, respectively. In comparison, the interest rate paid on total average interest-bearing liabilities declined 44 basis points from 1.62% for the first nine months of 2011 to 1.18% for the first nine months of 2011 with the average rate paid on interest-bearing deposits declining 45 basis points from 1.53% to 1.08% over the same period. When comparing the nine-month periods the average rate paid on time deposits declined 57 basis points from 2.18% for the first nine months of 2010 to 1.61% for the same period in 2011. The decline in the yield on earning assets as well as in the cost of deposits reflects the impact of a long period of historically low interest rates.

Asset Quality, Provision for Loan Loss and Allowance for Loan Loss

QNB closely monitors the quality of its loan portfolio and as a result of increases in non-performing and classified loans, higher than normal levels of charge-offs and continued concerns about the economy, continues to record significant provisions for loan losses to reflect these conditions.

Total non-performing assets were $24,718,000 at September 30, 2011 compared with $13,844,000 as of June 30, 2011 and $11,634,000 as of December 31, 2010. Included in this classification are non-performing loans, other real estate owned (OREO) and repossessed assets, and non-performing pooled trust preferred securities. 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 $21,956,000, or 4.64% of total loans, at September 30, 2011 compared with $11,882,000, or 2.49% of total loans, at June 30, 2011 and $9,872,000, or 2.05% of total loans, at December 31, 2010. The increase in non-performing assets between the second and third quarter of 2011 is primarily the result of several large commercial loan relationships that had signs of financial difficulty and tight collateral values. These loans were placed on non-accrual status because it is possible that all principal and interest payments will not be received as expected. Loans on non-accrual status were $19,219,000 at September 30, 2011 compared with $9,455,000 at June 30, 2011 and $7,183,000 at December 31, 2010. In cases where there is a collateral shortfall on non-accrual loans, specific impairment reserves have been established based on updated collateral values even if the borrower continues to pay in accordance with the terms of the agreement. Of the $19,219,000 of non-accrual loans at September 30, 2011, $12,999,000 are current or past due less than 30 days at September 30, 2011. Total delinquent loans that are thirty days or more past due represented 1.90% of total loans at September 30, 2011 compared with 1.72% of total loans at June 30, 2011 and 2.82% of total loans at December 31, 2010.

QNB had OREO and other repossessed assets of $884,000 as of September 30, 2011 compared with $0 at June 30, 2011 and $90,000 at December 31, 2010. Non-performing pooled trust preferred securities are carried at fair value which was $1,878,000, $1,962,000 and $1,672,000 at September 30, 2011, June 30, 2011 and December 31, 2010, respectively.

QNB recorded a provision for loan losses of $650,000 in the third quarter of 2011 compared to $450,000 in the second quarter of 2011 and $1,200,000 in the third quarter of 2010. For the nine month periods ended September 30, 2011 and 2010 the provision for loan losses was $1,750,000 and $2,600,000, respectively. Net loan charge-offs were $633,000 for the third quarter of 2011, or 0.53% annualized of total average loans, compared with $792,000 for the second quarter of 2011, or 0.67% annualized of total average loans, and $77,000 for the third quarter of 2010, or

0.07% annualized of total average loans. Most of the loans charged-off in the third quarter of 2011 had been recognized as impaired with specific reserves established prior to June 30, 2011. For the nine-month periods ended September 30, 2011 and 2010 net loan charge-offs were $1,838,000, or 0.52% annualized, and $685,000, or 0.20% annualized, respectively.

QNB's allowance for loan losses of $8,867,000 represents 1.87% of total loans at September 30, 2011 compared to an allowance for loan losses of $8,955,000, or 1.86% of total loans, at December 31, 2010 and $8,132,000, or 1.70% of total loans, at September 30, 2010.

QNB CORP. AND SUBSIDIARY

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

RESULTS OF OPERATIONS – OVERVIEW (Continued)

Non-Interest Income
Total non-interest income was $1,082,000 for the third quarter of 2011, an increase of $78,000 compared with the same period in 2010. ATM and debit card income increased $42,000, or 13.2%, and gains on the sale of residential mortgage loans increased $43,000, or 53.1%, when comparing the three month periods. The increase in ATM and debit card income reflects increased usage while the increase in gains on the sale of loans reflects an increase in refinancing activity resulting from the decline in mortgage interest rates during the third quarter of 2011.

Total non-interest income for the nine month period ended September 30, 2011 was $3,092,000, a decrease of $71,000, or 2.2%, from the amount recorded in 2010. Fees for services to customers declined $166,000, or 13.8%, to $1,037,000 and gains on the sale of residential mortgage loans declined $117,000, or 39.3%, to $181,000. The decrease in fees for services to customers was primarily caused by lower overdraft charges as a result of the implementation of new rules under Regulation E. The decline in gains on the sale of residential mortgage loans is a result of less residential mortgage activity during the first six months of 2011 compared with the first six months of 2010 as well as a smaller profit per loan on those sold. As mentioned previously mortgage activity picked up during the third quarter of 2011 as a result of actions by the Federal Reserve Bank to reduce longer term interest rates. Partially offsetting these declines was a $151,000 increase in ATM and debit card income and a $71,000 increase in income on bank-owned life insurance.

Non-Interest Expense
Total non-interest expense was $4,514,000 for the third quarter of 2011, an increase of $36,000, or 0.8%, compared to $4,478,000 for the third quarter of 2010. Salaries and employee benefits expense increased $113,000 or 4.7% when comparing the two quarters. Included in salary and benefit expense for the third quarter of 2011 is an accrual of $186,000 for incentive compensation compared to an accrual of $109,000 for the third quarter of 2010. Also included in the third quarter of 2010 was severance related expenses of $130,000 for two former officers of the Bank. Excluding these items salary and benefit expense increased $166,000, or 7.6%, when comparing the two quarters. This increase is primarily a result of filling the Chief Operating Officer, Chief Compliance Officer and Chief Information and Technology Officer positions and normal merit increases. Also contributing to the increase in non-interest expense was a $79,000 increase in third party services, primarily costs associated with the conversion to a new online and mobile banking system introduced in September 2011. Partially offsetting these higher costs was a reduction in FDIC insurance expense of $227,000. The FDIC changed the method of calculating the basis of the premium as well as reducing the rate charged.

Total non-interest expense was $13,518,000 for the nine-month period ended September 30, 2011. This represents an increase of $681,000, or 5.3%, from the same period in 2010. Higher salary and benefits expense contributed $604,000 of the increase with the accrual for incentive compensation accounting for $283,000 of the total increase in salary and benefits expense. The other items mentioned above for the quarter, including the severance paid in 2010 and the staffing of certain positions also impacted the nine month salary and benefit expense comparison. Also contributing to the increase in total non-interest expense is a $115,000 increase in net occupancy and furniture and fixtures expense. This increase is primarily related to land lease expense and depreciation on leasehold improvements for the permanent Wescosville branch which opened in October 2010 and an increase in equipment maintenance costs. Third party services costs increased $104,000, or 12.6%, when comparing the nine-month periods with costs associated with the conversion to a new online and mobile banking system and the costs of an executive search firm being the primary contributors. Partially offsetting these increases was a $200,000 reduction in FDIC insurance premiums as noted above.

These items noted in the foregoing overview, as well as others, will be discussed and analyzed more thoroughly in the next sections.

QNB CORP. AND SUBSIDIARY

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

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

	Three Months Ended					
	September 30, 2011			September 30, 2010		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
Assets						
Federal funds sold	$ -	0.00 %	$ -	$ -	0.00 %	$ -
Investment securities:						
U.S. Treasury	-	0.00 %	-	4,968	0.56 %	7
U.S. Government agencies	66,101	2.22 %	367	51,819	2.69 %	349
State and municipal	72,834	5.80 %	1,056	60,807	6.17 %	937
Mortgage-backed and CMOs	185,949	3.02 %	1,405	137,150	3.65 %	1,251
Other debt securities	4,275	1.31 %	14	4,290	1.45 %	16
Equities	3,320	3.41 %	28	3,126	3.21 %	25
Total investment securities	332,479	3.45 %	2,870	262,160	3.94 %	2,585
Loans:						
Commercial real estate	262,743	5.73 %	3,794	257,567	5.95 %	3,861
Residential real estate	24,431	5.35 %	327	24,293	5.87 %	356
Home equity loans	54,410	4.66 %	639	59,688	4.97 %	748
Commercial and industrial	87,109	5.05 %	1,109	84,212	5.29 %	1,122
Indirect lease financing	12,751	9.56 %	305	13,851	9.18 %	318
Consumer loans	2,448	14.45 %	89	2,954	15.22 %	113
Tax-exempt loans	31,657	5.77 %	460	32,338	6.12 %	499
Total loans, net of unearned income*	475,549	5.61 %	6,723	474,903	5.86 %	7,017
Other earning assets	22,526	0.24 %	14	17,475	0.23 %	10
Total earning assets	830,554	4.59 %	9,607	754,538	5.05 %	9,612
Cash and due from banks	11,321			11,088		
Allowance for loan losses	(9,003)			(7,270)		
Other assets	26,562			26,144		
Total assets	$ 859,434			$ 784,500		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing demand	$ 87,075	0.45 %	98	$ 82,981	0.66 %	138
Municipals	71,157	0.66 %	119	43,436	0.94 %	104
Money market	69,416	0.38 %	67	73,021	0.70 %	128
Savings	157,231	0.75 %	299	99,376	0.79 %	197
Time	190,334	1.51 %	722	209,417	1.96 %	1,033
Time of $100,000 or more	104,833	1.53 %	404	104,930	2.07 %	548
Total interest-bearing deposits	680,046	1.00 %	1,709	613,161	1.39 %	2,148

Short-term borrowings		27,206	0.72	%		50		32,950	1.01	%		84
Long-term debt		20,302	4.75	%		246		20,105	4.75	%		244
Total interest-bearing liabilities		727,554	1.09	%		2,005		666,216	1.47	%		2,476
Non-interest-bearing deposits		64,573						56,595				
Other liabilities		2,919						3,362				
Shareholders' equity		64,388						58,327				
Total liabilities and shareholders' equity	$	859,434					$	784,500				
Net interest rate spread			3.50	%					3.58	%		
Margin/net interest income			3.63	%	$	7,602			3.75	%	$	7,136

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

QNB CORP. AND SUBSIDIARY

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

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

	Nine Months Ended					
	September 30, 2011			September 30, 2010		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
Assets						
Federal funds sold	$ -	0.00 %	$ -	$ -	0.00 %	$ -
Investment securities:						
U.S. Treasury	-	0.00 %	-	5,001	0.57 %	21
U.S. Government agencies	63,350	2.18 %	1,035	56,431	3.14 %	1,329
State and municipal	69,575	5.87 %	3,064	57,942	6.26 %	2,718
Mortgage-backed and CMOs	169,189	3.31 %	4,204	130,901	3.95 %	3,880
Other debt securities	4,152	1.22 %	38	4,388	1.27 %	42
Equities	3,287	3.56 %	87	2,981	3.57 %	80
Total investment securities	309,553	3.63 %	8,428	257,644	4.18 %	8,070
Loans:						
Commercial real estate	262,340	5.89 %	11,554	249,497	5.95 %	11,108
Residential real estate	23,722	5.42 %	964	24,534	5.80 %	1,067
Home equity loans	55,720	4.75 %	1,981	60,610	5.06 %	2,295
Commercial and industrial	87,354	5.16 %	3,370	82,039	5.23 %	3,211
Indirect lease financing	13,214	9.15 %	906	13,916	8.92 %	931
Consumer loans	2,521	14.10 %	266	3,272	13.74 %	336
Tax-exempt loans	31,591	5.97 %	1,412	30,242	5.98 %	1,353
Total loans, net of unearned income*	476,462	5.74 %	20,453	464,110	5.85 %	20,301
Other earning assets	17,244	0.24 %	31	16,874	0.23 %	29
Total earning assets	803,259	4.81 %	28,912	738,628	5.14 %	28,400
Cash and due from banks	10,359			10,108		
Allowance for loan losses	(9,087)			(6,743)		
Other assets	26,531			25,997		
Total assets	$ 831,062			$ 767,990		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing demand	$ 87,610	0.49 %	323	$ 83,576	0.68 %	428
Municipals	53,166	0.73 %	290	37,186	1.01 %	281
Money market	70,769	0.46 %	245	74,270	0.82 %	455
Savings	149,007	0.79 %	881	87,792	0.79 %	518
Time	194,228	1.59 %	2,306	213,159	2.15 %	3,427
Time of $100,000 or more	100,955	1.64 %	1,241	105,780	2.24 %	1,771
	655,735	1.08 %	5,286	601,763	1.53 %	6,880

Total interest-bearing deposits								
Short-term borrowings	26,291	0.83	%	163	27,319	1.00	%	204
Long-term debt	20,305	4.75	%	731	22,673	4.71	%	810
Total interest-bearing liabilities	702,331	1.18	%	6,180	651,755	1.62	%	7,894
Non-interest-bearing deposits	63,148				55,874			
Other liabilities	2,966				3,395			
Shareholders' equity	62,617				56,966			
Total liabilities and shareholders' equity	$ 831,062				$ 767,990			
Net interest rate spread		3.63	%			3.52	%	
Margin/net interest income		3.78	%	$ 22,732		3.71	%	$ 20,506

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

QNB CORP. AND SUBSIDIARY

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

Rate/Volume Analysis. The following table shows the fully taxable equivalent effect of changes in volumes and rates on interest income and interest expense. Changes in net interest income that could not be specifically identified as either a rate or volume change were allocated to changes in volume.

	Three Months Ended September 30, 2011 compared to September 30, 2010			Nine Months Ended September 30, 2011 compared to September 30, 2010		
	Total	Due to change in:		Total	Due to change in:	
	Change	Volume	Rate	Change	Volume	Rate
Interest income:						
Federal funds sold	$ -	$ -	$ -	$ -	$ -	$ -
Investment securities:						
U.S. Treasury	(7)	(7)	-	(21)	(21)	-
U.S. Government agencies	18	96	(78)	(294)	164	(458)
State and municipal	119	186	(67)	346	546	(200)
Mortgage-backed and CMOs	154	445	(291)	324	1,134	(810)
Other debt securities	(2)	-	(2)	(4)	(2)	(2)
Equities	3	1	2	7	7	-
Loans:						
Commercial real estate	(67)	77	(144)	446	572	(126)
Residential real estate	(29)	2	(31)	(103)	(36)	(67)
Home equity loans	(109)	(66)	(43)	(314)	(185)	(129)
Commercial and industrial	(13)	38	(51)	159	208	(49)
Indirect lease financing	(13)	(25)	12	(25)	(47)	22
Consumer loans	(24)	(19)	(5)	(70)	(77)	7
Tax-exempt loans	(39)	(11)	(28)	59	61	(2)
Other earning assets	4	3	1	2	1	1
Total interest income	(5)	720	(725)	512	2,325	(1,813)
Interest expense:						
Interest-bearing demand	(40)	7	(47)	(105)	20	(125)
Municipals	15	66	(51)	9	121	(112)
Money market	(61)	(6)	(55)	(210)	(21)	(189)
Savings	102	115	(13)	363	361	2
Time	(311)	(95)	(216)	(1,121)	(305)	(816)
Time of $100,000 or more	(144)	(1)	(143)	(530)	(80)	(450)
Short-term borrowings	(34)	(14)	(20)	(41)	(8)	(33)
Long-term debt	2	2	-	(79)	(84)	5
Total interest expense	(471)	74	(545)	(1,714)	4	(1,718)
Net interest income	$ 466	$ 646	$ (180)	$ 2,226	$ 2,321	$ (95)

QNB CORP. AND SUBSIDIARY

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

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 three- and nine-month periods ended September 30, 2011 and 2010.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Total interest income	$ 9,085	$ 9,117	$ 27,368	$ 26,994
Total interest expense	2,005	2,476	6,180	7,894
Net interest income	7,080	6,641	21,188	19,100
Tax-equivalent adjustment	522	495	1,544	1,406
Net interest income (fully taxable-equivalent)	$ 7,602	$ 7,136	$ 22,732	$ 20,506

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 tables that appear 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 rate margin, which includes interest-free sources of funds, is net interest income expressed as a percentage of average interest-earning assets. The Investment and Asset/Liability Management Committees work to manage and maximize the net interest margin for the Company.

Quarter to Quarter Comparison

Net interest income increased $439,000, or 6.6%, to $7,080,000 for the quarter ended September 30, 2011 as compared to the quarter ended September 30, 2010. However, it reflects a slight decline from the $7,151,000 reported for the second quarter of 2011. Negatively impacting net interest income in the third quarter of 2011 was the reversal of $70,000 in interest income on loans that were placed on nonaccrual status during the quarter. The increase in the amount of loans on nonaccrual status also had a negative impact on net interest income as interest on these loans is no longer recognized but deferred. On a tax-equivalent basis, net interest income increased $466,000, or 6.5%, from $7,136,000 for the three months ended September 30, 2010 to $7,602,000 for the same period ended September 30, 2011.

Strong growth in deposits and the investment of these deposits into the securities portfolio was the primary contributor to the increase in net interest income when comparing the two quarters. Average earning assets grew by $76,016,000, or 10.1%, when comparing the third quarter of 2011 to the same period in 2010, with average investment securities increasing $70,319,000, or 26.8%. On the funding side, average deposits increased $74,863,000, or 11.2%, with average transaction accounts increasing $94,043,000, or 26.5%. The growth in transaction accounts is largely due to the success of QNB's Online eSavings account and the seasonal tax deposits of several local school districts and municipalities. Offsetting a portion of this growth was a decline in average time deposits of $19,180,000 when comparing the third quarter 2011 with the same period in 2010.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

With the growth in earning assets occurring in the investment portfolio, the mix of earning assets changed which contributed to a decline in the net interest margin, as investment securities generally earn a lower yield than loans. In addition, the Federal Open Market Committee’s announcement that they were likely to leave the federal funds rate at exceptionally low levels through mid-2013 and their decision to purchase longer term Treasury securities in an effort to further reduce longer term interest rates had the impact of reducing interest rates to historically low levels. As a result, a significant amount of higher yielding bonds with call features were called and prepayments on mortgage-related securities increased, with these proceeds being reinvested in lower yielding investment securities. The net interest margin for the third quarter of 2011 was 3.63% compared to 3.75% for the third quarter of 2010 and 3.84% for the second quarter of 2011. The reversal of interest on loans placed on non-accrual noted above had a negative impact of approximately three basis points on the net interest margin for the third quarter of 2011.

The economy continues to struggle as underscored by issues in the residential and commercial real estate markets, high levels of unemployment and continued uncertainty in the equity markets. As a result of these factors, as well as concerns over the stability of some European economies, interest rates, while extremely volatile, remain at historically low levels and could remain at these levels for an extended period of time. 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.

The Rate-Volume Analysis tables, as presented on a tax-equivalent basis, highlight the impact of changing rates and volumes on interest income and interest expense. Total interest income on a tax-equivalent basis decreased $5,000 to $9,607,000 for the third quarter of 2011, while total interest expense decreased $471,000, or 19.0%, to $2,005,000. The increase in interest income resulting from volume growth in earning assets was offset by the decrease in interest income resulting from the impact of the decline in interest rates. Volume growth contributed an additional $720,000 of interest income but was offset by a decline in interest income of $725,000 resulting from lower interest rates. With regard to interest expense, lower funding costs resulted in a decline in interest expense of $545,000 which was partially offset by $74,000 in interest expense resulting from an increase in interest-bearing liabilities, primarily deposits.

The yield on earning assets on a tax-equivalent basis decreased 46 basis points from 5.05% for the third quarter of 2010 to 4.59% for the third quarter of 2011 and also declined by 28 basis points from the 4.87% reported for the second quarter of 2011. In comparison, the rate paid on interest-bearing liabilities decreased 38 basis points from 1.47% for the third quarter of 2010 to 1.09% for the third quarter of 2011 and decreased eight basis points when compared to 1.17% reported in the second quarter of 2011.

Interest income on investment securities increased $285,000 when comparing the two quarters as the increase in average balances more than offset the 49 basis point decline in the average yield of the portfolio. The average yield on the investment portfolio was 3.45% for the third quarter of 2011 compared with 3.94% for the third quarter of 2010. 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 prepayments speeds on mortgage-backed securities and CMOs ramped-up as did the amount of calls of agency and municipal securities. The actions by the Federal Open Market Committee noted above have resulted in a further increase in prepay speeds and calls. The reinvestment of these funds was 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 and agency issued mortgage-backed and CMO securities as well as in tax-exempt state and municipal bonds.

Income on Government agency securities increased $18,000, as the 27.6% growth in average balances offset a 47 basis point decline in the yield from 2.69% for the third quarter of 2010 to 2.22% for the same period in 2011. Offsetting the impact of the decline in yield for the quarter was the increase in average balances which contributed $96,000 to interest income. 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 as well as liquidity from deposit growth were reinvested in securities with significantly lower yields.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

Interest income on tax-exempt municipal securities increased $119,000 with higher balances accounting for $186,000 of additional income. Average balances of tax-exempt municipal securities increased $12,027,000, or 19.8%, to $72,834,000 for the third quarter of 2011. As a result of credit concerns in the municipal market arising from issues with the insurance companies that insure the bonds and concerns over the general health of state and municipal governments because of declining revenues and budget issues resulting from economic conditions, 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 37 basis points from 6.17% for the third quarter of 2010 to 5.80% for the third quarter of 2011. This decline in yield reduced interest income by $67,000 when comparing the two quarters.

Interest income on mortgage-backed securities and CMOs increased $154,000 with an increase in average balances offsetting the impact of lower rates. Average balances increased $48,799,000, or 35.6%, to $185,949,000 when comparing the two periods and contributed $445,000 in additional income. The yield on the mortgage-backed and CMO portfolio decreased 63 basis points from 3.65% for the third quarter of 2010 to 3.02% for the third quarter of 2011, resulting in a $291,000 reduction in interest income. This portfolio was expanded because it provides higher yields relative to agency bonds and also provides monthly cash flow which can be used for liquidity purposes or can be reinvested when interest rates eventually increase. With the historically low interest rate environment mortgage refinancing activity over the past two years 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 proceeds from the cash flow of these securities as well as the investment of excess deposits into this portfolio at lower yields also contributed to the reduction in the yield on the total portfolio.

With the issues in the economy and the actions by the Federal Reserve Open Market Committee, Treasury yields declined significantly and the yield curve flattened with the 10-year rate declining below 2.00% during the third quarter of 2011. As a result yields on agency bonds, mortgage-backed securities and municipal securities also declined significantly. It appears that this environment will be present for the next couple of years and 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 reinvested at current market rates which are significantly below the projected portfolio yield at September 30, 2011 of 3.34%.

Income on loans decreased $294,000 to $6,723,000 when comparing the third quarters of 2011 and 2010 with the decline in the portfolio yield being the reason. 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. The yield on the loan portfolio decreased 25 basis points to 5.61% when comparing the same periods, resulting in a reduction in interest income of $290,000. When comparing the two quarters average balances were relatively unchanged. Prior to the third quarter of 2011, QNB was able to minimize the decline in the portfolio yield by implementing interest rate floors on some variable rate commercial loans and home equity lines of credit and by maintain its pricing structure. However, during the third quarter, as a result of the decline in market rates and an increase in competition for quality loans, QNB lowered the rates offered on new loans and reduced rates on some existing loans.

The largest category of the loan portfolio is 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. The category also includes construction and land development loans. Income on commercial real estate loans decreased $67,000 as the decline in yield offset an increase in average balances. The yield on commercial real estate loans was 5.73% for the third quarter of 2011, a decrease of 22 basis points from the 5.95% reported for both the third quarter of 2010 and the second quarter of 2011. Average balances increased $5,176,000, or 2.0%, to $262,743,000, for the three months ended September 30, 2011 compared with the same quarter in 2010.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

Income on commercial and industrial loans, the second largest category, decreased $13,000 with the positive impact from the growth in balances again being offset by the decline in the yield. Average commercial and industrial loans increased $2,897,000, or 3.4%, to $87,109,000 for the third quarter of 2011, contributing an additional $38,000 in interest income. The average yield on these loans decreased 24 basis points to 5.05% resulting in a decrease in income of $51,000.

Income on home equity loans declined by $109,000 when comparing the third quarter of 2011 and 2010. During this same time period average home equity loans decreased $5,278,000, or 8.8%, to $54,410,000, while the yield on the home equity portfolio decreased 31 basis points to 4.66%. The demand for home equity loans has declined as home values have fallen preventing some homeowners from having equity in their homes to borrow against while others have taken advantage of the low interest rates on mortgages and refinanced their home equity loans into a new mortgage.

For the most part, earning assets are funded by deposits, which increased on average by $74,863,000, or 11.2%, to $744,619,000, when comparing the third quarters of 2011 and 2010. 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. The recently enacted Dobb-Frank Act made the increase in the basic limit on FDIC coverage from $100,000 to $250,000 permanent. In addition, QNB participated in the “Transaction Account Guarantee Program”, a program whereby the FDIC fully guaranteed all non-interest bearing transaction accounts until December 31, 2010. These programs likely contributed to the growth in deposits.

While total income on earning assets on a tax-equivalent basis decreased $5,000 when comparing the third quarter of 2011 to the third quarter of 2010, total interest expense declined $471,000. Interest expense on total deposits decreased $439,000 while interest expense on borrowed funds decreased $32,000 when comparing the two quarters. The rate paid on interest-bearing liabilities decreased 38 basis points from 1.47% for the third quarter of 2010 to 1.09% for the third quarter of 2011. During this same period, the rate paid on interest-bearing deposits decreased 39 basis points from 1.39% to 1.00%.

When comparing the third quarter of 2011 to the same quarter in 2010, three out of five categories of average deposits increased. Time deposit and money market accounts experienced declines during the quarter. Unlike prior years, the growth was not centered in time deposits but in accounts with greater liquidity, such as interest- and non-interest-bearing demand, interest-bearing municipal accounts and savings deposits. Average non-interest-bearing demand accounts increased $7,978,000, or 14.1%, to $64,573,000 for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Although the average balance increased about 4.9%, the interest expense on interest-bearing demand accounts decreased from $138,000 for the third quarter of 2010 to $98,000 for the third quarter of 2011 while the average rate paid decreased from 0.66% to 0.45%, respectively. The decrease in interest expense and the average rate paid on interest-bearing demand accounts is primarily the result of a reduction in the rate paid on QNB-Rewards checking, a high-rate checking account product. The rate paid on this account, on balances up to $25,000, was 2.75% at the beginning of the third quarter in 2010 and ended the quarter at 2.05%. This rate for the entire third quarter of 2011 was 1.75%. 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 and clear per statement cycle. For the third quarter of 2011, the average balance in the product was $26,745,000 and the related interest expense was $90,000 for an average yield of 1.33%. This lower rate than the 1.75% reflects the lower rate paid on accounts that do not meet the qualifications (0.15%) or on balances in excess of $25,000 which paid 0.50% during the third quarter of 2011. In comparison the average balance for the third quarter of 2010 was $27,024,000 with a related interest expense of $131,000 and an average rate paid of 1.92%. This product also generates fee income through the use of the check card. The QNB Rewards yield was reduced to 1.50% on November 1, 2011. Even with the reduction in the rates paid on the QNB-Rewards product, the yield of 1.50% for the first $25,000 and 0.50% on balances over $25,000, assuming qualifications are met, is still an attractive rate relative to competitors' offerings as well as other QNB products.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

Interest expense on municipal interest-bearing demand accounts was $119,000 and $104,000 for the third quarter of 2011 and 2010, respectively. The average balance of municipal interest-bearing demand accounts increased $27,721,000, or 63.8%, to $71,157,000 for the third quarter of 2011. Partially offsetting the impact of higher balances was a decline in the average interest rate paid on these accounts from 0.94% for the third quarter of 2010 to 0.66% for the third quarter of 2011 as short-term interest rates declined. Most of these accounts are tied directly to the Federal funds rate with most having rate floors between 0.25% and 0.75%. 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. QNB was successful in increasing their relationships with several of these customers in 2011, accounting for the increase in balances. Interest expense on money market accounts decreased $61,000 to $67,000 when comparing the third quarter of 2011 to the same period in 2010. The decline in money market accounts is partly attributable to customers' attraction to the eSavings product discussed below. Average money market accounts decreased $3,605,000, or 4.9%, to $69,416,000 for the third quarter of 2011 compared with the third quarter of 2010. The average interest rate paid on money market accounts was 0.70% for the third quarter of 2010 and 0.38% for the third quarter of 2011, a decline of 32 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 the Select money market accounts for the third quarter of 2011 was 0.43%, a decline of 36 basis points from the average rate of 0.79% paid for the third quarter of 2010.

During the second quarter of 2009 QNB introduced an online only 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 $107,581,000 at September 30, 2011. As market rates declined, the eSavings yield was also reduced and was 1.00% at September 30, 2011. The average yield paid on these accounts was 1.04% for the third quarter of 2011 compared with a yield of 1.40% for the third quarter of 2010. The average balance of this product was $105,423,000 for the third quarter of 2011 compared to $48,355,000 for the third quarter of 2010 and contributed to the $57,855,000, or 58.2%, increase in total average savings accounts when comparing the two quarters. Traditional statement savings accounts, passbook savings and club accounts are also included in the savings category; however, experienced little change when comparing the third quarter 2011 average to the same 2010 quarter. As a result of the decrease in the rate paid on the eSavings product more than offsetting its growth in comparison to the other lower rate savings accounts, the average rate paid on total savings accounts decreased four basis points from 0.79% for the third quarter of 2010 to 0.75% for the third quarter of 2011. Interest expense increased 51.8% from $197,000 to $299,000 over the same period. 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 has had the greatest impact on total interest expense when comparing the two quarters. Total interest expense on time deposits decreased $455,000, or 28.8%, to $1,126,000 for the third quarter of 2011. Average total time deposits decreased by $19,180,000, or 6.1%, to $295,167,000 for the third quarter of 2011. 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 2010 and the nine months of 2011 a significant amount of time deposits have repriced lower as rates have declined. The average rate paid on time deposits decreased from 1.99% to 1.51% when comparing the third quarter of 2010 to the same period in 2011.

Approximately $139,114,000, or 47.6%, of time deposits at September 30, 2011 will reprice or mature over the next 12 months. The average rate paid on these time deposits is approximately 1.09%. 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 may continue to decline in the near term 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 product or be withdrawn.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

Short-term borrowings are primarily comprised of sweep accounts structured as repurchase agreements with our commercial customers. Interest expense on short-term borrowings decreased by $34,000 to $50,000 when comparing the two quarters. During this period the average rate paid declined from 1.01% to 0.72% while the average balances declined from $32,950,000 to $27,206,000.

Nine Month Comparison

For the nine-month period ended September 30, 2011 tax-equivalent net interest income increased $2,226,000, or 10.9%. Average earning assets increased $64,631,000, or 8.8%, to $803,259,000 with average investment securities and loans increasing 20.1% and 2.7%, respectively. Average total deposits increased $61,246,000, or 9.3%, to $718,883,000 for the nine-month period ended September 30, 2011 compared to the same period in 2010. The net interest margin on a tax-equivalent basis was 3.78% for the nine-month period ended September 30, 2011 compared with 3.71% for the same period in 2010.

Total interest income on a tax-equivalent basis increased $512,000, from $28,400,000 to $28,912,000, when comparing the nine-month periods ended September 30, 2010 and September 30, 2011 as the additional interest income generated from the growth in earning assets offset the impact of declining yields on those assets. Interest income increased $2,325,000 as a result of volume increases but declined $1,813,000 as a result of lower yields. Average loans increased $12,352,000 to $476,462,000, with average commercial real estate loans increasing $12,843,000, or 5.1%, and average commercial and industrial loans increasing $5,315,000, or 6.5%, when comparing the nine-month periods.

Over this same period average investment securities increased $51,909,000, to $309,553,000 with most of the growth occurring in U.S. Government agency bonds, agency issued mortgage-backed and CMO securities and state tax-exempt municipal bonds. The yield on earning assets decreased from 5.14% to 4.81% for the nine-month periods with the yield on loans decreasing from 5.85% to 5.74% during this time. The yield on investments decreased from 4.18% to 3.63% when comparing the nine-month periods. As discussed previously, the decline in yields reflects the impact of historically low levels of interest rates over the past several years. The impact has been more significant on the investment portfolio as many of the bonds have call features which have been exercised by the issuers or are subject to prepayments as mortgages are refinanced.

In addition to the activity during the third quarter of 2011 noted above, QNB in the first quarter of 2011 sold $10 million in callable agency bonds with maturities ranging from 3 to 5 years that had an average yield of 1.25% and $7.5 million in faster paying mortgage-backed securities with a yield of 3.36%. The net yield on the bonds sold was 2.16%. The proceeds of these bonds were reinvested in lower coupon mortgage-backed securities with an average yield of 3.19%. The 103 basis point pick-up in yield will allow the $169,000 loss to be recouped during the current year and provide additional income over the 3.4 year average term of the bonds sold. The transaction was analyzed under base case interest rates at the time of the trade as well as the impact of rising and falling interest rates. The transaction produced additional income under all scenarios and resulted in a slight extension in the average life of the portfolio in the base case or with rates higher.

Total interest expense decreased $1,714,000, from $7,894,000 for the nine-month period ended September 30, 2010 to $6,180,000, for the nine-month period ended September 30, 2011. The decrease in interest expense was a result of lower rates paid on deposits, especially time deposits. Interest expense on interest-bearing deposits declined by $1,594,000 with interest expense on time deposits declining $1,651,000. The average rate paid on time deposits decreased 57 basis points to 1.61% from 2.18% when comparing the nine-month periods ended September 30, 2011 and 2010. The average balance of total time deposits declined $23,756,000, or 7.4%, to $295,183,000 for the nine months ended September 30, 2011 compared with the similar 2010 period.

QNB CORP. AND SUBSIDIARY

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

NET INTEREST INCOME (Continued)

While the average balances on time deposits declined when comparing the nine-month periods, the average balances of transaction accounts increased significantly as customers sought the liquidity of these accounts as well as the higher rate being offered on the QNB-Rewards checking product and the Online eSavings product. Interest expense on interest- bearing demand deposits decreased $105,000, resulting from the 19 basis point decrease in the average rate paid more than offset the $4,034,000, or 4.8%, increase in average balances. The interest rate paid on interest-bearing demand accounts decreased from 0.68% for the first nine months of 2010 to 0.49% for the first nine months of 2011. As discussed previously, a reduction in the rate paid on the QNB-Rewards checking account was the primary factor for the decrease in cost of funds in this category. Average savings account balances increased $61,215,000, or 69.7% to $149,007,000 while the average rate paid was unchanged at 0.79%. Virtually all of the growth in this category was related to the Online eSavings account. Even if the rates paid on savings accounts don't change, the overall cost of funds on savings accounts could continue to increase if the growth in the Online eSavings product continues as this product pays a much higher rate than the other savings account products in this category.

Also contributing to the reduction in interest expense when comparing the nine-month periods was the repayment of long-term debt in the first half of 2010. 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. Interest expense on long-term debt declined by $79,000 as the average balance declined from $22,673,000 for the first nine months of 2010 to $20,305,000 for the first nine-months of 2011.

PROVISION FOR LOAN LOSSES AND ALLOWANCE 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. Management believes that it uses the best information available to make determinations about the adequacy of the allowance and that it has established its existing allowance for loan losses in accordance with U.S. generally accepted accounting principles (GAAP). The determination of an appropriate level for the allowance for loan losses is based upon an analysis of the risks inherent in QNB's loan portfolio. Management, in determining the allowance for loan losses, makes significant estimates and assumptions. Since the allowance for loan losses is dependent, to a great extent, on conditions that may be beyond QNB's control, it is at least reasonably possible that management's estimates of the allowance for loan losses and actual results could differ. In addition, various regulatory agencies, as an integral part of their examination process, periodically review QNB's allowance for losses on loans. Such agencies may require QNB to recognize changes to the allowance based on their judgments about information available to them at the time of their examination. Actual loan losses, net of recoveries, serve to reduce the allowance.

Management closely monitors the quality of its loan portfolio and performs a quarterly analysis of the appropriateness of the allowance for loan losses. This analysis considers a number of relevant factors including: specific impairment reserves, historical loan loss experience, general economic conditions, levels of and trends in delinquent and non-performing loans, levels of classified loans, trends in the growth rate of loans and concentrations of credit.

Economic conditions over the past few years have 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 increases in specific reserves and in non-performing, impaired and classified loans. These factors when combined with the inherent risk related to the significant growth in the loan portfolio prior to 2011 and continued concerns related to economic conditions have resulted in elevated levels of the provision for loan losses and the allowance for loan losses. Since December 31, 2008, the start of the financial crisis, QNB has increased its allowance for loan losses from $3,836,000, or 0.95% of total loans, to $8,867,000, or 1.87%, of total loans at September 30, 2011. Over the past year the allowance for loan losses has been relatively stable representing $8,955,000, or 1.86% of total loans at December 31, 2010, and $8,132,000, or 1.70% of total loans at September 30, 2010. The allowance for loan losses at September 30, 2011 is at a level that QNB management believes is adequate as of that date based on its analysis of known and inherent losses in the portfolio.

QNB CORP. AND SUBSIDIARY

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

PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES (Continued)

QNB recorded a provision for loan losses of $650,000 in the third quarter of 2011 compared to $450,000 in the second quarter of 2011 and $1,200,000 in the third quarter of 2010. For the nine-month periods ended September 30, 2011 and 2010 the provision for loan losses was $1,750,000 and $2,600,000, respectively. Net loan charge-offs were $633,000 for the third quarter of 2011, or 0.53% annualized of total average loans, compared with $792,000 for the second quarter of 2011, or 0.67% annualized of total average loans, and $77,000 for the third quarter of 2010, or 0.07% annualized of total average loans. Most of the loans charged-off in the second and third quarters of 2011 had been recognized as impaired with specific reserves identified prior to their charge-off. For the nine-month periods ended September 30, 2011 and 2010 net loan charge-offs were $1,838,000, and $685,000, 0.52% and 0.20% annualized of total average loans, respectively.

As referenced in the following table the levels of non-performing loans have trended higher over the past year. At September 30, 2011 non-performing loans totaled $21,956,000, as compared to $11,882,000 at June 30, 2011, $9,872,000 at December 31, 2010 and $9,908,000 at September 30, 2010. As a percentage of total loans, non-performing loans have risen from 2.07% at September 30, 2010 to 4.64% at September 30, 2011. The increase in non-performing loans between the second and third quarter of 2011 is primarily the result of several large commercial loan relationships that had signs of financial difficulty and tight collateral values. These loans were placed on non-accrual status because it is possible that all principal and interest payments will not be received as expected. Loans on non-accrual status were $19,219,000 at September 30, 2011 compared with $9,455,000 at June 30, 2011 and $7,183,000 at December 31, 2010. In cases where there is a collateral shortfall on non-accrual loans, specific impairment reserves have been established based on the updated collateral values even if the borrower continues to pay in accordance with the terms of the agreement. Of the total amount of non-accrual loans at September 30, 2011, $12,999,000, or 67.6%, are current or past due less than 30 days at September 30, 2011.

Delinquent loans are considered performing loans and exclude non-accrual loans, restructured loans and loans 90 days or more past due and still accruing interest (all of which are considered non-performing loans). Total delinquent loans at September 30, 2011, December 31, 2010 and September 30, 2010 represent 0.56%, 1.47% and 1.20% of total loans, respectively.

A loan is considered impaired, based on current information and events, if it is probable that QNB will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include the borrowers financial condition, payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls may not be classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration all the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower’s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans and indirect lease financing loans by either the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the collateral, if the loan is collateral dependent. At September 30, 2011 and December 31, 2010, the recorded investment in loans for which impairment has been identified totaled $35,213,000 and $20,863,000 of which $27,694,000 and $12,568,000, respectively, required no specific allowance for loan loss. The recorded investment in impaired loans requiring an allowance for loan losses was $7,519,000 and $8,295,000 at September 30, 2011 and

December 31, 2010, respectively. At September 30, 2011 and December 31, 2010, the related allowance for loan losses associated with these loans was $2,008,000 and $2,281,000, respectively. Most of the loans that have been identified as impaired are collateral-dependent. See Note 8 to the Notes to Consolidated Financial Statements for additional detail of impaired loans.

QNB CORP. AND SUBSIDIARY

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

PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows detailed information and ratios pertaining to the Company's loan and asset quality:

	September 30, 2011	December 31, 2010
Non-accrual loans	$ 19,219	$ 7,183
Loans past due 90 days or more and still accruing interest	87	268
Restructured loans (not included above)	2,650	2,421
Total non-performing loans	21,956	9,872
Other real estate owned and repossessed assets	884	90
Non-accrual investment securities	1,878	1,672
Total non-performing assets	$ 24,718	$ 11,634
Average total loans (YTD)	$ 476,462	$ 467,063
Total loans, including loans held-for-sale	472,978	482,410
Allowance for loan losses	8,867	8,955
Allowance for loan losses to:		
Non-performing loans	40.39 %	90.72 %
Total loans	1.87 %	1.86 %
Average total loans	1.86 %	1.92 %
Non-performing loans to total loans	4.64 %	2.05 %
Non-performing assets to total assets	2.82 %	1.44 %

An analysis of loan charge-offs for the three and nine months ended September 30, 2011 compared to 2010 is as follows:

	For the Three Months Ended September 30, 2011	2010	For the Nine Months Ended September 30, 2011	2010
Net charge-offs	$ 633	$ 77	$ 1,838	$ 685
Net charge-offs (annualized) to:				
Total loans	0.54 %	0.06 %	0.52 %	0.19 %
Average total loans	0.53 %	0.06 %	0.52 %	0.20 %
Allowance for loan losses	28.56 %	3.78 %	27.64 %	11.28 %

QNB CORP. AND SUBSIDIARY

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

NON-INTEREST INCOME

Non-Interest Income Comparison

	Three Months Ended September 30,		Change from Prior Year		Nine Months Ended September 30,		Change from Prior Year	
	2011	2010	Amount	Percent	2011	2010	Amount	Percent
Fees for services to customers	$363	$392	$(29)	-7.4%	$1,037	$1,203	$(166)	-13.8%
ATM and debit card	359	317	42	13.2%	1,053	902	151	16.7%
Bank-owned life insurance	80	67	13	19.4%	270	199	71	35.7%
Merchant	85	73	12	16.4%	229	205	24	11.7%
Net gain (loss) on investment securities	(32)	(47)	15	31.9%	(21)	22	(43)	-195.5%
Net gain on sale of loans	124	81	43	53.1%	181	298	(117)	-39.3%
Other	103	121	(18)	-14.9%	343	334	9	2.7%
Total	$1,082	$1,004	$78	7.8%	$3,092	$3,163	$(71)	-2.2%

QNB, through its core banking business, generates various fees and service charges. Total non-interest income includes service charges on deposit accounts, ATM and check card income, income on bank-owned life insurance, merchant income and gains and losses on the sale of investment securities and residential mortgage loans.

Quarter to Quarter Comparison

Total non-interest income for the third quarter of 2011 was $1,082,000, an increase of $78,000 compared to $1,004,000 for the third quarter of 2010.

Fees for services to customers were $363,000 for the third quarter of 2011, a $29,000, or 7.4% decline from the same period in 2010. Overdraft income, which represented approximately 69.0% of total fees for services to customers during the third quarter of 2011, declined by $26,000, or 9.4%, to $250,000. The decline in overdraft income is primarily the result of the implementation of new rules under Regulation E during the third quarter of 2010.

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 $359,000 for the third quarter of 2011, an increase of $42,000, or 13.2%, from the amount recorded during the third quarter of 2010. Debit card income increased $17,000, or 7.7%, to $234,000, while ATM interchange income increased $28,000, or 37.0%, to $105,000. 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 implementation 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.

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 $80,000 and $67,000 in the third quarter of 2011 and 2010, respectively. Positively impacting income for the third quarter of 2011 was the exchange of several policies into higher yielding investments during the fourth quarter of 2010. 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.

QNB CORP. AND SUBSIDIARY

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

NON-INTEREST INCOME (Continued)

Merchant income represents fees charged to merchants for the bank's handling of credit card or charge sales. Merchant income was $85,000 for the third quarter of 2011, an increase of $12,000, or 16.4%, from the amount reported in the same period in 2010. 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 and 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.

Net securities losses were $32,000 and $47,000 for the three months ended September 30, 2011 and 2010, respectively. During the third quarter of 2011 and 2010 QNB recorded credit related other-than-temporary impairment charges of $97,000 and $51,000, respectively. The 2011 charges relate to losses in the equity securities portfolio while the 2010 charges relate to trust preferred securities. Partially offsetting the third quarter 2011 OTTI charges were gains of $65,000 realized on the sale of $4.8 million of higher coupon premium mortgage-backed securities that were prepaying at fast speeds.

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 $124,000 and $81,000 for the quarters ended September 30, 2011 and 2010, respectively. The $43,000 increase in the net gain on sale of loans reflects an increase in refinancing activity resulting from the significant decline in mortgage interest rates during the third quarter of 2011. Proceeds from the sale of residential mortgages were $2,834,000 and $1,671,000 for the third quarters of 2011 and 2010, respectively.

The $18,000 decrease in other non-interest income when comparing the two quarters is primarily the result of a decrease in mortgage servicing income. 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. As a result of the significant decline in mortgage interest rates and the resulting increase in refinancing activity, prepayment speeds increased. This had the impact of reducing the value of the mortgage servicing asset. As a result QNB recorded a $15,000 impairment charge during the third quarter of 2011.

Nine-Month Comparison

Total non-interest income for the nine month periods ended September 30, 2011 and 2010 was $3,092,000 and $3,163,000, respectively. Excluding net gains on investment securities and loans for both periods total non-interest income was $2,932,000 and $2,843,000, an increase of $89,000, or 3.1%.

Fees for services to customers declined $166,000, or 13.8%, to $1,037,000. The impact of the implementation of the new rules under Regulation E as well as a $2.00 reduction in the per item fee charged to customers in March 2010 reduced overdraft income by $173,000. Partially offsetting this lost revenue was an increase in activity fees and internet banking fees on business customers.

ATM and debit card income was $1,053,000 for the first nine months of 2011, an increase of $151,000, or 16.7%, from the amount recorded during the first nine months of 2010. Debit card income increased $60,000, or 9.6% to $688,000, while ATM interchange income increased $100,000, or 48.2%, to $307,000.The reason for the growth in income is attributable to the same items discussed for the quarter.

QNB CORP. AND SUBSIDIARY

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

NON-INTEREST INCOME (Continued)

Income on Bank-owned life insurance was $270,000 and $199,000 for the first nine months of 2011 and 2010, respectively. Included in total BOLI income for 2011 was the recognition of a death benefit payment of $31,000 received during the first quarter on a life insurance policy in which the Bank was the beneficiary. As noted in the review of the quarter, also positively impacting income for the first half of 2011 was the exchange of several policies into higher yielding investments.

The net gain on the sale of residential mortgage loans was $181,000 and $298,000 for the nine months ended September 30, 2011 and 2010, respectively. This $117,000 decrease in the net gain on sale of loans was primarily a result of decreased mortgage activity as well as the interest rate environment at the time of the sale. Proceeds from the sale of residential mortgages were $5,915,000 and $7,057,000 for the first nine months of 2011 and 2010, respectively. Loans sold during the first nine months of 2010 were sold at a higher profit per loan as interest rates declined significantly between the time the loans were originated and the time they were sold. With the decline in mortgage rates to historically low levels during the third quarter of 2011, the amount of refinancing activity has increased substantially. The results of this activity should be realized during the fourth quarter of 2011 as the mortgages settle and are sold. The profit or loss realized will depend on where mortgages rates are at the time of sale.

NON-INTEREST EXPENSE

Non-Interest Expense Comparison

	Three Months Ended September 30,		Change from Prior Year		Nine Months Ended September 30,		Change from Prior Year	
	2011	2010	Amount	Percent	2011	2010	Amount	Percent
Salaries and employee benefits	$2,522	$2,409	$113	4.7 %	$7,317	$6,713	$604	9.0 %
Net occupancy	386	386	-	0.0 %	1,153	1,115	38	3.4 %
Furniture and equipment	319	295	24	8.1 %	942	865	77	8.9 %
Marketing	165	155	10	6.5 %	546	515	31	6.0 %
Third-party services	342	263	79	30.0 %	930	826	104	12.6 %
Telephone, postage and supplies	141	157	(16)	-10.2 %	447	456	(9)	-2.0 %
State taxes	152	143	9	6.3 %	452	422	30	7.1 %
FDIC insurance premiums	41	268	(227)	-84.7 %	579	779	(200)	-25.7 %
Other	446	402	44	10.9 %	1,152	1,146	6	0.5 %
Total	$4,514	$4,478	$36	0.8 %	$13,518	$12,837	$681	5.3 %

Quarter to Quarter Comparison

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 $4,514,000 for the third quarter of 2011, an increase of $36,000, or 0.8% compared to the third quarter of 2010. 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 were 52.0% and 55.0% for the three months ended September 30, 2011 and 2010, respectively and compare favorably with Pennsylvania commercial banks with assets between $500 million and $1 billion which had an average efficiency ratio of 67.8% for the second quarter of 2011, the most recent period available.

QNB CORP. AND SUBSIDIARY

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

NON-INTEREST EXPENSE (Continued)

Salaries and benefits 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 the third quarter of 2011 were $2,522,000, an increase of $113,000, or 4.7%, over the $2,409,000 reported in the third quarter of 2010. Salary expense increased $99,000, or 5.1%, during the period to $2,058,000. Included in salary expense in the third quarter of 2011 was an accrual for incentive compensation of $173,000 compared to an accrual of $101,000 for the third quarter of 2010. Also included in the third quarter of 2010 was severance related expenses of $130,000 for two former officers of the Bank. Excluding these items salary expense increased 9.1% when comparing the two quarters. Also impacting salary expense in 2011 was the hiring of a Chief Operating Officer, a Chief Compliance Officer and a Chief Information and Technology Officer, positions that were vacant during all or part of the third quarter of 2010 as well as normal merit increases. Comparing the two quarters, benefits expense increased $14,000, or 3.1%, to $464,000. An increase in payroll taxes and retirement plan expense, both a function of salary expense, account for the increase in benefits expense.

Net occupancy expense was $386,000 for both the third quarters of 2011 and 2010 while furniture and equipment expense increased $24,000, or 8.1%, to $319,000 when comparing the two quarters.. The increase in furniture and equipment expense relates to higher equipment maintenance costs, which increased $28,000 when comparing the third quarter of 2011 to the third quarter of 2010. An increase in either maintenance contract costs or actual repair costs for HVAC, ATM machines, copiers and printers contributed to the increase in equipment maintenance expense.

Marketing expense was $165,000 for the third quarter of 2011, an increase of $10,000, or 6.5%, compared to the same period in 2010. An increase in advertising accounts for the variance.

Third party services are comprised of professional services, including legal, accounting, auditing and consulting services, as well as fees paid to outside vendors for support services of day-to-day operations. These support services include internet and mobile banking, correspondent banking services, statement printing and mailing, investment security safekeeping and supply management services. Third party services expense increased $79,000, or 30.0%, to $342,000 for the three months ended September 30, 2011 compared to the same period in 2010. The largest portion of the increase related to the following third party services:

- Consultant expense increased $15,000 as a result of using an executive search firm to hire a Chief Information and Technology Officer.
- Third party IT services increased $70,000, with $58,000 related to costs associated with the conversion to a new online and mobile banking system that was introduced during the third quarter of 2011 and $13,000 related to the outsourcing of the Bank’s email system.

Telephone, postage and supplies expense was $141,000 for the third quarter of 2011. This represents a reduction of $16,000 from the amount reported during the third quarter of 2010. Supplies expense was $13,000 higher in 2010.

State tax expense represents the accrual of the Pennsylvania shares tax, which is based on the equity of the Bank, Pennsylvania sales and use tax and the Pennsylvania capital stock tax. State tax expense was $152,000 for the third quarter of 2011, an increase of $9,000 compared to the same period in 2010. The Bank’s Pennsylvania Shares Tax was $148,000 for the third quarter of 2011, an increase of $8,000 resulting from an increase in the Bank’s equity.

FDIC insurance premium expense decreased $227,000 to $41,000, when comparing the third quarter of 2011 to 2010. Beginning April 1, 2011, the FDIC changed the method used to calculate insurance premiums. Prior to this date deposits were used as the base for calculating the premium while going forward assets less tangible equity will be used as the base. In addition the rate was reduced by approximately seven basis points for institutions classified as Risk Category 1. The third quarter also includes a reversal of an over accrual of $115,000 related to the change in the calculation.

QNB CORP. AND SUBSIDIARY

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

NON-INTEREST EXPENSE (Continued)

Nine-Month Comparison

Total non-interest expense was $13,518,000 for the nine-month period ended September 30, 2011 compared to $12,837,000 for the same period in 2010, an increase of $681,000, or 5.3%.

Salaries and benefits expense increased $604,000, to $7,317,000 for the nine months ended September 30, 2011 compared to the same period in 2010. Salary expense increased $477,000 or 8.9% during the period to $5,842,000. Included in salary expense in the first nine months of 2011 was an accrual for incentive compensation of $365,000 compared to an accrual of $101,000 for the first nine months of 2010. Excluding the incentive compensation accrual in both years and severance expense of $130,000 discussed previously for 2010, salary expense increased 6.7% compared to the first nine months of 2010. Similar to the quarter, the filling of the three positions previously identified as well as normal merit increases also contributed to the increase in salary expense in 2011. Comparing the nine month periods, benefits expense increased $127,000, or 9.4%, to $1,475,000. Payroll related tax expense increased $55,000 and retirement plan expense increased $11,000, while medical and dental premiums and reimbursement claims increased $32,000 comparing the nine month periods. Also contributing to the increase in benefit expense in 2011 was $32,000 in relocation costs for the Chief Operating Officer.

Net occupancy expense increased $38,000, or 3.4%, to $1,153,000 for the first nine months of 2011 while furniture and equipment expense increased $77,000, or 8.9%, to $942,000 compared to the same 2010 period. Most of the increase in net occupancy expense relates to lease expense and the depreciation of leasehold improvements for the Wescosville branch opened in October 2010 offset by lower utility and building maintenance costs. The increase in furniture and equipment expense relates to higher equipment maintenance costs of $76,000, similar to what was discussed for the quarter.

Marketing expense increased $31,000, or 6.0%, to $546,000 for the first nine months of 2011. An increase in charitable contributions, advertising and public relations costs account for most of the increase in marketing expense. QNB contributes to many not-for-profit organizations and clubs and sponsors many local events in the communities it serves.

Third party services expense increased $104,000, or 12.6%, to $930,000 for the nine months ended September 30, 2011 when compared to the same period in 2010. The largest portion of the increase related to the following third party services:

- Consultant expense increased $53,000 as a result of using an executive search firm to hire a Chief Information and Technology Officer in 2011. This was partially offset by an $18,000 reduction in leadership training expense that was recorded in 2010.
- Third party IT services increased $106,000, with $82,000 related to costs associated with the conversion to a new online and mobile banking system that was introduced during the third quarter of 2011 and $18,000 related to the outsourcing of the Bank’s email system at the end of the second quarter of 2011.
- Legal expense decreased $16,000, or 15.0%, to $88,000 for the first nine months of 2011. A reduction in general corporate legal expense as well as loan collection costs accounts for the decline.

As mentioned in the quarterly analysis the FDIC changed the method of calculating the basis of the premium as well as reducing the rate charged. These changes resulted in a $200,000 reduction in FDIC insurance premium expense when comparing the the nine month periods. FDIC expense wsa $579,000 for the first nine months of 2011 compared to $779,000 for the same period in 2010.

QNB CORP. AND SUBSIDIARY

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

INCOME TAXES

QNB utilizes an asset and liability approach for financial accounting and reporting of income taxes. As of September 30, 2011, QNB’s net deferred tax asset was $869,000. The primary components of deferred taxes are a deferred tax asset of $3,015,000 relating to the allowance for loan losses, a deferred tax asset of $221,000 generated by OTTI charges on equity securities and a deferred tax asset of $435,000 related to OTTI charges on pooled trust preferred securities. Partially offsetting these deferred tax assets was a deferred tax liability of $2,389,000 resulting from unrealized gains on available-for-sale securities. As of September 30, 2010, QNB’s net deferred tax asset was $934,000. The primary components of deferred taxes at September 30, 2010 are a deferred tax asset of $2,765,000 relating to the allowance for loan losses, a deferred tax asset of $269,000 generated by OTTI charges on equity securities and a deferred tax asset of $435,000 related to OTTI charges on trust preferred securities. Partially offsetting these deferred tax assets was a deferred tax liability of $2,270,000 resulting from unrealized gains on available-for-sale securities.

The realizability of deferred tax assets is dependent upon a variety of factors, including the generation of future taxable income, the existence of taxes paid and recoverable, the reversal of deferred tax liabilities and tax planning strategies. Based upon these and other factors, management believes it is more likely than not that QNB will realize the benefits of these remaining deferred tax assets. The net deferred tax asset is included in other assets on the consolidated balance sheet.

Applicable income taxes and effective tax rates were $676,000, or 22.6%, for the three-month period ended September 30, 2011, and $349,000, or 17.7%, for the same period in 2010. For the nine-month periods ended September 30, 2011 and 2010 applicable income taxes and the effective tax rate were $2,044,000, or 22.7%, and $1,419,000, or 20.8%, respectively. The higher effective tax rate for both periods in 2011 is predominantly a result of tax-exempt income from loans and securities comprising a lower proportion of pre-tax income.

FINANCIAL CONDITION ANALYSIS

The following balance sheet analysis compares average balance sheet data for the nine months ended September 30, 2011 and 2010, as well as the period ended balances as of September 30, 2011 and December 31, 2010.

Average earning assets for the nine-month period ended September 30, 2011 increased $64,631,000, or 8.8%, to $803,259,000 from $738,628,000 for the nine months ended September 30, 2010. The mix of earning assets changed when comparing the two periods as most of the growth in earning assets has occurred in the investment portfolio as loan demand is slack. Average loans increased $12,352,000, or 2.7%, while average investment securities increased $51,909,000, or 20.1%. Average loans represented 59.3% of earning assets for the nine months of 2011, while average investment securities represented 38.5% of earning assets for the same period. This compares to 62.8% and 34.9%, respectively, for the first nine months of 2010.

QNB’s primary business is accepting deposits and making loans to meet the credit needs of the communities it serves. Loans are the most significant component of earning assets and growth in loans to small businesses and residents of these communities has been a primary focus of QNB. Inherent within the lending function is the evaluation and acceptance of credit risk and interest rate risk. QNB manages credit risk associated with its lending activities through portfolio diversification, underwriting policies and procedures and loan monitoring practices. Loan activity which had been strong for 2009 and most of 2010, slowed significantly during the fourth quarter of 2010 and the first nine months of 2011. In light of economic conditions businesses appear to be holding off investing in new equipment or any other type of financing and are paying down their lines with excess cash. As a result total loans decreased 1.0% between September 30, 2010 and September 30, 2011 and decreased 1.9% since December 31, 2010. Despite the lack of growth in the loan portfolio, QNB remains committed to make credit available to its customers.

Average total commercial loans increased $19,507,000 when comparing the first nine months of 2011 to the first nine months of 2010. Most of the 5.4% growth in average commercial loans was in loans secured by real estate, either commercial or residential properties, which increased $12,843,000, or 5.1%, to $262,340,000. Commercial and industrial loans represent commercial purpose loans that are either secured by collateral other than real estate or unsecured. Many of these loans are for operating lines of credit. Average commercial and industrial loans increased $5,315,000, or 6.5%, when comparing the average balances for the nine month periods while average tax-exempt loans to state and municipal organizations increased $1,349,000, or 4.5% over the same time period.

QNB CORP. AND SUBSIDIARY

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

FINANCIAL CONDITION ANALYSIS (Continued)

Average home equity loans continue to decline with average balances decreasing from $60,610,000 for the first nine months of 2010 to $55,720,000 for the first nine months of 2011. With the decline in mortgage interest rates customers have paid down their home equity loans when they refinance their first mortgage. The other impact of the low interest rate environment is movement from fixed rate home equity loans to floating rate lines tied to prime rate.

As a result of the continued strong growth in deposits and the decline in loan balances since December 31, 2010, investment security balances have increased significantly from December 31, 2010 to September 30, 2011. Total investment securities were $352,251,000 at September 30, 2011 compared with $327,936,000 at June 30, 2011 and $293,231,000 at December 31, 2010. In addition, with the further decline in interest rates and the flattening of the yield curve, cash flow from the portfolio from calls and prepayments increased during the third quarter of 2011. When combined with the sales of bonds, discussed previously, the cash flow from the portfolio and deposit growth resulted in $176,940,000 in purchases during the first nine months of 2011. This activity combined with the relative value of mortgage backed and tax-exempt securities has led to a change in the composition of the portfolio since December 31, 2010 with agency mortgage-backed securities, collateralized mortgage obligations(CMOs) and tax-exempt state and municipal securities increasing by $32,785,000, $13,589,000 and $14,742,000, respectively, when comparing December 31, 2010 and September 30, 2011.

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 portfolios. 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 banks or bank holding companies, 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 $1,878,000 at September 30, 2011. During the first nine months of 2010 a $277,000 credit-related other-than-temporary impairment charge was taken on three issues. There was no credit-related other-than-temporary impairment charge in the first nine months of 2011. It is possible that future calculations could require recording additional other-than-temporary impairment charges through earnings. For additional detail on these securities see Note 7 Investment Securities and Note 9 Fair Value Measurements and Disclosures.

For the most part, earning assets are funded by deposits. Total average deposits increased $61,246,000, or 9.3%, to $718,883,000 for the first nine months of 2011 compared to the first nine months of 2010. Customers are continuing to look for 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.

Most of the increase in average deposits was in savings accounts which increased $61,215,000, or 69.7%, to $149,007,000 for the first nine months of 2011. The growth in savings accounts is largely due to the success of QNB’s newest deposit product, Online eSavings, which pays a rate significantly higher than the average savings account rate.

The average balance of this product was $97,055,000 for the first nine months of 2011, an increase of $60,294,000 from the average balance for the first nine months of 2010. The average rate paid on this account for the first nine months of 2011 was 1.11%.

Average non-interest bearing demand accounts increased $7,274,000, or 13.0%, when comparing the nine month periods with growth in business accounts being the primary contributor. Average interest-bearing demand and municipal accounts increased $4,034,000, or 4.8%, and $15,980,000, or 43.0%, respectively, when comparing the first nine months of 2011 and 2010. The growth in relationships with several school districts contributed to the increase in municipal balances. These balances tend to be seasonal in nature and generally peak during the third quarter when taxes are collected. Total average time deposits decreased $23,756,000, or 7.4%, when comparing the nine month periods as customers were looking for the liquidity of transaction accounts including the eSavings product.

QNB CORP. AND SUBSIDIARY

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

FINANCIAL CONDITION ANALYSIS (Continued)

Total assets at September 30, 2011 were $875,211,000 compared with $809,260,000 at December 31, 2010, an increase of $65,951,000, or 8.1%. This also represents an increase of $35,931,000 from total reported assets at June 30, 2011. As noted previously most of these increases were centered in investment securities which increased $59,020,000, or 20.1% since December 31, 2010. In addition, cash and cash equivalents increased from $14,912,000 at December 31, 2010 to $32,436,000 at September 30, 2011 with most of the increase occurring in interest-earning balances at the Federal Reserve Bank. These balances were temporarily maintained at higher levels as a result of the increase in municipal deposits and the anticipated withdrawal of some of these deposits. In contrast, total loans decreased $9,204,000, or 1.9%, to $472,978,000 at September 30, 2011. As discussed previously there is currently very little demand for loans by businesses and consumers.

On the liability side, total deposits increased by $62,163,000, or 8.9%, since year-end and $37,459,000 since June 30, 2011. The growth since December was centered in lower-cost core deposits, including savings accounts which increased $39,814,000, or 33.7%, to $157,880,000. The increase in savings accounts was entirely in the Online eSavings product whose balances increased from $67,435,000 at December 31, 2010 to $107,581,000 at September 30, 2011. Also contributing to the increase in total deposits was growth in non-interest bearing demand accounts which increased $8,297,000 to $63,674,000 at September 30, 2011 and interest-bearing demand accounts which increased $28,411,000, or 21.4% to $160,911,000 at September 30, 2011. The growth in interest-bearing demand accounts was attributable to municipal deposits which increased $29,313,000 between December 31, 2010 and September 30, 2011. Municipal deposit growth also accounts for the majority of the increase in deposits between June 30, 2011 and September 30, 2011 with interest-bearing demand municipal balances increasing by $23,560,000 and municipal money market accounts increasing by $14,508,000 between June and September. Offsetting these increases was a decline in time deposit balances between December 31, 2010 and September 30, 2011. Time deposits declined $17,999,000, or 5.8%, from $310,232,000 at December 31, 2010 to $292,233,000 at September 30, 2011 as customers continue to look for liquidity. Another contributing factor would be that the rate paid on the Online eSavings product is higher than the rates paid on many of the short-term time deposits.

LIQUIDITY

Liquidity represents an institution's ability to generate cash or otherwise obtain funds at reasonable rates to satisfy demand for loans and deposit withdrawals. QNB attempts to manage its mix of cash and interest-bearing balances, Federal funds sold and investment securities in an attempt to match the volatility, seasonality, interest sensitivity and growth trends of its loans and deposits. The Company manages its liquidity risk by measuring and monitoring its liquidity sources and estimated funding needs. Liquidity is provided from asset sources through maturities and repayments of loans and investment securities. The portfolio of investment securities classified as available-for-sale and QNB's policy of selling certain residential mortgage originations in the secondary market also provide sources of liquidity. Core deposits and cash management repurchase agreements have historically been the most significant funding source for QNB. These deposits and repurchase agreements are generated from a base of consumers, businesses and public funds primarily located in the Company's market area.

Additional sources of liquidity are provided by the Bank's membership in the FHLB. At September 30, 2011, the Bank had a maximum borrowing capacity with the FHLB of approximately $180,700,000. The maximum borrowing capacity changes as a function of qualifying collateral assets. QNB has no outstanding borrowings with the FHLB at

September 30, 2011. In addition, the Bank maintains two unsecured Federal funds lines with two correspondent banks totaling $18,000,000. At September 30, 2011, there were no outstanding borrowings under these lines. Future availability under these lines is subject to the policies of the granting banks and may be withdrawn. As part of its contingency funding plan QNB successfully tested its ability to borrow from these sources during the third quarter of 2011.

QNB CORP. AND SUBSIDIARY

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

LIQUIDITY (Continued)

Total cash and cash equivalents, available-for-sale investment securities and loans held-for-sale totaled $382,846,000 and $305,704,000 at September 30, 2011 and December 31, 2010, respectively. The increase in liquid sources is primarily the result of a $59,846,000 increase in available-for-sale investment securities as of September 30, 2011 and a $15,297,000 increase in interest-bearing cash at the Federal Reserve Bank. These sources were primarily funded from an increase in total deposits and a reduction in total loans. These sources should be adequate to meet normal fluctuations in loan demand or deposit withdrawals. With the current low interest rate environment, it is anticipated that the investment portfolio will continue to provide significant liquidity as agency and municipal bonds are called and as cash flow on mortgage-backed and CMO securities continues to be steady. In the event that interest rates would increase the cash flow available from the investment portfolio could decrease.

Approximately $173,095,000 and $133,446,000 of available-for-sale securities at September 30, 2011 and December 31, 2010, respectively, were pledged as collateral for repurchase agreements and deposits of public funds. The increase in pledged securities relates to the increase in seasonal deposits of schools and municipalities during the third quarter of 2011.

As an additional source of liquidity, QNB is a member of the Certificate of Deposit Account Registry Service (CDARS) program offered by the Promontory Interfinancial Network, LLC. CDARS is a funding and liquidity management tool used by banks to access funds and manage their balance sheet. It enables financial institutions to provide customers with full FDIC insurance on time deposits over $250,000 that are placed in the program. During the third quarter of 2011, QNB began offering Insured Cash Sweep (ICS), a product similar to CDARS, but one that provides liquidity like a money market or savings account.

CAPITAL ADEQUACY

A strong capital position is fundamental to support continued growth and profitability and to serve the needs of depositors. QNB's shareholders' equity at September 30, 2011 was $69,445,000, or 7.93% of total assets, compared to shareholders' equity of $61,090,000, or 7.55% of total assets, at December 31, 2010. Shareholders’ equity at September 30, 2011 and December 31, 2010 included a positive adjustment of $4,638,000 and $1,539,000, respectively, related to unrealized holding gains, net of taxes, on investment securities available-for-sale. Without these adjustments, shareholders' equity to total assets would have been 7.44% and 7.37% at September 30, 2011 and December 31, 2010, respectively.

Average shareholders' equity and average total assets were $62,617,000 and $831,062,000 for the first nine months of 2011, an increase of 8.7% and 7.0%, respectively, from the averages for the year ended December 31, 2010. The ratio of average total equity to average total assets was 7.53% for the first nine months of 2011 compared to 7.42% for all of 2010.

QNB is subject to various regulatory capital requirements as issued by Federal regulatory authorities. Regulatory capital is defined in terms of Tier I capital (shareholders’ equity excluding unrealized gains or losses on available-for-sale debt securities and disallowed intangible assets), Tier II capital, which includes the allowable portion of the allowance for loan losses which is limited to 1.25% of risk-weighted assets and a portion of the unrealized gains on equity securities, and total capital (Tier I plus Tier II). Risk-based capital ratios are expressed as a

percentage of risk-weighted assets. Risk-weighted assets are determined by assigning various weights to all assets and off-balance sheet arrangements, such as letters of credit
and loan commitments, based on associated risk. Regulators have also adopted minimum Tier I leverage ratio standards, which measure the ratio of Tier I capital to total quarterly average assets.

QNB CORP. AND SUBSIDIARY

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

CAPITAL ADEQUACY (Continued)

The following table sets forth consolidated information for QNB Corp.:

Capital Analysis

	September 30, 2011	December 31, 2010
Tier I		
Shareholder's equity	$ 69,445	$ 61,090
Net unrealized securities gains	(4,638)	(1,539)
Total Tier I risk-based capital	$ 64,807	$ 59,551
Tier II		
Allowable portion: Allowance for loan losses	$ 7,096	$ 7,100
Unrealized gains on equity securities	87	281
Total risk-based capital	$ 71,990	$ 66,932
Risk-weighted assets	$ 565,876	$ 566,109
Average assets	$ 859,434	$ 802,144

Capital Ratios

	September 30, 2011	December 31, 2010
Tier I capital/risk-weighted assets	11.45 %	10.52 %
Total risk-based capital/risk-weighted assets	12.72 %	11.82 %
Tier I capital/average assets (leverage ratio)	7.54 %	7.42 %

The minimum regulatory capital ratios are 4.00% for Tier I, 8.00% for the total risk-based capital and 4.00% for leverage. All capital ratios have improved from December 31, 2010 as the growth rate of Tier I and total risk based capital has exceeded the growth rate of risk-weighted assets and quarterly average assets.

During the first quarter of 2010, QNB began offering a Dividend Reinvestment and Stock Purchase Plan (the "Plan") to provide participants a convenient and economical method for investing cash dividends paid on the Company's common stock in additional shares at a discount. The Plan also allows participants to make additional cash purchases of stock at a discount. Stock purchases under the Plan contributed $529,000 to capital during first nine months of 2011.

The Board of Directors has authorized the repurchase of up to 100,000 shares of its common stock in open market or privately negotiated transactions. The repurchase authorization does not bear a termination date. As of September 30, 2011, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000. There were no shares repurchased under the plan since the first quarter of 2009.

Continuing to impact risk-weighted assets is the $27,215,000 of risk-weighted assets due to mezzanine tranches of pooled trust preferred securities that were downgraded below investment grade during the first quarter of 2009. Although the amortized cost of these securities was only $3,640,000 at September 30, 2011, regulatory guidance required an additional $27,215,000 to be included in risk-weighted assets. The Bank utilized the method as outlined in the Call Report Instructions for an available-for-sale bond that has not triggered the Low Level Exposure (LLE) rule.

The mezzanine tranches of CDOs that utilized this method of risk-weighting are five out of eight pooled trust preferred securities (PreTSLs) held by the Bank as of September 30, 2011. The other three pooled trust preferred securities have only one tranche remaining so the treatment noted above does not apply.

QNB CORP. AND SUBSIDIARY

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

CAPITAL ADEQUACY (Continued)

The Federal Deposit Insurance Corporation Improvement Act of 1991 established five capital level designations ranging from "well capitalized" to "critically undercapitalized." At September 30, 2011 and December 31, 2010, management believes that the Company and the Bank met all capital adequacy requirements to which they are subject and have met the "well capitalized" criteria which requires minimum Tier I and total risk-based capital ratios of 6.00% and 10.00%, respectively, and a leverage ratio of 5.00%.

INTEREST RATE SENSITIVITY

Since the assets and liabilities of QNB have diverse repricing characteristics that influence net interest income, management analyzes interest sensitivity through the use of gap analysis and simulation models. Interest rate sensitivity management seeks to minimize the effect of interest rate changes on net interest margins and interest rate spreads and to provide growth in net interest income through periods of changing interest rates. QNB’s Asset/Liability Management Committee (ALCO) is responsible for managing interest rate risk and for evaluating the impact of changing interest rate conditions on net interest income.

Gap analysis measures the difference between volumes of rate-sensitive assets and liabilities and quantifies these repricing differences for various time intervals. Static gap analysis describes interest rate sensitivity at a point in time. However, it alone does not accurately measure the magnitude of changes in net interest income because changes in interest rates do not impact all categories of assets and liabilities equally or simultaneously. Interest rate sensitivity analysis also involves assumptions on certain categories of assets and deposits. For purposes of interest rate sensitivity analysis, assets and liabilities are stated at their contractual maturity, estimated likely call date, or earliest repricing opportunity. Mortgage-backed securities, CMOs and amortizing loans are scheduled based on their anticipated cash flow. Interest-bearing demand accounts, money market accounts and savings accounts do not have stated maturities or repricing terms and can be withdrawn or repriced at any time. This may impact QNB’s margin if more expensive alternative sources of deposits or borrowed funds are required to fund loans or deposit runoff. Management projects the repricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity.

A positive gap results when the amount of interest rate sensitive assets exceeds interest rate sensitive liabilities. A negative gap results when the amount of interest rate sensitive liabilities exceeds interest rate sensitive assets. Generally a positive or asset sensitive position is beneficial in a rising rate environment while a negative gap or liability sensitive position is beneficial in a declining rate environment.

QNB primarily focuses on the management of the one-year interest rate sensitivity gap. The one-year cumulative gap, which reflects QNB’s interest sensitivity over a period of time, was a negative $24,576,000 at September 30, 2011. The cumulative one-year gap equals -2.9% of total rate sensitive assets. This position compares to a negative gap position of $138,751,000, or -17.5% of total rate sensitive assets, at December 31, 2010. The decrease in the negative gap position is primarily the result of a decrease in the amount of time deposits scheduled to reprice over the next twelve months. As of December 31, 2010 there were $232,201,000 of time deposits scheduled to reprice in 2011 with $191,090,000 scheduled to reprice during the first nine months of 2011. This compares to $139,114,000 in time deposits as of September 30, 2011 scheduled to reprice over the next twelve months. QNB was successful in retaining the majority of the time deposits that matured during the first nine months of 2011 and usually in a lower cost time deposit or in the online eSavings product. Total time deposits decreased $17,999,000 between December 31, 2010 and September 30, 2011 while savings account balances increased $39,814,000 during this same time period. Also contributing to the reduction in the negative gap position from December 31, 2010 to September 30, 2011 was an increase in amount of expected cash flow from the investment portfolio over the next twelve months. The amount of investments expected to mature, prepay or be called over a twelve month period at September 30, 2011 was $143,511,000 compared with $76,068,000 at December 31, 2010. Estimated prepayments on mortgage-backed securities and CMO's have increased as has the amount of anticipated calls of Agency and Municipal securities as Treasury rates have declined and the yield curve has flattened.

QNB CORP. AND SUBSIDIARY

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

INTEREST RATE SENSITIVITY (Continued)

QNB also uses a simulation model to assess the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, and the size, composition and maturity or repricing characteristics of the balance sheet. The assumptions are based on the interest rate environment at period end. Management also evaluates the impact of higher and lower interest rates by simulating the impact on net interest income of changing rates. While management performs rate shocks of 100, 200 and 300 basis points, it believes that, given the level of interest rates at September 30, 2011, it is unlikely that interest rates would decline by 200 or 300 basis points. The simulation results can be found in the chart below.

Net interest income declines in a falling rate environment. This result reflects that income on earning assets would decline to a greater degree than the expense associated with interest-bearing liabilities. In a lower rate environment, the cash flow or repricing characteristics from both the loan and investment portfolios would increase and be reinvested at lower rates resulting in less income. Loan customers would likely either refinance their fixed rate loans at lower rates or request rate reductions on their existing loans. While interest expense on time deposits could decrease slightly, the interest rate floors on some municipal interest-bearing demand accounts, hypothetical interest rate floors on interest-bearing transaction accounts, money market accounts and savings accounts would prevent a significant reduction in interest expense on these accounts.

In a rising rate environment net interest income increases for the first 200 basis point increase in interest rates as earning assets reprice by a larger amount than do interest-bearing liabilities. Actual results may differ from simulated results due to various factors including time, magnitude and frequency of interest rate changes, the relationship or spread between various rates, loan pricing and deposit sensitivity, and asset/liability strategies.

The results of the simulation model are inconsistent with the anticipated results from using GAP analysis and highlight some of the weakness of just using GAP analysis which for example does not take into consideration that rates on different products do not change by the same magnitude and does not take into consideration interest rates floors and caps.

Management believes that the assumptions utilized in evaluating the vulnerability of QNB's net interest income to changes in interest rates approximate actual experience. However, the interest rate sensitivity of QNB's assets and liabilities as well as the estimated effect of changes in interest rates on net interest income could vary substantially if different assumptions are used or actual experience differs from the experience on which the assumptions were based.

The nature of QNB's current operation is such that it is not subject to foreign currency exchange or commodity price risk. At September 30, 2011, QNB did not have any hedging transactions in place such as interest rate swaps, caps or floors.

The table below summarizes estimated changes in net interest income over a twelve-month period, under alternative interest rate scenarios.

Change in Interest Rates	Net Interest Income	Dollar Change	% Change
+300 Basis Points	$ 28,046	$ 1,083	4.0 %
+200 Basis Points	28,255	1,292	4.8

+100 Basis Points	28,113	1,150	4.3
Flat Rate	26,963	-	-
-100 Basis Points	25,463	(1,500)	(5.6)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.

The information required in response to this item is set forth in Item 2, above.

ITEM 4. CONTROLS AND PROCEDURES

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the consolidated financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report. No changes were made to our internal control over financial reporting during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

QNB CORP. AND SUBSIDIARY

PART II. OTHER INFORMATION

SEPTEMBER 30, 2011

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There were no material changes to the Risk Factors described in Item 1A in QNB's Annual Report on Form 10-K for the period ended December 31, 2010.

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

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that may yet be Purchased Under the Plan
July 1, 2011 through July 31, 2011	-	-	-	42,117
August 1, 2011 through August 31, 2011	-	-	-	42,117
September 1, 2011 through September 30, 2011	-	-	-	42,117
Total	-	-	-	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 total number of shares approved for repurchase under QNB's current stock repurchase plan is 100,000.

(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.

Item 3. Default Upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit 3(i)	Articles of Incorporation of Registrant, as amended. (Incorporated by reference to Exhibit 3(i) of Registrants Form DEF 14-A filed with the Commission on April 15, 2005).
Exhibit 3(ii)	Bylaws of Registrant, as amended. (Incorporated by reference to Exhibit 3(ii) of Registrants Form 8-K filed with the Commission on January 23, 2006).
Exhibit 11	Statement Re: Computation of Earnings Per Share. (Included in Part I, Item I, hereof.)
Exhibit 31.1	Section 302 Certification of Chief Executive Officer
Exhibit 31.2	Section 302 Certification of Chief Financial Officer
Exhibit 32.1	Section 906 Certification of Chief Executive Officer
Exhibit 32.2	Section 906 Certification of Chief Financial Officer

The following Exhibits are being furnished* as part of this report:

No.	Description
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definitions Linkbase Document.*

* These interactive data files are being furnished as part of this Quarterly Report, and, in accordance with Rule 402 of Regulation S-T, shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

SIGNATURES

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

		QNB Corp.
Date: November 14, 2011	By:	/s/ Thomas J. Bisko Thomas J. Bisko Chief Executive Officer
Date: November 14, 2011	By:	/s/ Bret H. Krevolin Bret H. Krevolin Chief Financial Officer