QNB CORP
Form 10-Q
November 14, 2013
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

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 (State or Other Jurisdiction of Incorporation or Organization)	23-2318082 (I.R.S. Employer Identification No.)
15 North Third Street, P.O. Box 9005 Quakertown, PA (Address of Principal Executive Offices)	18951-9005 (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 No____

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes _ No____

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ____ No ___

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 6, 2013
Common Stock, par value $0.625	3,262,295

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QNB CORP. AND SUBSIDIARY

FORM 10-Q

QUARTER ENDED SEPTEMBER 30, 2013

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QNB Corp. and Subsidiary

CONSOLIDATED BALANCE SHEETS

	(in thousands, except share data) (unaudited) September 30, 2013	December 31, 2012
Assets		
Cash and due from banks	$15,772	$14,859
Interest-bearing deposits in banks	3,752	594
Total cash and cash equivalents	19,524	15,453
Investment securities		
Available-for-sale (amortized cost $410,244 and $394,750)	407,248	401,502
Held-to-maturity (fair value $162 and $166)	146	146
Restricted investment in bank stocks	1,868	2,244
Loans held-for-sale	385	1,616
Loans receivable	487,537	477,733
Allowance for loan losses	(8,995)	(9,772)
Net loans	478,542	467,961
Bank-owned life insurance	10,312	10,074
Premises and equipment, net	9,456	8,973
Accrued interest receivable	2,644	2,803
Other assets	8,990	9,102
Total assets	$939,115	$919,874
Liabilities		
Deposits		
Demand, non-interest bearing	$75,123	$73,685
Interest-bearing demand	246,988	191,335
Money market	57,809	76,047
Savings	203,973	191,337
Time	156,589	173,889
Time of $100,000 or more	87,470	95,345
Total deposits	827,952	801,638
Short-term borrowings	28,058	32,488
Long-term debt	5,000	5,287
Accrued interest payable	383	487
Other liabilities	1,979	2,351
Total liabilities	863,372	842,251
Shareholders' Equity		
	2,142	2,121

Common stock, par value $0.625 per share; authorized 10,000,000 shares; 3,426,864 shares and 3,392,572 shares issued; 3,262,295 and 3,228,003 shares outstanding		
Surplus	13,518	12,787
Retained earnings	64,537	60,735
Accumulated other comprehensive (loss) income, net of tax	(1,978)	4,456
Treasury stock, at cost; 164,569 shares	(2,476)	(2,476)
Total shareholders' equity	75,743	77,623
Total liabilities and shareholders' equity	$939,115	$919,874

The accompanying notes are an integral part of the 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,	
	2013	**2012**	**2013**	**2012**
Interest income				
Interest and fees on loans	$5,588	$6,036	$16,758	$18,477
Interest and dividends on investment securities:				
Taxable	1,407	1,519	4,152	4,719
Tax-exempt	663	707	2,034	2,104
Interest on interest-bearing balances and other interest income	20	14	34	33
Total interest income	7,678	8,276	22,978	25,333
Interest expense				
Interest on deposits				
Interest-bearing demand	176	175	478	501
Money market	32	55	105	192
Savings	205	272	631	902
Time	440	592	1,455	1,833
Time of $100,000 or more	282	368	918	1,117
Interest on short-term borrowings	28	27	81	80
Interest on long-term debt	63	64	189	403
Total interest expense	1,226	1,553	3,857	5,028
Net interest income	6,452	6,723	19,121	20,305
Provision for loan losses	150	300	250	600
Net interest income after provision for loan losses	6,302	6,423	18,871	19,705
Non-interest income				
Total other-than-temporary impairment loss on investment securities	-	-	(43)	-
Less: Portion of loss recognized in other comprehensive income (before taxes)	-	-	-	-
Net other-than temporary impairment losses on investment securities	-	-	(43)	-
Net gain (loss) on sale of investment securities	303	(37)	862	493
Net gain (loss) on investment securities	303	(37)	819	493
Fees for services to customers	435	394	1,170	1,078
ATM and debit card	386	367	1,116	1,098
Bank-owned life insurance	77	78	226	234
Merchant Income	94	97	276	283
Net gain on sale of loans	36	186	359	644
Other	222	40	574	187
Total non-interest income	1,553	1,125	4,540	4,017

Non-interest expense				
Salaries and employee benefits	2,691	2,609	7,923	7,783
Net occupancy	382	407	1,233	1,228
Furniture and equipment	431	387	1,261	1,090
Marketing	272	176	762	633
Third party services	356	426	1,116	1,130
Telephone, postage and supplies	162	146	502	452
State taxes	172	159	517	486
FDIC insurance premiums	180	173	533	515
Other	477	451	1,307	1,296
Total non-interest expense	5,123	4,934	15,154	14,613
Income before income taxes	2,732	2,614	8,257	9,109
Provision for income taxes	604	540	1,827	2,059
Net income	$2,128	$2,074	$6,430	$7,050
Earnings per share - basic	$0.65	$0.65	$1.98	$2.21
Earnings per share - diltued	$0.65	$0.64	$1.98	$2.20
Cash dividends per share	$0.27	$0.26	$0.81	$0.78

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

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands - unaudited)

Three months ended September 30,	**2013**			**2012**		
	Before tax amount	**Tax expense (benefit)**	**Net of tax amount**	**Before tax amount**	**Tax expense**	**Net of tax amount**
Net income	$2,732	$ 604	$ 2,128	$2,614	$ 540	$ 2,074
Other comprehensive income:						
Net unrealized holding gains on securities:						
Unrealized holding gains arising during the period	362	123	239	1,408	479	929
Reclassification adjustment for (gains) losses included in net income	(303)	(102)	(201)	37	13	24
Other comprehensive income	59	21	38	1,445	492	953
Total comprehensive income	$2,791	$ 625	$ 2,166	$4,059	$ 1,032	$ 3,027

Nine months ended September 30,	**2013**			**2012**		
	Before tax amount	**Tax expense (benefit)**	**Net of tax amount**	**Before tax amount**	**Tax expense (benefit)**	**Net of tax amount**
Net income	$8,257	$ 1,827	$6,430	$9,109	$ 2,059	$ 7,050
Other comprehensive income:						
Net unrealized holding gains on securities:						
Unrealized holding (losses) gains arising during the period	(8,929)	(3,036)	(5,893)	1,902	647	1,255
Reclassification adjustment for gains included in net income	(819)	(278)	(541)	(493)	(167)	(326)
Other comprehensive (loss) income	(9,748)	(3,314)	(6,434)	1,409	480	929
Total comprehensive (loss) income	$(1,491)	$(1,487)	$(4)	$10,518	$ 2,539	$ 7,979

The accompanying notes are an integral part of the 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 (Loss)	**Treasury** Stock	**Total**
Balance, December 31, 2012	3,228,003	$ 2,121	$ 12,787	$ 60,735	$ 4,456	$ (2,476)	$ 77,623
Net income		-	-	6,430	-	-	6,430
Other comprehensive loss, net of tax		-	-	-	(6,434)	-	(6,434)
Cash dividends declared ($0.81 per share)		-	-	(2,628)	-	-	(2,628)
Stock issued in connection with dividend reinvestment and stock purchase plan	28,234	18	632	-	-	-	650
Stock issued for employee stock purchase plan	1,913	1	39	-	-	-	40
Stock issued for options exercised	4,145	2	10	-	-	-	12
Tax benefit of stock options exercised		-	2	-	-	-	2
Stock-based compensation expense		-	48	-	-	-	48
Balance, September 30, 2013	3,262,295	$ 2,142	$ 13,518	$ 64,537	$ (1,978)	$ (2,476)	$ 75,743

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

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(in thousands, unaudited)	
Nine months ended September 30,	**2013**	**2012**
Operating Activities		
Net income	$6,430	$7,050
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	843	727
Provision for loan losses	250	600
Net gains on investment securities	(819)	(493)
Net loss on sale of repossessed assets	150	34
Net gain on sale of loans	(359)	(644)
Loss on disposal of premises and equipment	-	4
Proceeds from sales of residential mortgages held-for-sale	15,332	15,908
Origination of residential mortgages held-for-sale	(13,742)	(14,678)
Income on bank-owned life insurance	(226)	(234)
Stock-based compensation expense	48	57
Deferred income tax (benefit) provision	216	(232)
Net (decrease) increase in income taxes payable	(117)	6
Net decrease (increase) in accrued interest receivable	159	(139)
Amortization of mortgage servicing rights and change in valuation allowance	38	149
Net amortization of premiums and discounts on investment securities	1,656	1,519
Net decrease in accrued interest payable	(104)	(288)
Decrease (increase) in other assets	3,761	(440)
Decrease in other liabilities	(372)	(75)
Net cash provided by operating activities	13,144	8,831
Investing Activities		
Proceeds from payments, maturities and calls of investment securities available-for-sale	96,892	111,479
held-to-maturity	-	1,181
Proceeds from the sale of investment securities available-for-sale	13,552	22,395
Purchases of investment securities available-for-sale	(126,775)	(210,615)
Proceeds from redemption of investment in restricted bank stock	552	139
Purchase of restricted bank stock	(176)	-
Net (increase) decrease in loans	(12,027)	10,729
Net purchases of premises and equipment	(1,326)	(1,367)
Proceeds from sales of repossessed assets	562	703
Net cash used in investing activities	(28,746)	(65,356)
Financing Activities		
Net increase in non-interest bearing deposits	1,438	635
Net increase in interest-bearing deposits	24,876	65,851
Net (decrease) increase in short-term borrowings	(4,430)	7,904
Repayments of long-term debt	(287)	(15,009)
Tax benefit from exercise of stock options	2	14
Cash dividends paid, net of reinvestment	(2,339)	(2,248)

Proceeds from issuance of common stock	413	485
Net cash provided by financing activities	19,673	57,632
Increase in cash and cash equivalents	4,071	1,107
Cash and cash equivalents at beginning of year	15,453	10,555
Cash and cash equivalents at end of period	$19,524	$11,662
Supplemental Cash Flow Disclosures		
Interest paid	$3,961	$5,316
Income taxes paid	1,725	2,270
Non-cash transactions:		
Transfer of loans to repossessed assets or other real estate owned	1,196	1,096

The accompanying notes are an integral part of the 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 2012 Annual Report incorporated in the Form 10-K. Operating results for the three and nine-month periods ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

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 period and are of a normal and recurring nature.

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, 2013, for items that should potentially be recognized or disclosed in these financial statements.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. The amendments in this guidance require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. This amendment is effective prospectively for reporting periods beginning after December 15, 2012 for public companies. The application of this standard did not have a material impact on the Company’s financial statements, but it did result in additional required disclosures that can be found in Note 6.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. STOCK-BASED COMPENSATION AND SHAREHOLDERS' EQUITY

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. 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 $18,000 and $16,000 for the three months ended September 30, 2013 and 2012, respectively, and $48,000 and $57,000 for the nine months ended September 30, 2013 and 2012, respectively. As of September 30, 2013, there was approximately $103,000 of unrecognized compensation cost related to unvested share-based compensation award grants that is expected to be recognized over the next 28 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, 2013, there were 225,058 options granted, 30,444 options forfeited, 164,814 options exercised and 29,800 options outstanding under this Plan. The 1998 Plan expired on March 10, 2008.

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, 2013, there were 143,200 options granted, 45,000 options forfeited, 11,100 options exercised, and 87,100 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 period:

Nine months ended September 30,	**2013**		**2012**	
Risk free interest rate	0.35	%	0.39	%
Dividend yield	4.26		4.68	
Volatility	34.10		33.81	
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 approximating 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 2013 and 2012 was $4.52 and $3.81, respectively.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Stock option activity during the nine months ended September 30, 2013 is as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2012	128,225	22.72		
Granted	20,000	23.20		
Exercised	(28,725)	20.35		
Forfeited	(2,600)	19.79		
Outstanding at September 30, 2013	116,900	$ 23.45	2.15	$ 366
Exercisable at September 30, 2013	58,900	$ 25.23	0.96	$ 203

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, 2013. As of September 30, 2013, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000.

5. EARNINGS PER SHARE

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

	Three months ended September 30,		Nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Numerator for basic and diluted earnings per share - net income	$2,128	$2,074	$6,430	$7,050
Denominator for basic earnings per share - weighted average shares outstanding	3,253,939	3,202,104	3,243,385	3,191,226
Effect of dilutive securities - employee stock options	12,542	13,572	11,543	13,605
Denominator for diluted earnings per share - adjusted weighted average shares outstanding	3,266,481	3,215,676	3,254,928	3,204,831
Earnings per share - basic	$0.65	$0.65	$1.98	$2.21
Earnings per share - diluted	$0.65	$0.64	$1.98	$2.20

There were 49,800 and 52,300 stock options that were anti-dilutive for both the three and nine-month periods ended September 30, 2013 and 2012, respectively. These stock options were not included in the above calculation.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. COMPREHENSIVE INCOME

The following shows the components of accumulated other comprehensive income at September 30, 2013 and December 31, 2012:

	September 30, 2013	**December 31,** 2012
Unrealized net holding (losses) gains on available-for-sale securities	$ (2,192)	$ 7,736
Unrealized losses on available-for-sale securities for which a portion of an other-than-temporary impairment loss has been recognized in earnings	(804)	(984)
Accumulated other comprehensive (loss) income	(2,996)	6,752
Tax benefit (expense)	1,018	(2,296)
Accumulated other comprehensive (loss) income, net of tax	$ (1,978)	$ 4,456

The following table presents amounts reclassified out of accumulated other comprehensive income for the nine months ended September 30, 2013:

Details about accumulated other comprehensive income	**Amount reclassified from accumulated other comprehensive income**	**Affected line item in the statement of income**
Unrealized net holding gains on available-for-sale securities	$ 862	Net gain on sale of investment securities

Other-than-temporary impairment losses on investment securities	(43)	Net other-than-temporary impairment losses on investment securities
	819	
Tax expense	(278)	Provision for income taxes
Total reclass out of accumulated other comprehensive income, net of tax	$ 541	Net of tax

7. INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities available-for-sale at September 30, 2013 and December 31, 2012 were as follows:

September 30, 2013	**Fair** value	**Gross** unrealized holding gains	**Gross** unrealized holding losses	**Amortized** cost
U.S. Government agency securities	$78,124	$ 267	$ 1,336	$ 79,193
State and municipal securities	88,873	1,301	1,351	88,923
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	147,425	1,985	1,693	147,133
Collateralized mortgage obligations (CMOs)	79,766	634	1,958	81,090
Pooled trust preferred securities	2,169	96	1,446	3,519
Corporate debt securities	6,007	12	16	6,011
Equity securities	4,884	590	81	4,375
Total investment securities available-for-sale	$407,248	$ 4,885	$ 7,881	$ 410,244

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. INVESTMENT SECURITIES (continued)

December 31, 2012	**Fair** value	**Gross** unrealized holding gains	**Gross** unrealized holding losses	**Amortized** cost
U.S. Government agency securities	$104,130	$ 750	$ 19	$ 103,399
State and municipal securities	86,789	3,141	91	83,739
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	107,973	3,169	33	104,837
Collateralized mortgage obligations (CMOs)	94,091	1,188	155	93,058
Pooled trust preferred securities	1,962	51	1,608	3,519
Corporate debt securities	2,502	44	-	2,458
Equity securities	4,055	402	87	3,740
Total investment securities available-for-sale	$401,502	$ 8,745	$ 1,993	$ 394,750

The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at September 30, 2013 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 and municipal securities that have been pre-refunded.

September 30, 2013	**Fair value**	**Amortized** cost
Due in one year or less	$ 7,863	$ 7,770
Due after one year through five years	207,044	205,227
Due after five years through ten years	145,966	149,662
Due after ten years	41,491	43,210
Equity securities	4,884	4,375
Total investment securities available-for-sale	$ 407,248	$ 410,244

Proceeds from sales of investment securities available-for-sale were approximately $13,552,000 and $22,395,000 for the nine months ended September 30, 2013 and 2012, respectively.

At September 30, 2013 and December 31, 2012, investment securities available-for-sale totaling approximately $219,825,000 and $170,433,000, 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:

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. INVESTMENT SECURITIES (continued)

	Nine months ended September 30, 2013				**Nine months ended September 30, 2012**			
	Gross realized gains	**Gross** realized losses	**Other-than-** temporary impairment losses	**Net gains**	**Gross** realized gains	**Gross** realized losses	**Other-than-** temporary impairment losses	**Net gains**
Equity securities	$672	$ -	$ (43)	$629	$427	$ -	$ -	$427
Debt securities	190	-	-	190	145	(79)	-	66
Total	$862	$ -	$ (43)	$819	$572	$ (79)	$ -	$493

The tax expense applicable to the net realized gains for the nine-month periods ended September 30, 2013 and 2012 amounted to approximately $278,000 and $167,000, respectively.

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 following table presents a roll forward 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 the beginning of the year. 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 on debt securities in the first nine months of 2013 or 2012.

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:

Nine months ended September 30,	**2013**	**2012**
Balance, beginning of period	$1,271	$1,279
Reductions: gain on payoff	-	8
Additions:		
Initial credit impairments	-	-
Subsequent credit impairments	-	-
Balance, end of period	$1,271	$1,271

QNB CORP. AND SUBSIDIARY

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(Unaudited)

7. INVESTMENT SECURITIES (continued)

The amortized cost and estimated fair values of investment securities held-to-maturity at September 30, 2013 and December 31, 2012 were as follows:

Held-To-Maturity

	September 30, 2013				**December 31, 2012**			
	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	$146	$ 16	-	$162	$146	$ 20	-	$166

The amortized cost and estimated fair value of securities held-to-maturity by contractual maturity at September 30, 2013 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.

September 30, 2013	**Fair value**	**Amortized** cost
Due in one year or less	-	-
Due after one year through five years	$ 162	$ 146
Due after five years through ten years	-	-
Due after ten years	-	-
Total investment securities held-to-maturity	$ 162	$ 146

There were no sales of investment securities classified as held-to-maturity during the nine months ended September 30, 2013 or 2012.

The following table indicates the length of time individual securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012:

September 30, 2013

		Less than 12 months		12 months or longer		Total	
	No. of	**Fair**	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**
	securities	value	losses	value	losses	value	losses
U.S. Government agency securities	42	$52,839	$ 1,309	$977	$ 27	$53,816	$ 1,336
State and municipal securities	81	34,967	1,270	1,442	81	36,409	1,351
U.S. Government agencies and sponsored enterprises (GSEs):							
Mortgage-backed securities	46	67,691	1,693	-	-	67,691	1,693
Collateralized mortgage obligations (CMOs)	43	43,399	1,639	9,122	319	52,521	1,958
Pooled trust preferred securities	5	-	-	1,772	1,446	1,772	1,446
Corporate debt securities	4	3,989	16	-	-	3,989	16
Equity securities	4	446	53	128	28	574	81
Total	225	$203,331	$ 5,980	$13,441	$ 1,901	$216,772	$ 7,881

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QNB CORP. AND SUBSIDIARY

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7. INVESTMENT SECURITIES (continued)

December 31, 2012

		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	4	$3,992	$ 19	-	-	$3,992	$ 19
State and municipal securities	15	6,472	91	-	-	6,472	91
U.S. Government agencies and sponsored enterprises (GSEs):							
Mortgage-backed securities	9	13,439	33	-	-	13,439	33
Collateralized mortgage obligations (CMOs)	19	28,396	155	-	-	28,396	155
Pooled trust preferred securities	5	-	-	$1,609	$ 1,608	1,609	1,608
Equity securities	7	587	45	272	42	859	87
Total	59	$52,886	$ 343	$1,881	$ 1,650	$54,767	$ 1,993

Management evaluates debt securities, which are comprised of U.S. Government agencies, states and municipalities, mortgage-backed securities, CMOs and corporate debt securities, 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 credit rating of each security. The unrealized losses at September 30, 2013 in U.S. Government securities, state and municipal securities, mortgage-backed securities, CMOs and corporate debt securities are primarily the result of fluctuating interest rates during the third quarter due to the fear of and eventual shutdown of the Federal government, the unknown direction of the Federal Reserve’s bond buying program and lack of clarity on who would be the next Federal Reserve Chairperson. 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.

QNB holds seven pooled trust preferred securities as of September 30, 2013. These securities have a total amortized cost of approximately $3,519,000 and a fair value of $2,169,000. Five of the seven securities have been in an unrealized loss position for more than twelve months. 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, 2013:

Deal	**Class**	**Book value**	**Fair value**	**Unrealized gains (losses)**	**Realized OTTI credit loss (YTD 2013)**	**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	$206	$(37)	$ -	$(1)	Caa2/B	5	-	18.0 %	139.6 %
PreTSL V	Mezzanine*	-	-	-	-	(118)	C/D	-	-	100.0	12.7
PreTSL XVII	Mezzanine	752	453	(299)	-	(222)	C/C	31	5	33.3	78.4
PreTSL XIX	Mezzanine	988	442	(546)	-	-	C/C	36	13	22.6	82.5
PreTSL XXV	Mezzanine	766	380	(386)	-	(222)	C/C	41	6	33.5	80.2
PreTSL XXVI	Mezzanine	469	291	(178)	-	(270)	C/C	40	7	30.2	83.7
PreTSL XXVI	Mezzanine	301	397	96	-	(438)	C/C	40	7	30.2	83.7
		$3,519	$2,169	$(1,350)	$ -	$(1,271)					

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

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QNB CORP. AND SUBSIDIARY

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(Unaudited)

7. INVESTMENT SECURITIES (continued)

The market for these securities at September 30, 2013 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.

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 book value and the fair value of the security less any current quarter credit related impairment. For the nine months ended September 30, 2013, 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 INTEXcalc 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 0-1%). In addition to the base prepayment assumption, due to the recent enactment of the Dodd-Frank financial legislation additional prepayment analysis was performed. First, trust preferred securities issued by banks with more than $15 billion in total assets at December 31, 2009 were identified. The current credit rating of these institutions was reviewed and it was assumed that any issuer with an investment grade credit rating would prepay their issuance as soon as possible, or July 1, 2015 for bank holding company subsidiaries of foreign banking organizations that have relied on Supervision and Regulation Letter SR-01-1. For those institutions rated below investment grade the holding companies’ approximate cost of long-term funding given their rating and marketplace interest rate 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 as soon as possible, or July 1, 2015. Finally, for issuers not impacted by the Tier 1 regulatory capital legislation enacted by the Dodd-Frank act, we identified the issuers that have shown a recent history of prepayment of both floating rate and fixed rate issues and assumed these issuers will prepay as soon as possible.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. INVESTMENT SECURITIES (continued)

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 for 2013 and beyond the rate used is calculated based on 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.

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 2013 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, 2013, it is probable that we will collect all contractual principal and interest payments on one of our seven 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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Loans held-for-sale consists of residential mortgage loans that 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:

1. Lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices.
2. Effect of external factors, such as legal and regulatory requirements.
3. 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.
4. Nature and volume of the portfolio including growth.
5. Experience, ability, and depth of lending management and staff.
6. Volume and severity of past due, classified and nonaccrual loans.
7. Quality of the Company's loan review system, and the degree of oversight by the Company's Board of Directors.
8. 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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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.

Major classes of loans are as follows:

	September 30, 2013	**December 31,** 2012
Commercial:		
Commercial and industrial	$ 102,562	$ 100,063
Construction	13,285	11,061
Secured by commercial real estate	191,992	192,867
Secured by residential real estate	45,448	41,003
State and political subdivisions	35,467	34,256
Loans to depository institutions	1,250	3,250
Indirect lease financing	8,685	9,685
Retail:		
1-4 family residential mortgages	28,112	28,733
Home equity loans and lines	58,140	54,860
Consumer	2,537	2,012
Total loans	487,478	477,790
Net unearned costs (fees)	59	(57)

Loans receivable	$ 487,537	$ 477,733

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, 2013 and December 31, 2012, overdrafts were approximately $129,000 and $103,000, 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, 2013, 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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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.

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.

Loans to depository institutions consist of a loan to a commercial bank in Lehigh County, Pennsylvania. This loan is secured by shares of common stock of the borrowing institution.

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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

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, 2013 and December 31, 2012:

September 30, 2013	**Pass**	**Special mention**	**Substandard**	**Doubtful**	**Total**
Commercial:					
Commercial and industrial	$96,489	$ 64	$ 6,009	$ -	$102,562
Construction	10,874	873	1,538	-	13,285
Secured by commercial real estate	161,598	4,238	26,156	-	191,992
Secured by residential real estate	41,118	-	4,330	-	45,448
State and political subdivisions	33,478	-	1,989	-	35,467
Loans to depository institutions	1,250	-	-	-	1,250
Indirect lease financing	8,492	-	193	-	8,685
	$353,299	$ 5,175	$ 40,215	$ -	$398,689

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

December 31, 2012	Pass	Special mention	Substandard	Doubtful	Total
Commercial:					
Commercial and industrial	$88,427	$3,843	$ 7,763	$ 30	$100,063
Construction	5,558	1,513	3,990	-	11,061
Secured by commercial real estate	157,678	7,493	27,696	-	192,867
Secured by residential real estate	36,078	1,199	3,726	-	41,003
State and political subdivisions	32,303	-	1,953	-	34,256
Loans to depository institutions	3,250	-	-	-	3,250
Indirect lease financing	9,329	-	356	-	9,685
	$332,623	$14,048	$ 45,484	$ 30	$392,185

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, 2013 and December 31, 2012:

September 30, 2013	Performing	Non-performing	Total
Retail:			
1-4 family residential mortgages	$ 27,823	$ 289	$28,112
Home equity loans and lines	57,865	275	58,140
Consumer	2,537	-	2,537
	$ 88,225	$ 564	$88,789

December 31, 2012	Performing	Non-performing	Total
Retail:			
1-4 family residential mortgages	$ 28,398	$ 335	$28,733

Home equity loans and lines	54,514	346	54,860
Consumer	2,012	-	2,012
	$ 84,924	$ 681	$85,605

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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, 2013 and December 31, 2012:

September 30, 2013	**30-59 days past due**	**60-89 days past due**	**90 days or more past due**	**Total past due loans**	**Current**	**Total loans receivable**
Commercial:						
Commercial and industrial	$544	-	-	$544	$102,018	$102,562
Construction	-	-	-	-	13,285	13,285
Secured by commercial real estate	588	$451	$2,548	3,587	188,404	191,992
Secured by residential real estate	1,043	1,111	-	2,154	43,294	45,448
State and political subdivisions	23	-	-	23	35,444	35,467
Loans to depository institutions	-	-	-	-	1,250	1,250
Indirect lease financing	100	138	13	251	8,435	8,685
Retail:						
1-4 family residential mortgages	-	118	153	271	27,841	28,112
Home equity loans and lines	2	45	101	148	57,992	58,140
Consumer	39	2	-	41	2,496	2,537
	$2,339	$1,865	$2,815	$7,019	$480,459	$487,478

December 31, 2012	**30-59 days past due**	**60-89 days past due**	**90 days or more past**	**Total past due loans**	**Current**	**Total loans receivable**

				due		
Commercial:						
Commercial and industrial	$76	-	-	$76	$99,987	$ 100,063
Construction	-	-	-	-	11,061	11,061
Secured by commercial real estate	407	$1,460	$3,097	4,964	187,903	192,867
Secured by residential real estate	44	523	293	860	40,143	41,003
State and political subdivisions	71	1	-	72	34,184	34,256
Loans to depository institutions	-	-	-	-	3,250	3,250
Indirect lease financing	344	80	35	459	9,226	9,685
Retail:						
1-4 family residential mortgages	-	197	-	197	28,536	28,733
Home equity loans and lines	152	153	197	502	54,358	54,860
Consumer	33	11	-	44	1,968	2,012
	$1,127	$2,425	$3,622	$7,174	$470,616	$ 477,790

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

The following tables disclose the recorded investment in loans receivable that are either on non-accrual status or past due 90 days or more and still accruing interest as of September 30, 2013 and December 31, 2012:

September 30, 2013	**90 days or more past due (still accruing)**	**Non-accrual**
Commercial:		
Commercial and industrial	$ -	$ 5,200
Construction	-	1,503
Secured by commercial real estate	-	4,824
Secured by residential real estate	-	3,187
State and political subdivisions	-	-
Loans to depository institutions	-	-
Indirect lease financing	-	51
Retail:		
1-4 family residential mortgages	-	289
Home equity loans and lines	-	275
Consumer	-	-
	$ -	$ 15,329

December 31, 2012	**90 days or more past due (still accruing)**	**Non-accrual**
Commercial:		

Commercial and industrial	$ -	$ 6,174
Construction	-	2,480
Secured by commercial real estate	-	6,748
Secured by residential real estate	-	2,390
State and political subdivisions	-	1
Loans to depository institutions	-	-
Indirect lease financing	-	98
Retail:		
1-4 family residential mortgages	-	335
Home equity loans and lines	-	346
Consumer	-	-
	$ -	$ 18,572

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Activity in the allowance for loan losses for the three months ended September 30, 2013 and 2012 are as follows:

Three months ended September 30, 2013	**Balance, beginning of period**	**Provision for (credit to) loan losses**	**Charge-offs**	**Recoveries**	**Balance, end of period**
Commercial:					
Commercial and industrial	$ 1,994	$ 131	$ (68)	$ 7	$ 2,064
Construction	242	38	-	-	280
Secured by commercial real estate	3,916	(1)	(491)	-	3,424
Secured by residential real estate	1,437	238	-	10	1,685
State and political subdivisions	277	(5)	(1)	-	271
Loans to depository institutions	10	(6)	-	-	4
Indirect lease financing	156	(64)	-	11	103
Retail:					
1-4 family residential mortgages	289	(40)	-	-	249
Home equity loans and lines	664	(14)	(53)	16	613
Consumer	28	24	(21)	4	35
Unallocated	418	(151)	N/A	N/A	267
	$ 9,431	$ 150	$ (634)	$ 48	$ 8,995

Three months ended September 30, 2012	**Balance, beginning of period**	**Provision for (credit to)**	**Charge-offs**	**Recoveries**	**Balance, end of period**

		loan losses			
Commercial:					
Commercial and industrial	$ 3,467	$ (577)	$ (27)	$ 1	$ 2,864
Construction	353	(58)	-	-	295
Secured by commercial real estate	3,190	419	-	14	3,623
Secured by residential real estate	811	272	-	-	1,083
State and political subdivisions	222	39	-	-	261
Loans to depository institutions	20	(5)	-	-	15
Indirect lease financing	268	(36)	(15)	1	218
Retail:					
1-4 family residential mortgages	300	3	-	-	303
Home equity loans and lines	595	(95)	-	-	500
Consumer	18	33	(26)	2	27
Unallocated	223	305	N/A	N/A	528
	$ 9,467	$ 300	$ (68)	$ 18	$ 9,717

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Activity in the allowance for loan losses for the nine months ended September 30, 2013 and 2012 are as follows:

Nine months ended September 30, 2013	**Balance, beginning of period**	**Provision for (credit to) loan losses**	**Charge-offs**	**Recoveries**	**Balance, end of period**
Commercial:					
Commercial and industrial	$ 2,505	$ (395)	$ (68)	$ 22	$ 2,064
Construction	209	71	-	-	280
Secured by commercial real estate	3,795	119	(491)	1	3,424
Secured by residential real estate	1,230	736	(336)	55	1,685
State and political subdivisions	260	12	(1)	-	271
Loans to depository institutions	15	(11)	-	-	4
Indirect lease financing	168	(91)	(1)	27	103
Retail:					
1-4 family residential mortgages	324	(75)	-	-	249
Home equity loans and lines	582	234	(225)	22	613
Consumer	27	40	(55)	23	35
Unallocated	657	(390)	N/A	N/A	267
	$ 9,772	$ 250	$ (1,177)	$ 150	$ 8,995

Nine months ended September 30, 2012	**Balance, beginning of period**	**Provision for (credit to)**	**Charge-offs**	**Recoveries**	**Balance, end of period**

		loan losses			
Commercial:					
Commercial and industrial	$ 2,959	$ (57)	$ (101)	$ 63	$ 2,864
Construction	556	(261)	-	-	295
Secured by commercial real estate	3,124	423	-	76	3,623
Secured by residential real estate	746	423	(86)	-	1,083
State and political subdivisions	195	66	-	-	261
Loans to depository institutions	20	(5)	-	-	15
Indirect lease financing	312	(83)	(38)	27	218
Retail:					
1-4 family residential mortgages	249	73	(21)	2	303
Home equity loans and lines	625	(118)	(19)	12	500
Consumer	20	46	(46)	7	27
Unallocated	435	93	N/A	N/A	528
	$ 9,241	$ 600	$ (311)	$ 187	$ 9,717

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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.

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 that may be 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 considered non-performing and 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.

QNB assesses all loan restructurings under the guidance of ASU 2011-02. Performing TDRs (not reported as non-accrual or past due 90 days or more and still accruing) totaled $4,246,000 and $2,578,000 as of September 30, 2013 and December 31, 2012, respectively. Non-performing TDRs totaled $4,718,000 and $3,299,000 as of September 30, 2013 and December 31, 2012, respectively. All TDRs are included in the impaired loan amounts presented throughout this footnote.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

The following table presents loans by loan class modified as TDRs during the three and nine months ended September 30, 2013 and 2012. 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, 2013 and 2012.

Three months ended September 30,	**2013**			**2012**		
	Number of contracts	**Pre-modification outstanding recorded investment**	**Post-modification outstanding recorded investment**	**Number of contracts**	**Pre-modification outstanding recorded investment**	**Post-modification outstanding recorded investment**
Commercial:						
Secured by commercial real estate	2	$ 2,289	$ 2,289	-	-	-
Secured by residential real estate	12	690	683	10	$ 564	$ 564
	14	$ 2,979	$ 2,972	10	$ 564	$ 564

Nine months ended September 30,	**2013**			**2012**		
	Number of contracts	**Pre-modification outstanding recorded investment**	**Post-modification outstanding recorded investment**	**Number of contracts**	**Pre-modification outstanding recorded investment**	**Post-modification outstanding recorded investment**
Commercial:						
Commercial and industrial	-	-	-	2	$ 482	$ 448
Secured by commercial real estate	3	$ 4,111	$ 4,111	1	2,380	2,346
Secured by residential real estate	12	690	683	10	564	564

Retail:						
1-4 family residential mortgages	-	-	-	1	145	139
Home equity loans and lines	-	-	-	1	38	37
	15	$ 4,801	$ 4,794	15	$ 3,609	$ 3,534

The TDR concessions made during the nine months ended September 30, 2013 involved primarily interest only repayment period on the loans. There was $549,000 of specific reserve for loan losses allocated to the loans modified as TDRs during the nine months ended September 30, 2013. Any required 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 nine months ended September 30, 2013 or 2012.

There were no loans modified as TDRs within 12 months prior to September 30, 2013 for which there was a payment default (30 days or more past due) during the nine months ended September 30, 2013.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

The following tables present the balance in the allowance for loan losses at September 30, 2013 and December 31, 2012 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, 2013	**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	$2,064	$ 1,030	$ 1,034	$102,562	$ 5,974	$ 96,588
Construction	280	-	280	13,285	1,537	11,748
Secured by commercial real estate	3,424	357	3,067	191,992	14,866	177,126
Secured by residential real estate	1,685	756	929	45,448	3,528	41,920
State and political subdivisions	271	-	271	35,467	1,697	33,770
Loans to depository institutions	4	-	4	1,250	-	1,250
Indirect lease financing	103	6	97	8,685	51	8,634
Retail:						
1-4 family residential mortgages	249	61	188	28,112	636	27,476
Home equity loans and lines	613	67	546	58,140	275	57,865
Consumer	35	-	35	2,537	-	2,537
Unallocated	267	N/A	N/A	N/A	N/A	N/A
	$8,995	$ 2,277	$ 6,451	$487,478	$ 28,564	$ 458,914

	Allowance for Loan Losses			Loans Receivable		
December 31, 2012	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	$2,505	$ 1,309	$ 1,196	$100,063	$ 7,753	$ 92,310
Construction	209	-	209	11,061	3,990	7,071
Secured by commercial real estate	3,795	619	3,176	192,867	14,931	177,936
Secured by residential real estate	1,230	543	687	41,003	2,843	38,160
State and political subdivisions	260	-	260	34,256	1,849	32,407
Loans to depository institutions	15	-	15	3,250	-	3,250
Indirect lease financing	168	13	155	9,685	98	9,587
Retail:						
1-4 family residential mortgages	324	90	234	28,733	456	28,277
Home equity loans and lines	582	127	455	54,860	384	54,476
Consumer	27	-	27	2,012	-	2,012
Unallocated	657	N/A	N/A	N/A	N/A	N/A
	$9,772	$ 2,701	$ 6,414	$477,790	$ 32,304	$ 445,486

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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, 2013 and December 31, 2012:

September 30, 2013	**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	$ 3,383	$ 3,735	$ -		
Construction	1,537	1,806	-		
Secured by commercial real estate	12,779	13,292	-		
Secured by residential real estate	1,059	1,087	-		
State and political subdivisions	1,697	1,697	-		
Loans to depository institutions	-	-	-		
Indirect lease financing	22	29	-		
Retail:					
1-4 family residential mortgages	363	385	-		
Home equity loans and lines	208	235	-		
Consumer	-	-	-		
	$ 21,048	$ 22,266	$ -		
With an allowance recorded:					
Commercial:					
Commercial and industrial	$ 2,591	$ 2,882	$ 1,030		
Construction	-	-	-		
Secured by commercial real estate	2,087	2,522	357		
Secured by residential real estate	2,469	2,628	756		
State and political subdivisions	-	-	-		
Loans to depository institutions	-	-	-		
Indirect lease financing	29	31	6		

Retail:					
1-4 family residential mortgages	273	285	61		
Home equity loans and lines	67	76	67		
Consumer	-	-	-		
	$ 7,516	$ 8,424	$ 2,277		
Total:					
Commercial:					
Commercial and industrial	$ 5,974	$ 6,617	$ 1,030	$ 6,487	$ 31
Construction	1,537	1,806	-	3,675	45
Secured by commercial real estate	14,866	15,814	357	13,709	309
Secured by residential real estate	3,528	3,715	756	3,036	25
State and political subdivisions	1,697	1,697	-	1,798	53
Loans to depository institutions	-	-	-	-	-
Indirect lease financing	51	60	6	69	-
Retail:					
1-4 family residential mortgages	636	670	61	465	4
Home equity loans and lines	275	311	67	301	1
Consumer	-	-	-	-	-
	$ 28,564	$ 30,690	$ 2,277	$ 29,540	$ 468

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

December 31, 2012	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	$ 5,241	$ 5,477	$ -		
Construction	3,990	4,170	-		
Secured by commercial real estate	11,392	12,128	-		
Secured by residential real estate	897	912	-		
State and political subdivisions	1,849	1,850	-		
Loans to depository institutions	-	-	-		
Indirect lease financing	37	44	-		
Retail:					
1-4 family residential mortgages	181	198	-		
Home equity loans and lines	184	196	-		
Consumer	-	-	-		
	$ 23,771	$ 24,975	$ -		
With an allowance recorded:					
Commercial:					
Commercial and industrial	$ 2,512	$ 2,687	$ 1,309		
Construction	-	-	-		
Secured by commercial real estate	3,539	4,023	619		
Secured by residential real estate	1,946	2,024	543		
State and political subdivisions	-	-	-		
Loans to depository institutions	-	-	-		
Indirect lease financing	61	67	13		
Retail:					
1-4 family residential mortgages	275	287	90		
Home equity loans and lines	200	214	127		
Consumer	-	-	-		
	$ 8,533	$ 9,302	$ 2,701		

Total:					
Commercial:					
Commercial and industrial	$ 7,753	$ 8,164	$ 1,309	$ 7,657	$ 74
Construction	3,990	4,170	-	4,972	111
Secured by commercial real estate	14,931	16,151	619	14,883	541
Secured by residential real estate	2,843	2,936	543	2,439	47
State and political subdivisions	1,849	1,850	-	1,478	64
Loans to depository institutions	-	-	-	-	-
Indirect lease financing	98	111	13	86	-
Retail:					
1-4 family residential mortgages	456	485	90	518	5
Home equity loans and lines	384	410	127	510	5
Consumer	-	-	-	-	-
	$ 32,304	$ 34,277	$ 2,701	$ 32,543	$ 847

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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.

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

The following table sets forth QNB's financial assets measured at fair value on a recurring and nonrecurring basis and the fair value measurements by level within the fair value hierarchy as of September 30, 2013:

September 30, 2013	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
Recurring fair value measurements				
Securities available-for-sale				
U.S. Government agency securities	-	$ 78,124	-	$78,124
State and municipal securities	-	88,873	-	88,873
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	-	147,425	-	147,425
Collateralized mortgage obligations (CMOs)	-	79,766	-	79,766
Pooled trust preferred securities	-	-	$ 2,169	2,169
Corporate debt securities	-	6,007	-	6,007
Equity securities	$ 4,884	-	-	4,884
Total securities available-for-sale	$ 4,884	$ 400,195	$ 2,169	$407,248
Total recurring fair value measurements	$ 4,884	$ 400,195	$ 2,169	$407,248
Nonrecurring fair value measurements				
Impaired loans	-	-	$ 5,239	$5,239
Mortgage servicing rights	-	-	523	523
Total nonrecurring fair value measurements	$ -	$ -	$ 5,762	$5,762

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the nine months ended September 30, 2013. There were also no transfers in or out of level 3 for the same period. There were no 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, 2013 and 2012, respectively.

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

The following table sets forth QNB's financial assets measured at fair value on a recurring and nonrecurring basis, the fair value measurements by level within the fair value hierarchy as of December 31, 2012:

December 31, 2012	**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**
Recurring fair value measurements				
Securities available-for-sale				
U.S. Government agency securities	-	$ 104,130	-	$104,130
State and municipal securities	-	86,789	-	86,789
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	-	107,973	-	107,973
Collateralized mortgage obligations (CMOs)	-	94,091	-	94,091
Pooled trust preferred securities	-	-	$ 1,962	1,962
Corporate debt securities	-	2,502	-	2,502
Equity securities	$ 4,055	-	-	4,055
Total securities available-for-sale	$ 4,055	$ 395,485	$ 1,962	$401,502
Total recurring fair value measurements	$ 4,055	$ 395,485	$ 1,962	$401,502
Nonrecurring fair value measurements				
Impaired loans	$ -	$ -	$ 5,832	$5,832
Mortgage servicing rights	-	-	448	448
Total nonrecurring fair value measurements	$ -	$ -	$ 6,280	$6,280

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which QNB has utilized Level 3 inputs to determine fair value:

	Quantitative information about Level 3 fair value measurements			
September 30, 2013	**Fair value**	**Valuation techniques**	**Unobservable input**	**Value or range of values**
Impaired loans	$5,239	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to -30%
			Liquidation expenses (2)	0% to -10%
Mortgage servicing rights	$523	Discounted cash flow	Remaining term (yrs)	3 - 30
			Discount rate	10% to 12%

(1) Fair value is primarily determined through appraisals of the underlying collateral by independent parties, which generally includes

various level 3 inputs which are not always identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The range is presented as a percent of the initial appraised value.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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, 2013:

Fair value measurements using

significant unobservable inputs

	(Level 3)
Balance, beginning of year	$1,962
Settlements	-
Total gains or losses (realized/unrealized)	
Included in earnings	-
Included in other comprehensive income	207
Transfers in and/or out of Level 3	-
Balance, September 30, 2013	$2,169

The Level 3 securities consist of seven collateralized debt obligation securities, PreTSL securities, which are backed by trust preferred securities issued by banks, thrifts, and insurance companies. The market for these securities at September 30, 2013 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.

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, 2013;

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 INTEXcalc 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, overall deal default rates are modeled. 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 banks 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.

QNB CORP. AND SUBSIDIARY

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(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

The base loss severity assumption and long-term loss severity assumptions are modeled at 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.

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 0-1%). 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. The current credit rating of these institutions was reviewed and it was assumed that any issuer with an investment grade credit rating would prepay their issuance as soon as possible, or July 1, 2015 for bank holding company subsidiaries of foreign banking organizations that have relied on Supervision and Regulation Letter SR-01-1. For those institutions rated below investment grade the holding companies' approximate cost of long-term funding given their rating and marketplace interest rate 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 as soon as possible, or July 1, 2015. Finally, for issuers not impacted by the Tier 1 regulatory capital legislation enacted by the Dodd-Frank Act, the issuers that have shown a recent history of prepayment of both floating rate and fixed rate issues were identified and it was assumed these issuers will prepay as soon as possible.

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 3.94% to 9.38%. 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
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.

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, 2013 and December 31, 2012:

Cash and cash equivalents, accrued interest receivable and accrued interest payable (carried at cost): The carrying amounts reported in the balance sheet approximate those assets' fair value.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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. Level 2 debt securities are valued by a third-party pricing service commonly used in the banking industry. Level 2 fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution date, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things. 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.

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.

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 stratified 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.

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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.

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 and off-balance sheet instruments are summarized as follows:

			Fair value measurements		
September 30, 2013	**Carrying amount**	**Fair value**	**Quoted prices**	**Significant other**	**Significant unobservable**

			in active markets for identical assets (Level 1)	observable inputs (Level 2)	inputs (Level 3)
Financial assets					
Cash and cash equivalents	$19,524	$19,524	$19,524	-	-
Investment securities available-for-sale	407,248	407,248	4,884	$400,195	$ 2,169
Investment securities held-to-maturity	146	162	-	162	-
Restricted investment in bank stocks	1,868	1,868	-	1,868	-
Loans held-for-sale	385	400	-	400	-
Net loans	478,542	475,868	-	-	475,868
Mortgage servicing rights	523	635	-	-	635
Accrued interest receivable	2,644	2,644	-	2,644	-
Financial liabilities					
Deposits with no stated maturities	$583,893	$583,893	$583,893	-	$ -
Deposits with stated maturities	244,059	246,142	-	$246,142	-
Short-term borrowings	28,058	28,058	28,058	-	-
Long-term debt	5,000	5,111	-	5,111	-
Accrued interest payable	383	383	-	383	-
Off-balance sheet instruments					
Commitments to extend credit	$-	$-	$-	$ -	$ -
Standby letters of credit	-	-	-	-	-

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

			Fair value measurements		
December 31, 2012	Carrying amount	Fair value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets					
Cash and cash equivalents	$15,453	$15,453	$15,453	-	-
Investment securities available-for-sale	401,502	401,502	4,055	$ 395,485	$ 1,962
Investment securities held-to-maturity	146	166	-	166	-
Restricted investment in bank stocks	2,244	2,244	-	2,244	-
Loans held-for-sale	1,616	1,674	-	1,674	-
Net loans	467,961	474,330	-	-	474,330
Mortgage servicing rights	448	464	-	-	464
Accrued interest receivable	2,803	2,803	-	2,803	-
Financial liabilities					
Deposits with no stated maturities	$532,404	$532,404	$532,404	-	$ -
Deposits with stated maturities	269,234	273,878	-	$ 273,878	-
Short-term borrowings	32,488	32,488	32,488	-	-
Long-term debt	5,287	5,694	-	5,694	-
Accrued interest payable	487	487	-	487	-
Off-balance sheet instruments					
Commitments to extend credit	$ -	$ -	$ -	$ -	$ -
Standby letters of credit	-	-	-	-	-

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,	**December 31,**
	2013	2012
Commitments to extend credit and unused lines of credit	$ 176,376	$ 138,425
Standby letters of credit	5,618	5,332
Total financial instrument commitments	$ 181,994	$ 143,757

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. OFF-BALANCE-SHEET FINANCIAL INSTRUMENTS AND GUARANTEES (continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. 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, 2013 and December 31, 2012 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.

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, 2013, 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 following table.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. REGULATORY RESTRICTIONS (continued)

	Capital levels					
	Actual		**Adequately capitalized**		**Well capitalized**	
As of September 30, 2013	Amount	**Ratio**	Amount	**Ratio**	**Amount**	**Ratio**
Total risk-based capital (to risk-weighted assets):						
Consolidated	$85,685	13.88%	$49,402	8.00 %	N/A	N/A
Bank	80,446	13.13	49,019	8.00	$61,274	10.00%
Tier I capital (to risk-weighted assets):						
Consolidated	77,721	12.59	24,701	4.00	N/A	N/A
Bank	72,770	11.88	24,510	4.00	36,764	6.00
Tier I capital (to average assets):						
Consolidated	77,721	8.26	37,637	4.00	N/A	N/A
Bank	72,770	7.77	37,449	4.00	46,811	5.00

	Capital levels					
	Actual		**Adequately capitalized**		**Well capitalized**	
As of December 31, 2012	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total risk-based capital (to risk-weighted assets):						
Consolidated	$80,758	13.60%	$47,490	8.00 %	N/A	N/A
Bank	76,154	12.92	47,170	8.00	$58,963	10.00%
Tier I capital (to risk-weighted assets):						
Consolidated	73,167	12.33	23,745	4.00	N/A	N/A
Bank	68,754	11.66	23,585	4.00	35,378	6.00
Tier I capital (to average assets):						
Consolidated	73,167	7.96	36,762	4.00	N/A	N/A
Bank	68,754	7.51	36,602	4.00	45,752	5.00

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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 Bucks, 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 variat of such words and similar expressions, or future or conditional verbs such as “will,” “would,” “should,” “could,” “may” or 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 2012 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 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 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 second quarter of 2013, there was a $43,000 other-than-temporary impairment (OTTI) charge on an equity security that had been in an unrealized loss position in excess of 20% for six months. There were no credit-related OTTI charges in the first nine months of 2012.

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.

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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.

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.

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RESULTS OF OPERATIONS - OVERVIEW

QNB reported net income for the third quarter of 2013 of $2,128,000, or $0.65 per share on a diluted basis. This compares to net income of $2,074,000, or $0.64 per share on a diluted basis, for the same period in 2012.

For the nine month period ended September 30, 2013, QNB reported net income of $6,430,000, or $1.98 per share on a diluted basis. This compares to net income of $7,050,000, or $2.20 per share on a diluted basis, reported for the nine month period ended September 30, 2012.

Net income expressed as an annualized rate of return on average assets and average shareholders' equity was 0.90% and 10.91%, respectively, for the quarter ended September 30, 2013 compared with 0.90% and 11.59%, respectively, for the quarter ended September 30, 2012. For the nine month periods the annualized rate of return on average assets and average shareholders' equity was 0.94% and 11.31%, respectively, for the period ended September 30, 2013 compared with 1.06% and 13.58%, respectively, for the period ended September 30, 2012.

The quarterly and nine month comparisons reflect:

- a decrease in net interest income and the net interest margin resulting from continued downward pressure on yields on earning assets,
- a lower provision for loan losses resulting from continued improvement in non-performing loans,
- an increase in gains on the sale of securities, primarily equity securities,
- an increase in fee income from deposit accounts,
- an increase in revenue from QNB Financial Services, the wealth management and retail brokerage area of the Bank,
- a decline in gains recognized on the sale of residential mortgages resulting from higher mortgage rates,
- higher losses on the sale of other real estate owned,
- ongoing costs associated with two new branch locations opened during the first quarter 2013.

Total assets as of September 30, 2013 were $939,115,000, compared with $919,874,000 at December 31, 2012. Total loans at September 30, 2013 were $487,537,000, compared with $477,733,000 at December 31, 2012, and total deposits at September 30, 2013 were $827,952,000, compared with $801,638,000 at December 31, 2012.

Net Interest Income and Net Interest Margin

Net interest income for the quarter ended September 30, 2013 totaled $6,452,000, a decrease of $271,000, or 4.0%, over the same period in 2012. However, net interest income increased by $116,000, or 1.8%, compared with the second quarter of 2013. Net interest income continues to be negatively impacted by declining yields on earning assets resulting from both the prolonged low interest rate environment and the extremely competitive interest rate environment for loans. In addition, the change in the mix of earning assets with investment securities representing a larger proportion of earning assets has also impacted the average yield on earning assets and the net interest margin. The net interest margin for the third quarter of 2013 was 3.04% compared to 3.26% for the third quarter of 2012 and 3.12% for the second quarter of 2013. The average rate earned on earning assets declined 39 basis points from 3.96% for the third quarter of 2012 to 3.57% for the third quarter of 2013. When comparing the change in the yield on earning assets between the two quarters, loans and investment securities declined from 5.09% and 2.74%, respectively, for the third quarter of 2012 to 4.66% and 2.45%, respectively, for the third quarter of 2013, a decline of 43 basis points and 29 basis points, respectively. In comparison, the cost of interest-bearing liabilities declined 18 basis points from 0.80% to 0.62% over the same time periods. The interest rate paid on interest-bearing deposits declined by 18 basis points to 0.60% for the third quarter of 2013 compared to the third quarter of 2012.

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Helping to partially offset the impact of lower net interest margin was growth in earning assets. Average earning assets for the third quarter of 2013 were $906,872,000, an increase of $22,009,000, or 2.5%, compared with the same period in 2012 and an increase of $29,023,000, or 3.3%, from the second quarter of 2013. Average investment securities for the third quarter of 2013 were $395,471,000, an increase of $16,073,000, or 4.2%, from the third quarter of 2012 and an increase of $10,092,000, or 2.6%, from the second quarter of 2013. In comparison, average loans for the third quarter of 2013 were $488,186,000, an increase of $4,755,000, or 1.0%, from the third quarter of 2012 and an increase of $5,323,000, or 1.1%, from the second quarter of 2013.

Partially funding the growth in earning assets was an increase in deposits. Average deposits for the third quarter of 2013 were $825,552,000, an increase of $14,372,000, or 1.8%, from the corresponding quarter in 2012 and an increase of $27,891,000, or 3.5%, from the second quarter of 2013. QNB has developed significant relationships with many of the school districts and municipalities in the communities it serves. During the third quarter of each year these entities deposit tax receipts resulting in seasonal growth in QNB’s deposit balances. Average interest-bearing municipal demand accounts increased $33,961,000, or 36.9%, to $125,986,000 for the third quarter of 2013 compared to the same period in 2012 and increased $43,835,000, or 53.4%, when compared to the second quarter of 2013. Also contributing to the growth in average deposits when comparing the third quarters of 2013 and 2012 was a $19,024,000, or 11.5%, increase in demand deposit accounts, both interest-bearing and non-interest bearing. The Bank continues to successfully open new business and consumer checking accounts which not only impacts balances but also provides an opportunity for fee income. Average savings accounts also increased $9,684,000, or 5.0%, to $204,914,000 when comparing the two quarters. Offsetting a portion of the growth in municipal deposits, demand deposits and savings deposits was a decline in average time deposits of $35,060,000, or 12.4%, and average money market balances of $13,237,000, or 17.4%, comparing the third quarter 2013 with the same period in 2012. Customers are still seeking the liquidity of a non-maturity account especially in light of the slight rate differential between these deposits and time deposits.

For the nine month period ended September 30, 2013 net interest income was $19,121,000, a decrease of $1,184,000, or 5.8%, from the $20,305,000 reported for the first nine months of 2012. For the nine month period ended September 30, 2013 average earning assets increased $31,807,000, or 3.7%, to $886,110,000, with average investment securities increasing 10.1% and average loans decreasing 0.2%. Average total deposits increased $27,541,000, or 3.5%, to $806,111,000 for the nine-month period ended September 30, 2013 compared to the same period in 2012. The net interest margin on a tax-equivalent basis was 3.11% for the nine-month period ended September 30, 2013 compared with 3.42% for the same period in 2012.

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

QNB closely monitors the quality of its loan portfolio and considers many factors when performing a quarterly analysis of the appropriateness of the allowance for loan losses and calculating the required provision 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.

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Asset quality has experienced modest improvement over the past year with the reduction in the level of non-accrual loans being somewhat offset by an increase in restructured loans. Total non-performing assets were $23,389,000 at September 30, 2013 compared with $24,273,000 at December 31, 2012 and $24,359,000 at September 30, 2012. Included in this classification are non-performing loans, other real estate owned (OREO) and repossessed assets, and non-accrual pooled trust preferred securities. Total non-performing loans, which represent loans on non-accrual status, loans past due 90 days or more and still accruing interest and troubled debt restructured loans were $19,575,000, or 4.01% of total loans, at September 30, 2013 compared with $21,150,000, or 4.41% of total loans, at December 31, 2012 and $21,211,000, or 4.44% of total loans, at September 30, 2012. Loans on non-accrual status were $15,329,000 at September 30, 2013 compared with $18,572,000 at December 31, 2012 and $18,582,000 at September 30, 2012. 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 total amount of non-accrual loans at September 30, 2013, $9,736,000 or 64% of the loans classified as non-accrual, are current or past due less than 30 days as of the end of the quarter. Loans classified as substandard or doubtful, which includes non-performing loans, continues to improve. At September 30, 2013 substandard or doubtful loans totaled $40,215,000, a reduction of $8,060,000, or 16.7%, from the $48,275,000 reported as of September 30, 2012.

QNB had other real estate owned and other repossessed assets of $1,645,000 as of September 30, 2013 compared with $1,161,000 at December 31, 2012 and $1,187,000 at September 30, 2012. Non-accrual pooled trust preferred securities are carried at fair value which was $2,169,000, $1,962,000, and $1,961,000 at September 30, 2013, December 31, 2012 and September 30, 2012, respectively. The increase in the balance of non-accrual pooled trust preferred securities reflects an improvement in the fair value of these securities and not the purchase of additional securities.

QNB recorded a provision for loan losses of $150,000 in the third quarter of 2013 compared to $100,000 in the second quarter of 2013 and $300,000 in the third quarter of 2012. For the nine month periods ended September 30, 2013 and 2012 the provision for loan losses was $250,000 and $600,000, respectively. Net loan charge-offs were $586,000 for the third quarter of 2013, or 0.48% annualized of total average loans, compared with net charge-offs of $20,000 for the second quarter of 2013, or 0.02% annualized of total average loans, and net loan charge-offs of $50,000 for the third quarter of 2012, or 0.04% annualized of total average loans. For the nine-month periods ended September 30, 2013 and 2012 net loan charge-offs were $1,027,000, or 0.29% annualized, and $124,000, or 0.03% annualized, respectively. The majority of charge-offs recorded during 2013 had specific reserves established during the allowance for loan loss calculation process prior to the ultimate decision to charge-off the loan.

QNB's allowance for loan losses of $8,995,000 represents 1.85% of total loans at September 30, 2013 compared to an allowance for loan losses of $9,772,000, or 2.05% of total loans, at December 31, 2012 and $9,717,000, or 2.03% of total loans, at September 30, 2012.

Non-Interest Income

Total non-interest income was $1,553,000 for the third quarter of 2013, an increase of $428,000, or 38.0%, compared with the same period in 2012. Net gains on investment securities account for $340,000 of the total increase in non-interest income compared to the third quarter of 2012. QNB recorded $303,000 of net gains on the sale of equity securities during the third quarter of 2013. This compares to net losses of $37,000 recognized in the third quarter of 2012. Fees for services to customers increased $41,000, or 10.4%, when comparing the three month-periods. The primary contributor to the increase in fees for services to customers was overdraft charges, net of waived fees. Gain on sale of loans for the third quarter of 2013 decreased $150,000, or 80.6%, when compared to the same 2012 quarter. This decline was primarily a result of a spike in mortgage interest rates at the end of the second quarter and into the third quarter. Since market prices move inversely to interest rates, the increase in interest rates resulted in lower prices for the mortgage loans at the time of sale compared to the loan prices when the rates were locked by the customer.

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Positively impacting other non-interest income was higher mutual fund and annuity income and mortgage servicing income. During the fourth quarter of 2012, QNB changed vendors and now provides securities and advisory services under the name of QNB Financial Services through Investment Professionals, Inc., a registered Broker/Dealer and Registered Investment Advisor. There has been a significant increase in revenue as a result of the change, contributing an additional $155,000 when comparing the two quarters. Mortgage servicing fees were $44,000 higher quarter-over-quarter primarily related to the change in fair value of mortgage servicing rights as calculated by an independent third-party. During the third quarter of 2013 the Bank recognized income related to the reversal of $10,000 of the previously established valuation allowance, while during the third quarter of 2012 the Bank recorded $22,000 of expense to increase the valuation allowance. Negatively impacting other non-interest income for the quarter was a loss of $65,000 on the sale of a property held in other real estate owned, which was $26,000 more than the loss recognized in the third quarter of 2012.

Total non-interest income for the nine month periods ended September 30, 2013 and 2012 was $4,540,000 and $4,017,000, respectively, an increase of $523,000, or 13.0%. Revenue from QNB Financial Services contributed an additional $351,000 and net gains on investment securities contributed an additional $326,000 in non-interest income when comparing the nine month periods. An increase in overdraft income was the primary factor in the $92,000 increase in service charges on deposit accounts. Mortgage servicing income contributed an additional $116,000 while income from QNB’s investment in a title company increased $45,000. Partially offsetting these increases was a $285,000 reduction in net gains on the sale of residential mortgage loans and an $115,000 increase in net losses on other real estate owned.

Non-Interest Expense

Total non-interest expense was $5,123,000 for the third quarter of 2013, an increase of $189,000, or 3.8%, compared to $4,934,000 for the third quarter of 2012. Salaries and benefits expense increased $82,000, or 3.1%, when comparing the two quarters. The third quarter of 2012 included an accrual for incentive compensation of $135,000. There was no accrual for incentive compensation during the third quarter of 2013. Contributing to the increase in salary and benefit expense was the addition of eleven full-time equivalent employees. The increase in employees was primarily related to the opening of two new branch locations in the first quarter of 2013 as well as two additional employees related to QNB Financial Services. The remainder of the increase in salary and benefits expense for the quarter relates primarily to higher medical and dental benefit premiums and claims as well as retirement plan expenses.

Also contributing to the increase in non-interest expense was a $58,000 increase in charitable donations. QNB contributes to many not-for-profit organizations and clubs and sponsors many local events in the communities it serves. The increase in expense during the third quarter of 2013 was mainly attributable to two multi-year commitments. Marketing expenses related to advertising, public relations, research and sales promotion were $38,000 higher for the three-month period ended September 30, 2013 than the same period in 2012.

Total non-interest expense was $15,154,000 for the nine-month period ended September 30, 2013 compared to $14,613,000 for the same period in 2012, an increase of $541,000, or 3.7%. Salary and benefits expense increased $140,000, as the impact of the new hires noted above was primarily offset by the impact of the lack of an accrual for incentive compensation. Net occupancy and furniture and equipment expense increased $176,000 to $2,494,000 for the nine month period ended September 30, 2013 compared to the same period in 2012. The opening of the two new branches in the first quarter of 2013 as well as an increase in building and equipment repairs and maintenance costs contributed to the increase in this category. Marketing expense, which includes charitable donations as noted above, increased $129,000 when comparing the nine month periods.

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

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

	Three Months Ended September 30, 2013				**September 30, 2012**			
	Average Balance	**Average** Rate		**Interest**	Average Balance	**Average** Rate		**Interest**
Assets								
Federal funds sold	$-	-		$ -	$-	-		$ -
Investment securities:								
U.S. Government agencies	75,280	1.35	%	254	86,599	1.27	%	275
State and municipal	88,521	4.54	%	1,004	81,065	5.29	%	1,071
Mortgage-backed and CMOs	218,979	2.02	%	1,106	202,024	2.35	%	1,186
Pooled trust preferred securities	3,519	0.18	%	1	3,527	0.81	%	7
Corporate debt securities	5,030	1.59	%	20	2,457	4.08	%	25
Equities	4,142	3.32	%	35	3,726	3.84	%	36
Total investment securities	395,471	2.45	%	2,420	379,398	2.74	%	2,600
Loans:								
Commercial real estate	252,200	4.83	%	3,071	252,832	5.24	%	3,329
Residential real estate	28,714	4.41	%	317	28,019	4.82	%	338
Home equity loans	52,867	3.96	%	528	50,938	4.28	%	549
Commercial and industrial	108,085	4.17	%	1,137	105,158	4.56	%	1,206
Indirect lease financing	9,026	10.00	%	226	10,990	10.16	%	279
Consumer loans	2,328	6.40	%	37	2,120	6.67	%	36
Tax-exempt loans	34,966	4.69	%	413	33,374	5.40	%	453
Total loans, net of unearned income*	488,186	4.66	%	5,729	483,431	5.09	%	6,190
Other earning assets	23,215	0.33	%	20	22,034	0.26	%	14
Total earning assets	906,872	3.57	%	8,169	884,863	3.96	%	8,804
Cash and due from banks	12,487				11,878			
Allowance for loan losses	(9,177)				(9,586)			
Other assets	30,742				29,397			
Total assets	$940,924				$916,552			
Liabilities and Shareholders' Equity								
Interest-bearing deposits:								
Interest-bearing demand	$109,820	0.24	%	66	$97,719	0.29	%	70

Municipals	125,986	0.35	%	110	92,025	0.45	%	105
Money market	62,841	0.20	%	32	76,078	0.29	%	55
Savings	204,914	0.40	%	205	195,230	0.55	%	272
Time	158,357	1.10	%	440	179,437	1.31	%	592
Time of $100,000 or more	88,778	1.26	%	282	102,758	1.42	%	368
Total interest-bearing deposits	750,696	0.60	%	1,135	743,247	0.78	%	1,462
Short-term borrowings	30,126	0.37	%	28	25,997	0.42	%	27
Long-term debt	5,129	4.76	%	63	5,292	4.75	%	64
Total interest-bearing liabilities	785,951	0.62	%	1,226	774,536	0.80	%	1,553
Non-interest-bearing deposits	74,856				67,933			
Other liabilities	2,745				2,870			
Shareholders' equity	77,372				71,213			
Total liabilities and shareholders' equity	$940,924				$916,552			
Net interest rate spread		2.95	%			3.16	%	
Margin/net interest income		3.04	%	$6,943		3.26	%	$7,251

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

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

	Nine Months Ended September 30, 2013				**September 30, 2012**			
	Average	**Average**		**Interest**	**Average**	**Average**		**Interest**
	Balance	Rate			Balance	Rate		
Assets								
Federal funds sold	$-	-		$-	$-	-		$-
Investment securities:								
U.S. Government agencies	83,921	1.26	%	794	72,946	1.54	%	840
State and municipal	86,145	4.77	%	3,081	78,253	5.43	%	3,188
Mortgage-backed and CMOs	209,883	2.05	%	3,225	194,186	2.55	%	3,712
Pooled trust preferred securities	3,519	0.18	%	5	3,592	0.42	%	11
Corporate debt securities	3,618	2.27	%	62	2,456	4.07	%	75
Equities	3,828	3.18	%	91	3,568	4.13	%	110
Total investment securities	390,914	2.48	%	7,258	355,001	2.98	%	7,936
Loans:								
Commercial real estate	249,756	4.92	%	9,191	254,295	5.35	%	10,176
Residential real estate	28,544	4.51	%	966	27,541	5.11	%	1,055
Home equity loans	51,708	4.11	%	1,589	51,169	4.47	%	1,711
Commercial and industrial	105,951	4.28	%	3,394	101,021	4.74	%	3,585
Indirect lease financing	9,438	9.96	%	705	11,640	9.83	%	858
Consumer loans	2,262	6.48	%	110	2,209	11.03	%	182
Tax-exempt loans	33,241	4.87	%	1,212	34,152	5.40	%	1,380
Total loans, net of unearned income*	480,900	4.77	%	17,167	482,027	5.25	%	18,947
Other earning assets	14,296	0.32	%	34	17,275	0.26	%	33
Total earning assets	886,110	3.69	%	24,459	854,303	4.21	%	26,916
Cash and due from banks	11,593				11,142			
Allowance for loan losses	(9,394)				(9,513)			
Other assets	30,737				28,971			
Total assets	$919,046				$884,903			
Liabilities and Shareholders' Equity								
Interest-bearing deposits:								
Interest-bearing demand	$109,412	0.24	%	194	$97,537	0.31	%	228

Municipals	96,051	0.39	%	284	67,424	0.54	%	273
Money market	68,572	0.20	%	105	75,923	0.34	%	192
Savings	201,153	0.42	%	631	187,298	0.64	%	902
Time	165,607	1.18	%	1,455	182,024	1.35	%	1,833
Time of $100,000 or more	92,717	1.32	%	918	102,295	1.46	%	1,117
Total interest-bearing deposits	733,512	0.65	%	3,587	712,501	0.85	%	4,545
Short-term borrowings	28,962	0.37	%	81	22,842	0.47	%	80
Long-term debt	5,232	4.75	%	189	11,152	4.75	%	403
Total interest-bearing liabilities	767,706	0.67	%	3,857	746,495	0.90	%	5,028
Non-interest-bearing deposits	72,599				66,069			
Other liabilities	2,747				2,970			
Shareholders' equity	75,994				69,369			
Total liabilities and shareholders' equity	$919,046				$884,903			
Net interest rate spread		3.02	%			3.31	%	
Margin/net interest income		3.11	%	$20,602		3.42	%	$21,888

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

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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, 2013 compared to September 30, 2012			**Nine Months Ended September 30, 2013 compared to September 30, 2012**		
	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. Government agencies	(21)	(37)	16	(46)	127	(173)
State and municipal	(67)	99	(166)	(107)	321	(428)
Mortgage-backed and CMOs	(80)	99	(179)	(487)	299	(786)
Pooled trust preferred securities	(6)	-	(6)	(6)	-	(6)
Corporate debt securities	(5)	26	(31)	(13)	36	(49)
Equities	(1)	4	(5)	(19)	8	(27)
Loans:						
Commercial real estate	(258)	1	(259)	(985)	(191)	(794)
Residential real estate	(21)	9	(30)	(89)	38	(127)
Home equity loans	(21)	22	(43)	(122)	16	(138)
Commercial and industrial	(69)	37	(106)	(191)	171	(362)
Indirect lease financing	(53)	(49)	(4)	(153)	(162)	9
Consumer loans	1	3	(2)	(72)	5	(77)
Tax-exempt loans	(40)	22	(62)	(168)	(38)	(130)
Other earning assets	6	2	4	1	(6)	7
Total interest income	(635)	238	(873)	(2,457)	624	(3,081)
Interest expense:						
Interest-bearing demand	(4)	10	(14)	(34)	28	(62)
Municipals	5	39	(34)	11	117	(106)
Money market	(23)	(9)	(14)	(87)	(19)	(68)
Savings	(67)	15	(82)	(271)	67	(338)

Time	(152)	(69)	(83)	(378)	(167)	(211)
Time of $100,000 or more	(86)	(49)	(37)	(199)	(106)	(93)
Short-term borrowings	1	5	(4)	1	22	(21)
Long-term debt	(1)	(1)	-	(214)	(214)	-
Total interest expense	(327)	(59)	(268)	(1,171)	(272)	(899)
Net interest income	$(308)	$297	$(605)	$(1,286)	$896	$(2,182)

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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, 2013 and 2012.

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Total interest income	$7,678	$8,276	$22,978	$25,333
Total interest expense	1,226	1,553	3,857	5,028
Net interest income	6,452	6,723	19,121	20,305
Tax-equivalent adjustment	491	528	1,481	1,583
Net interest income (fully taxable-equivalent)	$6,943	$7,251	$20,602	$21,888

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 Asset/Liability and Investment Management Committee works to manage and maximize the net interest margin for the Company.

Quarter to Quarter Comparison

Net interest income for the quarter ended September 30, 2013 totaled $6,452,000, a decrease of $271,000, or 4.0%, over the same period in 2012. On a tax-equivalent basis, net interest income decreased $308,000, or 4.2%, from $7,251,000 for the three months ended September 30, 2012 to $6,943,000 for the same period ended September 30, 2013.

As has been the case for the past couple of years, the decline in net interest income is primarily a result of the prolonged period of extremely low interest rates which has exerted downward pressure on yields on earning assets, primarily loans and investment securities. The impact of lower yields on earning assets has exceeded the impact on funding costs resulting in a decline in the net interest margin. The net interest margin for the third quarter of 2013 was 3.04%, a decline of 22 basis points from the 3.26% recorded in the third quarter of 2012. Another factor negatively impacting the net interest margin is the change in the mix of earning assets. While loan demand showed signs of improvement during the second quarter of 2013, the growth in investment securities, which tend to earn a lower yield than loans, was still significantly greater than loans. Average earning assets grew by $22,009,000, or 2.5%, when comparing the third quarter of 2013 to the same period in 2012, with average investment securities increasing $16,073,000, or 4.2%, and average loans increasing by $4,755,000, or 1.0%. On the funding side, average deposits increased $14,372,000, or 1.8%, with average transaction accounts increasing $49,432,000, or 9.3%. The growth in transaction accounts was broad based across all product lines, except for money market accounts which declined $13,237,000, or 17.4%. Offsetting a portion of this growth was a decline in average time deposits of $35,060,000, or 12.4%, when comparing the third quarter 2013 with the same period in 2012. Customers are still seeking the liquidity of a non-maturity transaction account especially in light of the slight rate differential between these deposits and time deposits. Two of the Bank’s highest paying products are the QNB-Rewards Checking account and the Online eSavings account. Short-term borrowings, primarily commercial sweep accounts, contributed an additional $4,129,000 in additional funding.

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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 $635,000, or 7.2%, to $8,169,000 for the third quarter of 2013, while total interest expense decreased $327,000, or 21.1%, to $1,226,000. Volume growth in earning assets contributed an additional $238,000 of interest income but was offset by a decline in interest income of $873,000 resulting from lower interest rates. With regard to interest expense, lower funding costs (interest rates paid) resulted in a decline in interest expense of $268,000, while the change in the mix and volume of interest bearing liabilities as discussed above resulted in an additional interest expense reduction of $59,000.

The yield on earning assets on a tax-equivalent basis decreased 39 basis points from 3.96% for the third quarter of 2012 to 3.57% for the third quarter of 2013 and also declined by 14 basis points from the 3.71% reported for the second quarter of 2013. As noted earlier the long period of historically low interest rates has resulted in a significant amount of higher yielding bonds with call features being called and prepayments on mortgage-related securities increasing, with these proceeds being reinvested in lower yielding investment securities. In addition, new loans are being originated at significantly lower rates, variable rate loans are repricing lower and some fixed rate loans are being modified lower due to competitive pressure. Also impacting net interest income, the yield on earning assets and the net interest margin are nonaccrual loans which declined from $18,582,000 at September 30, 2012 to $15,329,000 at September 30, 2013.

In comparison, the rate paid on interest-bearing liabilities decreased 18 basis points from 0.80% for the third quarter of 2012 to 0.62% for the third quarter of 2013 and decreased six basis points when compared to 0.68% reported in the second quarter of 2013.

Interest income on investment securities decreased $179,000 when comparing the two quarters as the increase in average balances could not offset the 29 basis point decline in the average yield of the portfolio. The average yield on the investment portfolio was 2.45% for the third quarter of 2013 compared with 2.74% for the third quarter of 2012. As noted previously, the decline in the yield on the investment portfolio is the result of the reinvestment of the cash flow into lower yielding securities. The yield on the investment portfolio seems to have stabilized as the increase in Treasury rates since the end of the second quarter has slowed down the amount of calls and prepayments in the portfolio and has also provided an opportunity to invest in bonds with slightly better yields than previously available. The growth in the investment portfolio was primarily in high-quality U.S. Government agency issued mortgage-backed and CMO securities as well as in tax-exempt state and municipal bonds.

Income on Government agency securities decreased $21,000, as average balances declined by $11,319,000 to $75,280,000 for the third quarter of 2013. Partially offsetting the volume impact was an increase in average yield of eight basis points to 1.35% for the third quarter of 2013 as some of the proceeds from the municipal deposits received during the third quarter of 2013 were invested at yields higher than the portfolio yield. In prior years, more of these municipal deposits would have been invested in this portfolio into bonds that had a very high likelihood of being called within six to nine months, the anticipated cash flow period of these deposits. With the increase in market rates in the second and third quarters of 2013 bonds with these characteristics were difficult to find resulting in the purchase of more mortgage-backed securities and CMO’s which provide cash flow on a monthly basis. Most of the bonds in the agency portfolio have call features ranging from three months to three years.

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Interest income on tax-exempt municipal securities decreased $67,000 as the 9.2% growth in average balances was offset by a 75 basis point decline in yield. The yield on the municipal portfolio was 4.54% for the third quarter of 2013 compared to 5.29% for the third quarter of 2012. QNB had purchased many municipal securities when rates were significantly higher. Many of these bonds have either reached maturity or their call dates and are being replaced with municipal bonds with lower yields. Typically QNB purchased municipal bonds with 10-15 year maturities; however, given the current rate environment has shortened the maturity range to between 5-7 years with call dates between 2-4 years.

Interest income on mortgage-backed securities and CMOs decreased $80,000. Average balances increased $16,955,000, or 8.4%, to $218,979,000 when comparing the two periods and contributed $99,000 in additional income. The yield on the mortgage-backed and CMO portfolio decreased 33 basis points from 2.35% for the third quarter of 2012 to 2.02% for the third quarter of 2013, resulting in a $179,000 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 three 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. With the increase in interest rates, mortgage prepayments have slowed and yields have increased slightly.

Income on loans decreased $461,000 to $5,729,000 when comparing the third quarters of 2013 and 2012 with the decline in the portfolio yield being the reason. The yield on the loan portfolio decreased 43 basis points to 4.66% when comparing the same periods, resulting in a reduction in interest income of $506,000. When comparing the two quarters average balances increased 1.0% resulting in an increase of $45,000 in interest income. 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. In addition, QNB has been aggressively promoting home equity and consumer loans with very competitive interest rates.

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 $258,000 as a result of the decline in yield. The yield on commercial real estate loans was 4.83% for the third quarter of 2013, a decrease of 41 basis points from the 5.24% reported for the third quarter of 2012 and a decrease of seven basis points from the 4.90% reported in the second quarter of 2013. Average balances decreased $632,000, or 0.2%, to $252,200,000, for the three months ended September 30, 2013 compared with the same quarter in 2012.

Income on commercial and industrial loans, the second largest category, decreased $69,000 as the impact of the decline in yield was greater than the impact of the increase in average balances. Average commercial and industrial loans increased $2,927,000, or 2.8%, to $108,085,000 for the third quarter of 2013 providing an additional $37,000 in interest income. However, the average yield on these loans decreased 39 basis points to 4.17% resulting in a decrease in income of $106,000. The yield of 4.17% for the third quarter of 2013 also represents a nine basis point decline from the second quarter of 2013. Many of the loans in this category are indexed to the prime interest rate and have floors.

Income on home equity loans declined by $21,000 when comparing the third quarter of 2013 and 2012. Beginning in the second quarter of 2013, QNB offered very attractive rates on both variable rate and fixed rate home equity loans in an attempt to increase demand. As a result average home equity loans increased $1,929,000, or 3.8%, to $52,867,000 for the third quarter of 2013. The yield on the home equity portfolio decreased 32 basis points to 3.96% when comparing the third quarters of 2013 and 2012 and decreased 15 basis points compared to the second quarter of 2012. The demand for home equity loans declined during prior periods as home values fell preventing some homeowners from having equity in their homes to borrow against while others took advantage of the low interest rates on mortgages and refinanced their home equity loans into a new mortgage. With the recent rise in mortgage interest rates and an improvement in home values it is expected that the demand for home equity loans will continue to improve.

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QNB purchases indirect lease financing receivables from a third party based on criteria specified by QNB. These loans are to small businesses and are collateralized by equipment. These loans tend to have higher risk characteristics but generally provide higher rates of return. As a result of these higher returns the market for these types of loans has become extremely competitive both in terms of rate and quality available and as a result QNB has been purchasing fewer. Average balances declined $1,964,000, or 17.9% when comparing the two quarters resulting in a reduction of $49,000 in interest income.

With the decline in interest rates QNB has renegotiated and rebid on many loans to municipalities. As a result, the average yield on the tax-exempt loan portfolio has declined from 5.40% for the third quarter of 2012 to 4.69% for the third quarter of 2013, contributing to the $40,000 decline in interest income when comparing the two periods. When comparing the same periods average balances have increased 4.8%, helping to partially offset the impact of the lower yield.

For the most part, earning assets are funded by deposits, which increased on average by $14,372,000, or 1.8%, to $825,552,000 and by borrowed funds which increased on average by $3,966,000 to $35,255,000, when comparing the third quarters of 2013 and 2012. When compared to the second quarter of 2013 average deposits increased by $27,891.000, or 3.5%. QNB has developed significant relationships with many of the school districts and municipalities in the communities it serves. During the third quarter of each year these entities deposit tax receipts resulting in seasonal growth in QNB’s deposit balances. Average interest-bearing municipal demand accounts increased $33,961,000, or 36.9%, to $125,986,000 for the third quarter of 2013 compared to the same period in 2012 and increased $43,835,000, or 53.4%, when compared to the second quarter of 2013.

Total interest expense decreased $327,000 to $1,226,000 for the third quarter of 2013 with interest expense on total deposits accounting for the entire decline. The rate paid on interest-bearing liabilities decreased 18 basis points from 0.80% for the third quarter of 2012 to 0.62% for the third quarter of 2013. During this same period, the rate paid on interest-bearing deposits decreased 18 basis points from 0.78% to 0.60%. These yields will most likely not decline much further as deposit rates are close to reaching an inherent floor.

Consistent with prior quarters, the growth in deposits when comparing the third quarter of 2013 with the third quarter of 2012 was in accounts with greater liquidity, such as non-interest-bearing and interest-bearing demand, interest-bearing municipal accounts as noted above, and savings deposits. Average non-interest-bearing demand accounts increased $6,923,000, or 10.2%, to $74,856,000 for the third quarter of 2013. QNB has been very successful in increasing business checking accounts as average balances in these accounts have increased by $8,499,000, or 17.1%, when comparing the two quarters. Average interest-bearing demand accounts increased $12,101,000, or 12.4%, to $109,820,000 for the third quarter of 2013 compared to the same quarter of 2012; however, interest expense on interest-bearing demand accounts decreased $4,000 to $66,000 for the third quarter of 2013 as the average rate paid decreased from 0.29% for the third quarter of 2012 to 0.24% for the third quarter of 2013. Included in this category is QNB-Rewards checking, a higher-rate checking account product. 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. Beginning the third quarter of 2012 the rate paid on this account was 1.25% on balances up to $25,000 and 0.50% for balances over $25,000. In the middle of August 2012 the rate was reduced to 1.00% on balances up to $25,000 and 0.25% for balances over $25,000, where it has remained. 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 2013, the average balance in this product was $31,232,000 and the related interest expense was $54,000 for an average yield of 0.69%. In comparison, the average balance of the QNB-Rewards accounts for the third quarter of 2012 was $28,753,000 with a related interest expense of $60,000 and an average rate paid of 0.82%. Even with the reduction in the rates paid on the QNB-Rewards product, the yield of 1.00% for the first $25,000 and 0.25% on balances over $25,000, assuming qualifications are met, is still an attractive rate relative to competitors' offerings as well as other QNB products. This product also generates fee income through the use of the check card. The average balance of other interest-bearing demand accounts included in this category increased from $68,966,000 for the third quarter of 2012 to $78,588,000 for the third quarter of 2013. The average rate paid on these balances was 0.06% for both three month periods ended September 30, 2012 and 2013.

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Interest expense on municipal interest-bearing demand accounts increased $5,000 to $110,000 for the third quarter of 2013. As mentioned above, the average balance of municipal interest-bearing demand accounts increased $33,961,000, or 36.9%, while the average interest rate paid on these accounts decreased from 0.45% for the third quarter of 2012 to 0.35% for the third quarter of 2013. Most of these accounts are indexed to the Federal funds rate with most having negotiated rate floors between 0.25% and 0.50%. QNB was successful in increasing its relationships with several of these customers as well as adding several new municipalities and school districts over the past year, accounting for the increase in balances.

Average money market accounts decreased $13,237,000, or 17.4%, to $62,841,000 for the third quarter of 2013 compared with the same period in 2012. Much of the decline in money market balances is a result of a shift in these balances to either municipal interest-bearing demand accounts or eSavings accounts. When comparing these same periods interest expense on money market accounts decreased $23,000 to $32,000 and the average interest rate paid declined nine basis points to 0.20% for the third quarter of 2013.

The QNB online eSavings account, introduced approximately four years ago, has been extremely successful and is the main reason for the growth of savings accounts to $203,973,000 at September 30, 2013. This product was introduced at a yield of 1.85% but as market rates declined, the eSavings interest rate paid was also reduced and declined from 0.75% at June 30, 2012 to 0.60% at September 30, 2012, to 0.50% at June 30, 2013 and to 0.45% at September 30, 2013. The average yield paid on these accounts was 0.49% for the third quarter of 2013 compared with a yield of 0.68% for the third quarter of 2012. The average balance of this product was $153,926,000 for the third quarter of 2013 compared to $147,207,000 for the third quarter of 2012 and contributed to the $9,684,000, or 5.0%, 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 and increased $2,965,000, or 6.2%, when comparing the third quarter 2013 average to the same 2012 quarter. The average rate paid on total savings accounts decreased 15 basis points from 0.55% for the third quarter of 2012 to 0.40% for the third quarter of 2013 and interest expense decreased 24.6% from $272,000 to $205,000 over the same period.

The repricing of time deposits at lower rates combined with the decline in average time deposit balances continues to have the greatest impact on total interest expense. Total interest expense on time deposits decreased $238,000, or 24.8%, to $722,000 for the third quarter of 2013. Average total time deposits decreased by $35,060,000, or 12.4%, to $247,135,000 for the third quarter of 2013. 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 2012 and the first nine months of 2013 a significant amount of time deposits have continued to reprice lower as rates have declined. The average rate paid on time deposits decreased from 1.35% to 1.16% when comparing the third quarter of 2012 to the same period in 2013.

Approximately $100,619,000, or 41.2%, of time deposits at September 30, 2013 will reprice or mature over the next 12 months. The average rate paid on these time deposits is approximately 0.67%. QNB has been trying to lengthen the maturity of the time deposit portfolio by offering a higher rate 59 month time deposit which has seen moderate success. The yield on the time deposit portfolio may decline slightly in the next quarter as short-term time deposits reprice. However, given the short-term nature of these deposits interest expense could increase if short-term time deposit rates were to increase suddenly.

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Short-term borrowings are primarily comprised of sweep accounts structured as repurchase agreements with commercial customers. Interest expense on short-term borrowings increased slightly from $27,000 for the third quarter of 2012 to $28,000 for the third quarter of 2013. When comparing these same periods average balances increased from $25,997,000 to $30,126,000 while the average rate paid declined from 0.42% to 0.37%.

Nine Month Comparison

For the nine month period ended September 30, 2013 net interest income was $19,121,000, a decrease of $1,184,000, or 5.8%, lower than the $20,305,000 reported for the first nine months of 2012. On a tax-equivalent basis net interest income declined $1,286,000, or 5.9%, to $20,602,000. For the nine month period ending September 30, 2013 average earning assets increased $31,807,000, or 3.7%, to $886,110,000, with average investment securities increasing $35,913,000, or 10.1%, to $390,914,000 and average loans decreasing $1,127,000, or 0.2%, to $480,900,000. Average total deposits increased $27,541,000, or 3.5%, to $806,111,000 for the nine-month period ended September 30, 2013 compared to the same period in 2012. The net interest margin on a tax-equivalent basis was 3.11% for the nine-month period ended September 30, 2013 compared with 3.42% for the same period in 2012.

Total interest income on a tax-equivalent basis decreased $2,457,000, from $26,916,000 to $24,459,000, when comparing the nine-month periods ended September 30, 2012 and 2013 as the additional interest income generated from the growth in earning assets was offset by the impact of declining yields on those assets. Interest income increased $624,000 as a result of volume increases but declined $3,081,000 as a result of lower yields. The analysis of the nine-month comparison periods is similar to what was described in the quarterly analysis; moderate deposit growth combined with minimal loan demand has resulted in significant growth of the investment securities portfolio. These factors when combined with the historically low interest rate environment and the repricing of earning assets has resulted in a decline in net interest income and the net interest margin.

The yield on earning assets decreased from 4.21% to 3.69% for the nine-month periods with the yield on loans decreasing from 5.25% to 4.77% during this time. The yield on investments decreased from 2.98% to 2.48% 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.

Total interest expense decreased $1,171,000, from $5,028,000 for the nine-month period ended September 30, 2012 to $3,857,000, for the nine-month period ended September 30, 2013. Most of the decrease in interest expense was a result of lower rates paid on deposits, especially time deposits and Online eSavings deposits. Interest expense on interest-bearing deposits declined by $958,000, with interest expense on time deposits and savings deposits declining $577,000 and $271,000, respectively. The average rate paid on time deposits decreased 16 basis points from 1.39% to 1.23% while the average rate paid on savings deposits decreased from 0.64% to 0.42% when comparing the nine-month periods ended September 30, 2012 and 2013. The average balance of total time deposits declined $25,995,000, or 9.1%, to $258,324,000 for the nine months ended September 30, 2013 compared with the similar 2012 period. Average savings account balances increased $13,855,000, or 7.4%, to $201,153,000 for the nine months ended September 30, 2013.

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. The average balance of non-interest and interest-bearing transaction accounts increased $53,536,000, or 10.8% to $547,787,000 for the nine-months ended September 30, 2013. Interest expense on interest-bearing demand deposits decreased $34,000, as the 7 basis point decrease in the average rate paid more than offset the impact on interest expense of the $11,875,000, or 12.2%, increase in average balances. The interest rate paid on interest-bearing demand accounts decreased from 0.31% for the first nine months of 2012 to 0.24% for the first nine months of 2013. 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.

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Interest expense on municipal deposits increased by $11,000 to $284,000 for the nine months ended September 30, 2013 as the $28,627,000 or 42.5% increase in balances offset the 15 basis point decline in the average rate paid. Interest expense on money market accounts declined by $87,000 to $105,000 for the nine month period ended September 30 2013 as the average rate paid declined from 0.34% for the first nine months of 2012 to 0.20% for the same period of 2013.

Also contributing to the reduction in interest expense, when comparing the nine-month periods, was lower expense on long-term debt. Interest expense on long-term debt declined by $214,000, primarily the result of the repayment of $15,000,000 in April 2012. The average balance of long-term debt was $5,232,000 for the first nine months of 2013 compared to $11,152,000 for the same period in 2012.

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 during the financial crisis and recession contributed to high rates of unemployment and a sharp decline in the residential and commercial real estate markets. These factors had a negative impact on both consumers and small businesses and contributed to higher than historical levels of net charge-offs, specific reserves and non-performing, impaired and classified loans. As a result higher provisions for loan losses were taken to bring the allowance for loan losses to adequate levels to support the decline in asset quality. 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 $8,995,000, or 1.85% of total loans at September 30, 2013. Over the past year economic conditions and asset quality have improved allowing for reduced provision for loan losses and a reduction in the required allowance for loan losses. The allowance for loan losses was $9,772,000, or 2.05% of total loans at December 31, 2012, and $9,717,000, or 2.03% of total loans at September 30, 2012. The allowance for loan losses at September 30, 2013 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.

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QNB recorded a provision for loan losses of $150,000 in the third quarter of 2013 compared to $100,000 in the second quarter of 2013 and $300,000 in the third quarter of 2012. For the nine month periods ended September 30, 2013 and 2012 the provision for loan losses was $250,000 and $600,000, respectively. Net loan charge-offs were $586,000 for the third quarter of 2013, or 0.48% annualized of total average loans, compared with net charge-offs of $20,000 for the second quarter of 2013, or 0.02% annualized of total average loans, and net loan charge-offs of $50,000 for the third quarter of 2012, or 0.04% annualized of total average loans. The majority of the charge-offs for the quarter relate to either a loan written down $339,000 on transfer to other real estate owned or a loan that was sold to a third party at a loss of $153,000. For the nine-month periods ended September 30, 2013 and 2012 net loan charge-offs were $1,027,000, or 0.29% annualized, and $124,000, or 0.03% annualized, respectively. In addition to the two loans noted above, year to date 2013 charge-offs include $336,000 in losses on a group of loans to three borrowers for the purchase of residential investment properties. The majority of charge-offs recorded during 2013 had specific reserves established during the allowance for loan loss calculation process prior to the ultimate decision to charge-off the loan.

Loan quality experienced modest improvement over the past year with the reduction in the level of non-accrual loans being somewhat offset by an increase in restructured loans. Total non-performing loans, which represent loans on non-accrual status, loans past due 90 days or more and still accruing interest and troubled debt restructured loans were $19,575,000, or 4.01% of total loans, at September 30, 2013 compared with $21,150,000, or 4.41% of total loans, at December 31, 2012 and $21,211,000, or 4.44% of total loans, at September 30, 2012. Loans on non-accrual status were $15,329,000 at September 30, 2013 compared with $18,572,000 at December 31, 2012 and $18,582,000 at September 30, 2012. Loans are placed on non-accrual status immediately if, in the opinion of management, collection is doubtful, or when principal or interest is past due 90 days or more and collateral is insufficient to cover principal and interest. 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 total amount of non-accrual loans at September 30, 2013, $9,736,000 or 64% of the loans classified as non-accrual, are current or past due less than 30 days as of the end of the quarter. Loans classified as substandard or doubtful, which includes non-performing loans, continues to improve. At September 30, 2013 substandard or doubtful loans totaled $40,215,000, a reduction of $8,060,000, or 16.7%, from the $48,275,000 reported as of September 30, 2012.

QNB had no loans past due 90 days or more and still accruing interest at September 30, 2013, December 31, 2012 or September 30, 2012. Restructured loans, not on nonaccrual, were $4,246,000 at September 30, 2013 compared to $2,578,000 at December 31, 2012 and $2,629,000 at September 30, 2012. Total loans 30 days or more past due, which includes non-accrual loans by actual number of days delinquent, represented 1.44% of total loans at September 30, 2013 compared with 1.50% at December 31, 2012 and 1.31% at September 30, 2012.

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 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 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, 2013 and December 31, 2012, the recorded investment in loans for which impairment has been identified totaled $28,564,000 and $32,304,000 of which $21,048,000 and $23,771,000, respectively, required no specific allowance for loan loss. The recorded investment in impaired loans requiring an allowance for loan losses was $7,516,000 and $8,533,000 at September 30, 2013 and December 31, 2012, respectively. At September 30, 2013 and December 31, 2012, the related allowance for loan losses associated with these loans was $2,277,000 and $2,701,000, 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.

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

	September 30, 2013	**December 31,** 2012	**September 30,** 2012
Non-accrual loans	$ 15,329	$ 18,572	$ 18,582
Loans past due 90 days or more and still accruing interest	-	-	-
Troubled debt restructured loans (not already included above)	4,246	2,578	2,629
Total non-performing loans	19,575	21,150	21,211
Other real estate owned and repossessed assets	1,645	1,161	1,187
Non-accrual investment securities	2,169	1,962	1,961
Total non-performing assets	$ 23,389	$ 24,273	$ 24,359
Total loans (excluding loans held-for-sale):			
Average total loans (YTD)	$ 479,892	$ 480,068	$ 481,231
Total loans	487,537	477,733	477,987
Allowance for loan losses	8,995	9,772	9,717
Allowance for loan losses to:			
Non-performing loans	45.96 %	46.20 %	45.81 %
Total loans (excluding held-for-sale)	1.85 %	2.05 %	2.03 %
Average total loans	1.87 %	2.04 %	2.02 %
Non-performing loans / total loans (excluding held-for-sale)	4.01 %	4.41 %	4.43 %
Non-performing assets / total assets	2.49 %	2.64 %	2.61 %

An analysis of loan charge-offs for the three and nine months ended September 30, 2013 compared to 2012 is as follows:

	Three months ended September 30, 2013	2012	Nine months ended September 30, 2013	2012
Net charge-offs	$586	$50	$1,027	$124
Net charge-offs (annualized) to:				
Total loans (excluding held-for-sale)	0.48%	0.04%	0.28%	0.03%
Average total loans (excluding held-for-sale)	0.48	0.04	0.29	0.03
Allowance for loan losses	25.81	2.10	15.26	1.70

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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	
	2013	**2012**	**Amount**	**Percent**	**2013**	**2012**	**Amount**	**Percent**
Net gain (loss) on investment securities	$303	$(37)	$340	918.9%	$819	$493	$326	66.1%
Fees for services to customers	435	394	41	10.4	1,170	1,078	92	8.5
ATM and debit card	386	367	19	5.2	1,116	1,098	18	1.6
Bank-owned life insurance	77	78	(1)	(1.3)	226	234	(8)	(3.4)
Merchant income	94	97	(3)	(3.1)	276	283	(7)	(2.5)
Net gain on sale of loans	36	186	(150)	(80.6)	359	644	(285)	(44.3)
Other	222	40	182	455.0	574	187	387	207.0
Total	$1,553	$1,125	$428	38.0%	$4,540	$4,017	$523	13.0%

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 2013 was $1,553,000, an increase of $428,000, compared to $1,125,000 for the third quarter of 2012. Net gains on investment securities account for $340,000 of the total increase in non-interest income compared to the third quarter of 2012. QNB recorded $303,000 of net gains on the sale of equity securities during the third quarter of 2013. This compares to net losses of $37,000 recognized in the third quarter of 2012.

Fees for services to customers were $435,000 for the third quarter of 2013, a $41,000, or 10.4%, increase over the same period in 2012. Overdraft income, representing approximately 69% of total fees for services to customers during the third quarter of 2013, increased by $47,000. The increase in overdraft income primarily reflects growth in the number of checking accounts as well as the positive impact of the introduction of an overdraft protection program on net overdraft income as the program reduced the amount of overdraft fees forgiven.

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. Net gains on the sale of residential mortgage loans for the third quarter of 2013 was $36,000, or $150,000 less than the third quarter of the prior year. During the tail end of the second quarter of 2013 and into the third quarter of 2013 mortgage interest rates increased significantly in reaction to the possible tapering of the purchase of mortgage-backed securities by the Federal Reserve Bank. This resulted in less favorable pricing and some losses on loans where the customer had locked in the interest rate prior to the increase in rates.

Other non-interest income increased $182,000 to $222,000 for the third quarter of 2013. During the fourth quarter of 2012, QNB changed vendors for its retail brokerage and wealth management area and now provides securities and advisory services under the name of QNB Financial Services through Investment Professionals, Inc., a registered Broker/Dealer and Registered Investment Advisor. There has been a significant increase in revenue as a result of the change, contributing an additional $155,000 when comparing the two quarters.

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. Mortgage servicing fees were $44,000 higher quarter over quarter primarily related to the change in fair value of mortgage servicing rights as calculated by an independent third-party. During the third quarter of 2013 the Bank recognized income related to the reversal of $10,000 of the previously established valuation allowance, while during the third quarter of 2012 the Bank recorded $22,000 of expense to increase the valuation allowance. Negatively impacting other non-interest income for the quarter was an additional loss of $65,000 on the sale of a property held in other real estate owned which had previously been impaired by $90,000 during the second quarter of 2013. The loss of $65,000 for the third quarter of 2013 was $26,000 more than the loss recognized in the third quarter of 2012.

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Nine-Month Comparison

Total non-interest income for the nine month periods ended September 30, 2013 and 2012 was $4,540,000 and $4,017,000, respectively, an increase of $523,000. A $326,000 increase in net gains on investment securities was mostly offset by a $285,000 decrease in net gains on the sale of residential mortgage loans.

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. In addition the Corporation owns a small portfolio of equity securities for the purpose of generating both dividend income and capital appreciation. Net investment securities gains were $819,000 for the nine months ended September 30, 2013 compared to $493,000 for the comparable period in 2012. Included in these gains were $672,000 and $427,000 recorded on the sale of equity securities during the nine month periods ended September 30, 2013 and 2012, respectively. There was a $43,000 credit-related OTTI charge on an equity security during the first nine months of 2013. There were no OTTI charges in the first nine months of 2012. Gains on the sale of fixed income securities were $190,000 and $66,000 for the respective nine month periods in 2013 and 2012. The gains were primarily from the sale of fast paying or odd-lot mortgage-backed and CMO securities.

As noted above, net gains on the sale of loans decreased $285,000, or 44.3%, when comparing the nine months ended September 30, 2013 to the same period in 2012. Proceeds from the sale of residential mortgages were $15,332,000 and $15,908,000 for the nine month periods ended September 30, 2013 and 2012, respectively. Although the total proceeds from loan sales did not decline significantly from prior year, smaller gains per loan (or losses) due to the interest rate environment at the time of sale were the biggest contributors to the decline.

Fees for services to customers increased $92,000, or 8.5%, to $1,170,000 for the nine-month period ended September 30, 2013. Similar to the quarter, the majority of the increase related to an increase in net overdraft service charges.

Other non-interest income increased $387,000, to $574,000, when comparing the nine-month periods ended September 30, 2013 and 2012. Similar to the comparison of the three month periods, revenue from QNB Financial Services was the biggest contributor with an increase of $351,000 when comparing the nine month periods. Mortgage servicing income contributed an additional $116,000. During the first nine months of 2013 QNB was able to reverse $34,000 of the valuation allowance recorded on mortgage servicing assets during previous years. This compares to a valuation allowance of $43,000 recorded during the first nine months of 2012. A slowdown in mortgage refinance activity during 2013 has also resulted in a $34,000 reduction in amortization of the mortgage servicing asset. In addition, title company income increased $45,000. Offsetting a portion of these increases was a $115,000 increase in net losses on other real estate owned primarily related to the valuation allowance and additional loss on the sale of a property as discussed for the quarter above.

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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	
	2013	**2012**	**Amount**	**Percent**	**2013**	**2012**	**Amount**	**Percent**
Salaries and employee benefits	$2,691	$2,609	$82	3.1%	$7,923	$7,783	$140	1.8%
Net occupancy	382	407	(25)	(6.1)	1,233	1,228	5	0.4
Furniture and equipment	431	387	44	11.4	1,261	1,090	171	15.7
Marketing	272	176	96	54.5	762	633	129	20.4
Third-party services	356	426	(70)	(16.4)	1,116	1,130	(14)	(1.2)
Telephone, postage and supplies	162	146	16	11.0	502	452	50	11.1
State taxes	172	159	13	8.2	517	486	31	6.4
FDIC insurance premiums	180	173	7	4.0	533	515	18	3.5
Other	477	451	26	5.8	1,307	1,296	11	0.8
Total	$5,123	$4,934	$189	3.8%	$15,154	$14,613	$541	3.7%

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.

Quarter to Quarter Comparison

Total non-interest expense was $5,123,000 for the third quarter of 2013, an increase of $189,000, or 3.8%, compared to the third quarter of 2012. 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 excluding realized gains and losses on investment securities. The Bank's efficiency ratios were 66.2% and 62.2% for the three months ended September 30, 2013 and 2012, respectively, and compare favorably with Pennsylvania commercial banks with assets between $500 million and $1 billion which had an average efficiency ratio of 69.9% for the second quarter of 2013, the most recent period available.

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 when appropriate. Salaries and benefits expense for the third quarter of 2013 were $2,691,000, an increase of $82,000, or 3.1%, from the $2,609,000 reported in the third quarter of 2012. The third quarter of 2012 included an accrual for incentive compensation of $135,000. There was no such accrual during the third quarter of 2013. Excluding the incentive accrual salary and benefits expense increased $217,000, or 8.8% when comparing the two quarters. When comparing the two quarters salary expense, net of incentive compensation, increased $161,000, or 8.1%. The primary reason for this increase was an additional eleven full-time equivalent employees primarily related to the opening of two new branch locations in the first quarter of 2013 as well as two additional employees for QNB Financial Services. These salary increases were partially offset by the reduction of one executive level position in 2013. When comparing the two quarters medical premiums and claims increased $31,000, or 21.1% and retirement plan expense increased $15,000, or 10.4%.

Net occupancy decreased $25,000, or 6.1% to $382,000 for the third quarter of 2013 while furniture and fixtures expense increased $44,000, or 11.4%. During the third quarter of 2013 an over-accrual of common area maintenance expense from prior years and an over-accrual of current year real estate tax expense totaling $36,000 was corrected. This was partially offset by an $11,000 increase in building depreciation expense primarily related to the new branch. The majority of the increase in furniture and fixture expense was attributable to higher depreciation expense and equipment maintenance costs. Much of the increase was related to the opening of two new locations during the first quarter, a full-service branch in Colmar, PA and a business office in Warminster, PA.

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Marketing expense increased $96,000, from $176,000 for the third quarter of 2012 to $272,000 for the third quarter of 2013. Included in this increase was a $58,000 increase in charitable donations. QNB contributes to many not-for-profit organizations and clubs and sponsors many local events in the communities it serves. The increase in expense during the third quarter of 2013 was mainly attributable to two multi-year commitments. Marketing expenses related to advertising, public relations, research and sales promotion were $38,000 higher for the three-month period ended September 30, 2013 than the same period in 2012. Most of these increases pertain to costs for promoting the two new locations or promoting consumer and commercial loans.

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 correspondent banking services, statement printing and mailing, investment security safekeeping and supply management services. Third party services expense decreased $70,000, or 16.4%, to $356,000 for the three months ended September 30, 2013 when compared to the same period in 2012. Legal expense, principally related to loan collection and corporate activities, declined $41,000 and consultant expense, primarily related to an operational efficiency study performed in 2012, decreased $23,000.

Telephone, postage and supplies expense increased $16,000, or 11.0% to $162,000 for the third quarter of 2013. Telephone expense which includes both voice and data costs increased $13,000 primarily a result of the two new branches.

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 $172,000 for the third quarter of 2013, an increase of $13,000 compared to the same period in 2012. The Bank’s Pennsylvania Shares Tax was $172,000 for the third quarter of 2013, an increase of $14,000 resulting from an increase in the Bank’s equity.

Nine-Month Comparison

Total non-interest expense was $15,154,000 for the nine-month period ended September 30, 2013, an increase of $541,000, or 3.7%, compared to the same period in 2012.

Salaries and benefits expense increased $140,000, or 1.8%, to $7,923,000 for the nine months ended September 30, 2013 compared to the same period in 2012. Salary expense and related taxes increased $71,000 during the period to $6,787,000. Excluding the prior year's accrual for incentive compensation of approximately $322,000 the increase would have been $393,000, or 6.2%. Similar to the quarter, an increase in full-time equivalent employees contributed to the increase in costs. Comparing the nine month periods, benefits expense increased $19,000, to $749,000. Medical and dental costs increased $36,000 and retirement plan costs increased $23,000 when comparing the nine month periods.

Furniture and equipment expense increased $171,000, or 15.7%, to $1,261,000 for the first nine months of 2013. As was the case for the quarter most of the increase pertains to higher depreciation and amortization costs primarily related to the two new locations opened in 2013 as well as the upgrade of most of the Bank's ATM machines. Higher equipment maintenance costs of $71,000 also contributed to the higher expense for the period. The majority of these additional costs relate to programs utilized for compliance and overdraft protection.

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Marketing expense increased $129,000, or 20.4%, to $762,000 for the nine months ended September 30, 2013. A $62,000 increase in donations as well as increases in advertising, public relations, research and sales promotions as noted during the quarterly discussion, account for the increase in marketing expense.

Telephone, postage and supplies expense was $50,000, or 11.1%, higher for the first three quarters of 2013 when compared to the same period in 2012 with telephone costs increasing $27,000 and supplies expense increasing $19,000. Much of these increases are attributable to the Colmar and Warminster locations opened in early 2013.

INCOME TAXES

QNB utilizes an asset and liability approach for financial accounting and reporting of income taxes. As of September 30, 2013, QNB’s net deferred tax asset was $4,775,000. The primary components of deferred taxes are a deferred tax asset of $3,058,000 relating to the allowance for loan losses, a deferred tax asset of $1,019,000 resulting from unrealized losses on available for sale securities, a deferred tax asset of $113,000 generated by OTTI charges on equity securities and a deferred tax asset of $432,000 related to OTTI charges on trust preferred securities. As of September 30, 2012, QNB’s net deferred tax asset was $913,000. The primary components of deferred taxes was a deferred tax asset of $3,304,000 relating to the allowance for loan losses, a deferred tax asset of $121,000 generated by OTTI charges on equity securities and a deferred tax asset of $432,000 related to OTTI charges on trust preferred securities. Partially offsetting these deferred tax assets was a deferred tax liability of $2,882,000 resulting from unrealized gains on available-for-sale securities. The increase in the amount of the deferred tax asset when comparing the balance at September 30, 2013 and 2012 is primarily related to the change from an unrealized gain position on the available-for-sale investment portfolio at September 30, 2012 to an unrealized loss position on the available-for-sale portfolio at September 30, 2013. This change was principally related to the impact of rising interest rates, particularly towards the end of the second quarter of 2013.

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 tax expense was $604,000 for the three-month period ended September 30, 2013 compared to $540,000 for the three-month period ended September 30, 2012. The effective tax rate for third quarter of 2013 was 22.1% compared with 20.7% for the third quarter of 2012. For the nine-month periods ended September 30, 2013 and 2012 applicable income taxes and the effective tax rates were $1,827,000, or 22.1% and $2,059,000, or 22.6%, respectively.

FINANCIAL CONDITION ANALYSIS

The following balance sheet analysis compares average balance sheet data for the nine months ended September 30, 2013 and 2012, as well as the period ended balances as of September 30, 2013 and December 31, 2012.

Average earning assets for the nine-month period ended September 30, 2013 increased $31,807,000, or 3.7%, to $886,110,000 from $854,303,000 for the nine months ended September 30, 2012. The mix of earning assets has changed somewhat when comparing the two periods. Average loans decreased $1,127,000, or 0.2%, while average investment securities increased $35,913,000, or 10.1%. Average loans represented 54.3% of earning assets for the first nine months of 2013, while average investment securities represented 44.1% of earning assets for the same period. This compares to 56.4% and 41.6%, respectively, for the first nine months of 2012. Average other earning assets, which include Federal Reserve deposits, decreased $2,979,000, or 17.2%, when comparing these same periods. Given the slow-down in loan growth and the relatively low yield of 0.25% on interest-bearing deposits at the Federal Reserve Bank, the decision was made to try and stay as fully invested as possible, while still retaining adequate liquidity.

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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 growth since December 31, 2010 has remained relatively flat as loan payoffs have matched new growth. Businesses and consumers are still reluctant to invest in new equipment or any other type of financing and are paying down their lines with excess cash. Despite the lack of demand QNB is committed to make credit available to its customers.

For the most part, earning assets are funded by deposits. Total average deposits increased $27,541,000, or 3.5%, to $806,111,000 for the first nine months of 2013 compared to the first nine months of 2012. Average interest-bearing demand and municipal accounts increased $ 11,875,000, or 12.2%, and $28,627,000, or 42.5%, respectively, when comparing the first nine months of 2013 and 2012. Business accounts are the primary factor behind the growth of the interest-bearing demand accounts while the growth in relationships with a couple of school districts contributed to the increase in municipal balances. Average savings balances increased $13,855,000, or 7.4%, to $201,153,000 for the first nine months of 2013 due to the continued success of QNB’s Online eSavings. The growth in this product, while still strong, has slowed over the past year. Average non-interest bearing demand accounts increased $6,530,000, or 9.9%, when comparing the nine month periods. Total average time deposits decreased $25,995,000, or 9.1%, when comparing the nine month periods as customers continue to look for the liquidity of transaction accounts and are hesitant to lock in longer term deposits at low rates.

Total assets at September 30, 2013 were $939,115,000 compared with $919,874,000 at December 31, 2012. During the second quarter of 2013 the demand for loans began to pick up resulting in a $9,804,000, or 2.1%, increase in total loans between December 31, 2012 and September 30, 2013. Total loans at September 30, 2013 were $487,537,000. Total investment securities increased by $5,746,000, or 1.4%, to $407,394,000 at September 30, 2013. The increase in interest rates during the latter part of the second quarter of 2013 contributed to the decline in investment securities as the fair value of the portfolio declined from an unrealized gain of $6,752,000 at December 31, 2012 to an unrealized loss of $2,996,000 at September 30, 2013. This also negatively impacted shareholder’s equity as accumulated other comprehensive income, net of tax, went from a gain of $4,456,000 at December 31, 2012 to a loss of $1,978,000 at September 30, 2013.

The composition of the investment portfolio has changed since December 31, 2012 as calls and maturities of U.S. Government and agency securities were generally replaced with mortgage-backed securities that are backed by U.S. Government agencies and sponsored enterprises (GSEs).

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 seven of these securities with an amortized cost of $3,519,000 and a fair value of $2,169,000 at September 30, 2013. There was no credit-related other-than-temporary impairment charge in the first nine months of 2013 or 2012. 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.

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On the liability side, total deposits increased by $26,314,000, or 3.3% to $827,952,000 at September 30, 2013 compared to $801,638,000 at December 31, 2012. Interest-bearing demand accounts, including municipal deposits, increased $55,653,000, or 29.1% to $246,988,000 at September 30, 2013. Included in this increase was an increase in municipal deposits of $59,680,000. During the third quarter tax money is received by the local school districts. These deposits are short-term and will flow out over the next year as the schools use the funds for operations. These deposits do provide incremental income as they are invested in short-term investment securities but will further reduce the net interest margin as the spread earned is significantly less than the current net interest margin. Savings accounts increased $12,636,000, or 6.6%, to $203,973,000 at September 30, 2013. Partially offsetting the growth in municipal and savings deposits was a decline in money market accounts, primarily business accounts which decreased $18,238,000, or 24.0%, from $76,047,000 at December 31, 2012 to $57,809,000 at September 30, 2013. Time deposits also decreased $25,175,000, or 9.4%, from $269,234,000 at December 31, 2012 to $244,059,000 at September 30, 2013 as customers continue to look for liquidity in anticipation of rising interest rates.

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 repayments and maturities 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, 2013, the Bank had a maximum borrowing capacity with the FHLB of approximately $240,866,000. The maximum borrowing capacity changes as a function of qualifying collateral assets. QNB has no outstanding borrowings with the FHLB at September 30, 2013. In addition, the Bank maintains two unsecured Federal funds lines with two correspondent banks totaling $26,000,000. At September 30, 2013, 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 2013.

Total cash and cash equivalents, available-for-sale investment securities and loans held-for-sale totaled $427,157,000 and $418,571,000 at September 30, 2013 and December 31, 2012, respectively. The sources and level of liquidity maintained should be adequate to meet normal fluctuations in loan demand or deposit withdrawals. Despite the recent increase in interest rates, particularly in the 5 to 10 year part of the yield curve, it is still anticipated that the investment portfolio will continue to provide sufficient liquidity as 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 continue to increase the cash flow available from the investment portfolio could decrease.

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Approximately $219,825,000 and $170,433,000 of available-for-sale securities at September 30, 2013 and December 31, 2012, respectively, were pledged as collateral for repurchase agreements and deposits of public funds. The increase in the amount of pledged securities corresponds with the increase in municipal deposits.

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. QNB also has available Insured Cash Sweep (ICS), another program through Promontory Interfinancial Network, LLC, which is 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, 2013 was $75,743,000, or 8.07% of total assets, compared to shareholders' equity of $77,623,000, or 8.44% of total assets, at December 31, 2012. Shareholders’ equity at September 30, 2013 included a negative adjustment of $1,978,000 related to unrealized holding losses, net of taxes, on investment securities available-for-sale, while shareholders’ equity at December 31, 2012 included a positive adjustment of $4,456,000 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 8.28% and 7.95% at September 30, 2013 and December 31, 2012, respectively.

Average shareholders' equity and average total assets were $75,994,000 and $919,046,000 for the first nine months of 2013, an increase of 8.3% and 2.9%, respectively, from the averages for the year ended December 31, 2012. The ratio of average total equity to average total assets was 8.27% for the first nine months of 2013 compared to 7.86% for all of 2012.

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.

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

Capital Analysis	**September 30,** 2013	**December 31,** 2012
Tier I		
Shareholders' equity	$ 75,743	$ 77,623
Net unrealized securities losses (gains), net of tax	1,978	(4,456)
Total Tier I risk-based capital	77,721	73,167
Tier II		
Allowable portion: Allowance for loan losses	7,735	7,449
Unrealized gains on equity securities, net of tax	229	142
Total risk-based capital	$ 85,685	$ 80,758
Risk-weighted assets	$ 617,528	$ 593,630
Average assets	$ 940,924	$ 919,040

Capital Ratios	**September 30,** 2013	**December 31,** 2012
Tier I capital/risk-weighted assets	12.59 %	12.33 %
Total risk-based capital/risk-weighted assets	13.88 %	13.60 %
Tier I capital/average assets (leverage ratio)	8.26 %	7.96 %

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, 2012 as the Tier I and total risk based capital levels have increased to a greater degree than the risk-weighted and 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 $650,000 to capital during first nine months of 2013.

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, 2013, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000. There have been no additional shares repurchased under the plan since the first quarter of 2009.

Continuing to impact risk-weighted assets is the $27,350,000 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 $3,275,000 at September 30, 2013, regulatory guidance required an additional $24,075,000 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 seven pooled trust preferred securities (PreTSLs) held by the Bank as of September 30, 2013. The other two pooled trust preferred securities have only one tranche remaining so the treatment noted above does not apply.

The Federal Deposit Insurance Corporation Improvement Act of 1991 established five capital level designations ranging from "well capitalized" to "critically undercapitalized." At September 30, 2013 and December 31, 2012, 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%.

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In July 2013, the Federal bank regulatory agencies adopted final rules that revise the agencies' capital adequacy guidelines and prompt corrective action rules. These final rules were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III.

The final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered "well capitalized"). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements are effective on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016.

QNB will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Bank.

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, 2013

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, 2012.

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, 2013 through July 31, 2013	-	-	-	42,117

August 1, 2013 through August 31, 2013	-	-	-	42,117
September 1, 2013 through September 30, 2013	-	-	-	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. Mine Safety Disclosures

None.

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, 2013

By: /s/ David W. Freeman
David W. Freeman
Chief Executive Officer

Date: November 14, 2013

By: /s/ Bret H. Krevolin
Bret H. Krevolin
Chief Financial Officer