QNB CORP
Form 10-Q
August 08, 2016

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 June 30, 2016
OR

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

For the transition period from to

Commission file number 0-17706

QNB Corp.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania	23-2318082
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

15 North Third Street, P.O. Box 9005 Quakertown, PA	18951-9005
(Address of Principal Executive Offices)	(Zip Code)

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 July 28, 2016
Common Stock, par value $0.625	3,391,320

QNB CORP. AND SUBSIDIARY

FORM 10-Q

QUARTER ENDED JUNE 30, 2016

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QNB Corp. and Subsidiary
CONSOLIDATED BALANCE SHEETS

	(in thousands, except share data) (current period unaudited)	
	June 30, 2016	**December 31, 2015**
Assets		
Cash and due from banks	$10,691	$9,159
Interest-bearing deposits in banks	47,258	7,832
Total cash and cash equivalents	57,949	16,991
Investment securities		
Trading	3,459	4,189
Available-for-sale (amortized cost $339,595 and $362,742)	344,253	361,915
Held-to-maturity (fair value $149 and $151)	147	147
Restricted investment in bank stocks	522	508
Loans held-for-sale	184	987
Loans receivable	604,478	615,270
Allowance for loan losses	(7,550)	(7,554)
Net loans	596,928	607,716
Bank-owned life insurance	11,122	10,978
Premises and equipment, net	8,913	9,257
Accrued interest receivable	2,376	2,562
Net deferred tax assets	1,891	3,673
Other assets	2,494	2,013
Total assets	$1,030,238	$1,020,936
Liabilities		
Deposits		
Demand, non-interest bearing	$117,650	$98,543
Interest-bearing demand	243,858	274,925
Money market	69,763	67,172
Savings	233,641	221,770
Time	133,684	135,251
Time of $100 or more	94,689	92,125
Total deposits	893,285	889,786
Short-term borrowings	36,693	37,163
Accrued interest payable	330	330
Other liabilities	2,723	3,214
Total liabilities	933,031	930,493
Shareholders' Equity		

Common stock, par value $0.625 per share; authorized 10,000,000 shares; 3,555,769 shares and 3,524,363 shares issued; 3,391,200 and 3,359,794 shares outstanding	2,222	2,203
Surplus	16,762	15,973
Retained earnings	77,625	75,289
Accumulated other comprehensive income (loss), net of tax	3,074	(546)
Treasury stock, at cost; 164,569 shares	(2,476)	(2,476)
Total shareholders' equity	97,207	90,443
Total liabilities and shareholders' equity	$1,030,238	$1,020,936

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

QNB Corp. and Subsidiary
CONSOLIDATED STATEMENTS OF INCOME

	(in thousands, except per share data - unaudited)			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Interest income				
Interest and fees on loans	$6,332	$5,965	$12,684	$11,846
Interest and dividends on investment securities (AFS & HTM):				
Taxable	1,291	1,256	2,647	2,598
Tax-exempt	489	469	1,005	955
Interest on trading securities	30	40	70	81
Interest on interest-bearing balances and other interest income	42	16	58	73
Total interest income	8,184	7,746	16,464	15,553
Interest expense				
Interest on deposits				
Interest-bearing demand	163	154	315	320
Money market	47	38	94	74
Savings	229	200	455	396
Time	371	389	744	785
Time of $100 or more	319	295	637	590
Interest on short-term borrowings	36	28	79	59
Total interest expense	1,165	1,104	2,324	2,224
Net interest income	7,019	6,642	14,140	13,329
Provision for loan losses	-	60	125	60
Net interest income after provision for loan losses	7,019	6,582	14,015	13,269
Non-interest income				
Total other-than-temporary impairment loss on investment securities	(122)	-	(192)	-
Net gain on sale of investment securities	137	214	526	717
Net gain on investment securities	15	214	334	717
Net gain (loss) on trading activites	52	(34)	86	(19)
Fees for services to customers	397	404	780	806
ATM and debit card	422	394	810	756
Retail brokerage and advisory income	126	204	296	377
Bank-owned life insurance	73	72	144	142
Merchant Income	83	81	156	151
Net gain on sale of loans	71	119	120	182
Other	135	145	224	164
Total non-interest income	1,374	1,599	2,950	3,276
Non-interest expense				
Salaries and employee benefits	2,988	3,053	6,042	6,049
Net occupancy	426	455	867	909
Furniture and equipment	440	432	865	861

Marketing	265	212	461	422
Third party services	403	445	806	846
Telephone, postage and supplies	174	175	360	369
State taxes	141	173	321	347
FDIC insurance premiums	157	150	327	317
Other	599	569	1,063	1,071
Total non-interest expense	5,593	5,664	11,112	11,191
Income before income taxes	2,800	2,517	5,853	5,354
Provision for income taxes	702	583	1,490	1,284
Net income	$2,098	$1,934	$4,363	$4,070
Earnings per share - basic	$0.62	$0.58	$1.29	$1.22
Earnings per share - diluted	$0.62	$0.58	$1.29	$1.22
Cash dividends per share	$0.30	$0.29	$0.60	$0.58

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 June 30,	**2016**			**2015**		
	Before tax amount	**Tax expense (benefit)**	**Net of tax amount**	**Before tax amount**	**Tax expense (benefit)**	**Net of tax amount**
Net income	$2,800	$ 702	$ 2,098	$2,517	$ 583	$1,934
Other comprehensive income:						
Net unrealized holding gains on securities:						
Unrealized holding gains (losses) arising during the period	1,333	453	880	(2,674)	(909)	(1,765)
Reclassification adjustment for gains included in net income	(15)	(5)	(10)	(214)	(73)	(141)
Other comprehensive income (loss)	1,318	448	870	(2,888)	(982)	(1,906)
Total comprehensive income (loss)	$4,118	$ 1,150	$ 2,968	$(371)	$ (399)	$28

Six months ended June 30,	**2016**			**2015**		
	Before tax amount	**Tax expense (benefit)**	**Net of tax amount**	**Before tax amount**	**Tax expense (benefit)**	**Net of tax amount**
Net income	$5,853	$ 1,490	$ 4,363	$5,354	$ 1,284	$4,070
Other comprehensive income:						
Net unrealized holding gains on securities:						
Unrealized holding gains (losses) arising during the period	5,819	1,979	3,840	(214)	(73)	(141)
Reclassification adjustment for gains included in net income	(334)	(114)	(220)	(717)	(244)	(473)
Other comprehensive income (loss)	5,485	1,865	3,620	(931)	(317)	(614)
Total comprehensive income	$11,338	$ 3,355	$ 7,983	$4,423	$ 967	$3,456

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

QNB Corp. and Subsidiary
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(unaudited) (in thousands, except share and per share data)	**Number of Shares Outstanding**	**Common Stock**	**Surplus**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total**
Balance, December 31, 2015	3,359,794	$ 2,203	$ 15,973	$ 75,289	$ (546)	$ (2,476)	$ 90,443
Net income	-	-	-	4,363	-	-	4,363
Other comprehensive income, net of tax	-	-	-	-	3,620	-	3,620
Cash dividends declared ($0.60 per share)	-	-	-	(2,027)	-	-	(2,027)
Stock issued in connection with dividend reinvestment and stock purchase plan	16,314	10	467	-	-	-	477
Stock issued for employee stock purchase plan	1,540	1	40	-	-	-	41
Stock issued for options exercised	13,552	8	228	-	-	-	236
Tax benefit of stock options exercised	-	-	12	-	-	-	12
Stock-based compensation expense	-	-	42	-	-	-	42
Balance, June 30, 2016	3,391,200	$ 2,222	$ 16,762	$ 77,625	$ 3,074	$ (2,476)	$ 97,207

(unaudited) (in thousands, except share and per share data)	**Number of Shares Outstanding**	**Common Stock**	**Surplus**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total**
Balance, December 31, 2014	3,316,658	$ 2,176	$ 14,819	$ 70,928	$ 907	$ (2,476)	$ 86,354
Net income	-	-	-	4,070	-	-	4,070
Other comprehensive loss, net of tax	-	-	-	-	(614)	-	(614)
Cash dividends declared ($0.58 per share)	-	-	-	(1,931)	-	-	(1,931)
Stock issued in connection with dividend reinvestment and stock purchase plan	16,123	10	443	-	-	-	453

Stock issued for employee stock purchase plan	1,721	1	42	-	-	-	43
Stock issued for options exercised	7,802	5	91	-	-	-	96
Tax benefit of stock options exercised	-	-	20	-	-	-	20
Stock-based compensation expense	-	-	46	-	-	-	46
Balance, June 30, 2015	3,342,304	$ 2,192	$ 15,461	$ 73,067	$ 293	$ (2,476)	$ 88,537

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

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QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(in thousands, unaudited)	
Six months ended June 30,	**2016**	**2015**
Operating Activities		
Net income	$4,363	$4,070
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	449	524
Provision for loan losses	125	60
Net gain on investment securities available-for-sale	(334)	(717)
Provision for repossessed assets and other real estate owned	-	89
Net gain on sale of other real estate owned, repossessed assets and premises and equipment	(1)	(70)
Net gain on sale of loans	(120)	(182)
Proceeds from sales of residential mortgages held-for-sale	3,556	6,487
Origination of residential mortgages held-for-sale	(2,633)	(6,391)
Income on bank-owned life insurance	(144)	(142)
Stock-based compensation expense	42	46
Net decrease in trading securities	730	336
Deferred income tax provision	(83)	49
Net increase (decrease) in income taxes payable	6	(453)
Net decrease in accrued interest receivable	186	244
Amortization of mortgage servicing rights and change in valuation allowance	36	31
Net amortization of premiums and discounts on investment securities	940	1,101
Net decrease in accrued interest payable	-	(7)
Increase in other assets	(493)	(304)
Decrease in other liabilities	(27)	(1,008)
Net cash provided by operating activities	6,598	3,763
Investing Activities		
Proceeds from payments, maturities and calls of investment securities available-for-sale	51,888	51,926
Proceeds from the sale of investment securities available-for-sale	28,814	26,795
Purchases of investment securities available-for-sale	(58,655)	(30,319)
Proceeds from redemption of investment in restricted bank stock	1,482	1,318
Purchase of restricted bank stock	(1,496)	(1,179)
Net decrease (increase) in loans	10,663	(23,595)
Net purchases of premises and equipment	(105)	(214)
Proceeds from sales of other real estate owned and repossessed assets	1	3,007
Net cash provided by investing activities	32,592	27,739
Financing Activities		
Net increase in non-interest bearing deposits	19,107	10,140
Net decrease in interest-bearing deposits	(15,608)	(35,651)
Net decrease in short-term borrowings	(470)	(2,293)
Tax benefit from exercise of stock options	12	20
Cash dividends paid, net of reinvestment	(1,772)	(1,717)
Proceeds from issuance of common stock	499	378
Net cash provided by (used in) financing activities	1,768	(29,123)

Increase in cash and cash equivalents	40,958	2,379
Cash and cash equivalents at beginning of year	16,991	18,245
Cash and cash equivalents at end of period	$57,949	$20,624
Supplemental Cash Flow Disclosures		
Interest paid	$2,324	$2,231
Income taxes paid	1,555	1,650
Non-cash transactions:		
Transfer of loans to repossessed assets or other real estate owned	-	215
Unsettled trades to purchase securities	-	4,729

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 2015 Annual Report incorporated in the Form 10-K. Operating results for the three and six month periods ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

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 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 June 30, 2016, for items that should potentially be recognized or disclosed in these financial statements.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606).* This ASU was issued to help improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets. The ASU's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This ASU is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. Early adoption is permitted for annual reporting periods beginning after December 31, 2015. QNB does not anticipate the adoption of this guidance will have a material impact on its consolidated financial statements.

On January 9, 2015, the FASB issued ASU 2015-01, *Extraordinary and Unusual Items (Subtopic 225-20)* which eliminates from U.S. Generally Accepted Accounting Principles (GAAP) the concept of an extraordinary item. The Board released the new guidance as part of its simplification initiative, which, as explained in the ASU, is intended to "identify, evaluate, and improve areas of U.S. GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to the users of financial statements." To be considered an extraordinary item under existing U.S. GAAP, an event or transaction must be unusual in nature and must occur infrequently. Stakeholders often questioned the decision-usefulness of labeling a transaction or event as extraordinary and indicated that it is difficult to ascertain whether an event or transaction satisfies both criteria. In light of this feedback and in a manner consistent with its simplification initiative, the FASB decided to eliminate the concept of an extraordinary item. As a result, an entity will no longer (1) segregate an extraordinary item from the results of ordinary operations; (2) separately present an extraordinary item on its income statement, net of tax, after income from continuing operations; and (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. However, the ASU does not affect the reporting and disclosure requirements for an event that is unusual in nature or that occurs infrequently. For all entities, the ASU is effective for annual periods beginning after December 15, 2015, and interim periods within those annual periods. Entities may apply the guidance prospectively or retrospectively to all prior periods presented in the financial statements. If an entity chooses to apply the guidance prospectively, it must disclose whether amounts included in income from continuing operations after adoption of the ASU are related to events and transactions previously recognized and classified as extraordinary items before the date of adoption. The adoption of this guidance did not have a material impact on QNB's consolidated financial statements.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. RECENT ACCOUNTING PRONOUNCEMENTS (continued)

On February 18, 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, which amends the consolidation requirements in ASC 810 and significantly changes the consolidation analysis required under U.S. GAAP. The amendments include the following:

- Limited partnerships will be variable interest entities (VIEs), unless the limited partners have either substantive kick-out or participating rights. Although more partnerships will be VIEs, it is less likely that a general partner will consolidate a limited partnership.
- The ASU changes the effect that fees paid to a decision maker or service provider have on the consolidation analysis. Specifically, it is less likely that the fees themselves will be considered a variable interest, that an entity will be a VIE, or that consolidation will result.
- The ASU significantly amends how variable interests held by a reporting entity's related parties or de facto agents affect its consolidation conclusion. Specifically, the ASU will result in less frequent performance of the related-party tiebreaker test (and mandatory consolidation by one of the related parties) than under current U.S. GAAP.
- For entities other than limited partnerships, the ASU clarifies how to determine whether the equity holders (as a group) have power over the entity (this will most likely result in a change to current practice). The clarification could affect whether the entity is a VIE.

This ASU will be effective for periods beginning after December 15, 2015, for public companies. The adoption of this guidance did not have a material impact on QNB's consolidated financial statements.

On April 7, 2015, the FASB issued ASU 2015-03, *Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, which changes the presentation of debt issuance costs in financial statements. Under the ASU, an entity presents such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs is reported as interest expense. For public business entities, the guidance in the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is allowed for all entities for financial statements that have not been previously issued. Entities would apply the new guidance retrospectively to all prior periods (i.e., the balance sheet for each period is adjusted). QNB has no debt issued at this time so the adoption of this ASU did not have a material impact on the Company.

On January 5, 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU was issued to enhance the reporting model for financial instruments to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. It will require the following:

- Equity investments with readily determinable fair values must be measured at fair value with changes in fair value recognized in net income.
- Equity investments without readily determinable fair values must be measured at either fair value or at cost adjusted for changes in observable prices minus impairment. Changes in value under either of these methods would be recognized in net income.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. RECENT ACCOUNTING PRONOUNCEMENTS (continued)

Entities that record financial liabilities at fair value due to a fair value option election must recognize changes in fair value in other comprehensive income if it is related to instrument-specific credit risk.

Entities must assess whether a valuation allowance is required for deferred tax assets related to available-for-sale debt securities.

This ASU is effective for public companies for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. If QNB had adopted this guidance in 2016 it would have resulted in an increase in net income of $15,000 and $41,000 for the three and six months ended June 30, 2016. There would have been no impact on shareholder’s equity as the equity securities held by QNB are already recorded at fair value through accumulated other comprehensive income (loss).

On February 25, 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This new standard on accounting for leases introduces a lessee model that brings most leases on the balance sheet, but recognizes expenses in the income statement similar to how items are recorded today. The new standard eliminates the requirement in current U.S. GAAP for an entity to use bright-line tests in determining lease classification. The ASU also eliminates the current real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. All entities will classify leases to determine how to recognize the related revenue and expense and this classification will affect amounts that lessors record on the balance sheet. The new guidance will be effective for public companies for annual periods beginning after December 15, 2018, and interim periods therein. Early adoption is permitted. QNB is evaluating the impact of this new standard on its consolidated financial statements.

On March 15, 2016, the FASB issued ASU 2016-07, *Investments – Equity Method and Joint Ventures (Topic 323), Simplifying the Transition to the Equity Method of Accounting*. This ASU simplifies the equity method of accounting by eliminating the requirement to retrospectively apply the equity method to an investment that subsequently qualifies for such accounting as a result of an increase in the level of ownership interest or degree of influence. The ASU further requires that unrealized holding gains or losses in accumulated other comprehensive income related to an available-for-sale security that becomes eligible for the equity method be recognized in earnings as of the date on which the investment qualifies for the equity method. The guidance in the ASU is effective for all entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years; early adoption is permitted for all entities. QNB does not anticipate the adoption of this guidance will have a material impact on its consolidated financial statements.

On March 17, 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*. This ASU amends the principal-versus agent implementation guidance and illustrations in the Board's new revenue standard (ASU 2014-09). The FASB issued the ASU in response to concerns identified by stakeholders, including those related to (1) determining the appropriate unit of account under the revenue standard's principal-versus-agent guidance and (2) applying the indicators of whether an entity is a principal or an agent in accordance with the revenue standard's control principle. This ASU clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. The ASU has the same effective date as the new revenue standard (as amended by the one-year deferral and the early adoption provisions in ASU 2015-14).

On March 30, 2016, the FASB issued ASU 2016-09, *Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting*. This ASU simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. Entities will be required to recognize the income tax effects of awards in the income statement when awards vest or are settled which will eliminate additional-paid-in-capital or APIC pools. For public companies, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods. QNB is evaluating this new standard, but does not anticipate the adoption of this guidance will have a material impact on its consolidated financial statements.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. RECENT ACCOUNTING PRONOUNCEMENTS (continued)

On June 16, 2016, the FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326)*. The new guidance requires organizations to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts.

To that end, the new guidance:

- Eliminates the probable initial recognition threshold in current U.S. GAAP and, instead, reflects an organization's current estimate of all expected credit losses over the contractual term of its financial assets
- Broadens the information an entity can consider when measuring credit losses to include forward-looking information
- Increases usefulness of the financial statements by requiring timely inclusion of forecasted information in forming expectations of credit losses
- Increases comparability of purchased financial assets with credit deterioration (PCD assets) with other purchased assets that do not have credit deterioration as well as originated assets because credit losses that are expected will be recorded through an allowance for credit losses for all assets
- Increases users' understanding of underwriting standards and credit quality trends by requiring additional information about credit quality indicators by year of origination (vintage)
- For available-for-sale debt securities, aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses (and subsequent changes in credit losses) through an allowance rather than a write down

The new guidance affects organizations that hold financial assets and net investments in leases that are not accounted for at fair value with changes in fair value reported in net income. The new guidance affects loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the new guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. QNB is evaluating the impact of this new standard on its consolidated financial statements.

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 $26,000 and $25,000 for the three months ended June 30, 2016 and 2015, respectively. Stock-based compensation expense was $42,000 and $46,000 for the six months ended June 30, 2016 and 2015, respectively. As of June 30, 2016, there was approximately $120,000 of unrecognized compensation cost related to unvested share-based compensation award grants that is expected to be recognized over the next 32 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 after a three-year period. As of June 30, 2016, there were 225,058 options granted, 60,244 options forfeited, 164,814 options exercised and no remaining options outstanding under this Plan. The 1998 Plan expired on March 10, 2008.

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

The 2005 Plan authorized 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 June 30, 2016, there were 184,200 options granted, 65,050 options forfeited, 63,980 options exercised, and 55,170 options outstanding under this Plan. The 2005 Plan expired on March 15, 2015.

The 2015 Plan authorizes the issuance of 300,000 shares. The terms of the 2015 Plan are identical to the 2005 Plan. There were 23,500 options granted and outstanding under this Plan as of June 30, 2016. There were no options forfeited or exercised as of June 30, 2016. The 2015 Plan expires on February 24, 2025.

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:

Six months ended June 30,	**2016**		**2015**	
Risk free interest rate	1.14	%	1.06	%
Dividend yield	3.78		3.86	
Volatility	22.62		26.74	
Expected life (years)	4.20		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 six months of 2016 and 2015 was $3.79 and $4.38, respectively.

Stock option activity during the six months ended June 30, 2016 and 2015 is as follows:

	Number of options	**Weighted average exercise price**	**Weighted average remaining contractual term (in years)**	**Aggregate intrinsic value**
Outstanding at December 31, 2015	82,875	$ 24.33		
Granted	23,500	30.40		
Exercised	(17,980)	20.66		
Forfeited	(9,725)	25.61		
Outstanding at June 30, 2016	78,670	$ 26.82	2.99	$ 407
Exercisable at June 30, 2016	23,545	$ 22.38	1.12	$ 226

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

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2014	88,375	$ 23.27		
Granted	21,000	29.25		
Exercised	(11,650)	17.73		
Forfeited	(12,650)	31.87		
Outstanding at June 30, 2015	85,075	$ 24.22	2.74	$ 440
Exercisable at June 30, 2015	30,875	$ 20.85	1.12	$ 264

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 six months ended June 30, 2016 and 2015. As of June 30, 2016, 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 June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Numerator for basic and diluted earnings per share - net income	$2,098	$1,934	$4,363	$4,070
Denominator for basic earnings per share - weighted average shares outstanding	3,383,109	3,333,018	3,376,445	3,327,384
Effect of dilutive securities - employee stock options	8,766	13,515	8,389	12,734
Denominator for diluted earnings per share - adjusted weighted average shares outstanding	3,391,875	3,346,533	3,384,834	3,340,118
Earnings per share - basic	$0.62	$0.58	$1.29	$1.22
Earnings per share - diluted	0.62	0.58	1.29	1.22

There were 41,350 stock options that were anti-dilutive for both the three and six-month periods ended June 30, 2016. There were 21,000 stock options that were anti-dilutive for both the three and six-month periods ended June 30, 2015. These stock options were not included in the above calculation.

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6. COMPREHENSIVE INCOME

The following shows the components of accumulated other comprehensive (loss) income at June 30, 2016 and December 31, 2015:

	June 30, 2016	December 31, 2015
Unrealized net holding gains (losses) on available-for-sale securities	$4,965	$ (568)
Unrealized losses on available-for-sale securities for which a portion of an other-than-temporary impairment loss has been recognized in earnings	(307)	(259)
Accumulated other comprehensive income (loss)	4,658	(827)
Tax effect	(1,584)	281
Accumulated other comprehensive income (loss), net of tax	$3,074	$ (546)

The following tables present amounts reclassified out of accumulated other comprehensive (loss) income for the three and six months ended June 30, 2016 and 2015:

Three months ended June 30,	**Amount reclassified from accumulated other comprehensive income**		
Details about accumulated other comprehensive income	**2016**	**2015**	**Affected line item in the statement of income**

Unrealized net holding gains on available-for-sale securities	$ 137	$ 214	Net gain on sale of investment securities
Other-than-temporary impairment losses on investment securities	(122)	-	Net other-than-temporary impairment losses on investment securities
	15	214	
Tax effect	(5)	(73)	Provision for income taxes
Total reclass out of accumulated other comprehensive income, net of tax	$ 10	$ 141	Net of tax

Six months ended June 30,	**Amount reclassified from accumulated other comprehensive income**		
Details about accumulated other comprehensive income	**2016**	**2015**	**Affected line item in the statement of income**
Unrealized net holding gains on available-for-sale securities	$ 526	$ 717	Net gain on sale of investment securities
Other-than-temporary impairment losses on investment securities	(192)	-	Net other-than-temporary impairment losses on investment securities
	334	717	
Tax effect	(114)	(244)	Provision for income taxes
Total reclass out of accumulated other comprehensive income, net of tax	$ 220	$ 473	Net of tax

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7. INVESTMENT SECURITIES

QNB engages in trading activities for its own account. Municipal securities that are held principally for resale in the near term are recorded in the trading account at fair value with changes in fair value recorded in non-interest income. There were net realized and unrealized gains of $52,000 and losses of $34,000 recorded for the three months ended June 30, 2016 and 2015, respectively. There were net realized and unrealized gains of $86,000 and losses of $19,000 recorded for the six months ended at June 30, 2016 and 2015, respectively. Unrealized gains on trading activity related to trading securities still held at June 30, 2016 and December 31, 2015 totaled $53,000 and $31,000, respectively. Interest and dividends are included in interest income.

Trading securities, at fair value, at June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016	**December 31, 2015**
State and municipal securities	$3,459	$ 4,189

The amortized cost and estimated fair values of investment securities available-for-sale at June 30, 2016 and December 31, 2015 were as follows:

June 30, 2016	**Fair value**	**Gross unrealized** holding	**Gross unrealized** holding	**Amortized cost**

		gains	losses	
U.S. Government agency	$60,510	$ 297	$ (1)	$ 60,214
State and municipal	73,888	2,072	(7)	71,823
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed	129,027	2,405	-	126,622
Collateralized mortgage obligations (CMOs)	62,545	654	(166)	62,057
Pooled trust preferred	2,400	248	(942)	3,094
Corporate debt	8,110	53	(17)	8,074
Equity	7,773	371	(309)	7,711
Total investment securities available-for-sale	$344,253	$ 6,100	$ (1,442)	$ 339,595

December 31, 2015	**Fair value**	**Gross unrealized** holding gains	**Gross unrealized** holding losses	**Amortized cost**
U.S. Government agency	$61,779	$ 88	$ (490)	$ 62,181
State and municipal	78,954	1,554	(31)	77,431
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed	136,681	944	(920)	136,657
Collateralized mortgage obligations (CMOs)	65,610	178	(1,178)	66,610
Pooled trust preferred	2,653	259	(897)	3,291
Corporate debt	9,004	15	(95)	9,084
Equity	7,234	516	(770)	7,488
Total investment securities available-for-sale	$361,915	$ 3,554	$ (4,381)	$ 362,742

QNB CORP. AND SUBSIDIARY

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7. INVESTMENT SECURITIES (continued)

The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at June 30, 2016 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.

June 30, 2016	**Fair value**	**Amortized cost**
Due in one year or less	$5,371	$ 5,292
Due after one year through five years	220,326	217,024
Due after five years through ten years	97,106	95,501
Due after ten years	13,677	14,067
Equity securities	7,773	7,711
Total investment securities available-for-sale	$344,253	$ 339,595

For the three months ended June 30, 2016 and 2015, proceeds from sales of investment securities available-for-sale were approximately $4,198,000 and $19,200,000. Proceeds from sales of investment securities available-for-sale were approximately $28,814,000 and $26,795,000 for the six months ended June 30, 2016 and 2015, respectively.

Due to favorable conditions in the U.S. equities markets, QNB sold 10 equity holdings, with a book value of $2,731,000 in mid-July 2016, which resulted in a gain on sale of $209,000, net of taxes.

At June 30, 2016 and December 31, 2015, investment securities available-for-sale totaling approximately $160,631,000 and $197,149,000, 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 (“OTTI”) 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:

	Three months ended June 30, 2016				**Three months ended June 30, 2015**			
	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	$ 36	$ -	$ (122)	$ (86)	$ 204	$ (23)	$ -	$ 181
Debt securities	101	-	-	101	66	(33)	-	33
Total	$ 137	$ -	$ (122)	$ 15	$ 270	$ (56)	$ -	$ 214

	Six months ended June 30, 2016				**Six months ended June 30, 2015**			
	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	$ 417	$ -	$ (192)	$ 225	$ 630	$ (23)	$ -	$ 607
Debt securities	182	(73)	-	109	154	(44)	-	110
Total	$ 599	$ (73)	$ (192)	$ 334	$ 784	$ (67)	$ -	$ 717

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7. INVESTMENT SECURITIES (continued)

The tax expense applicable to the net realized gains for the quarters and six-month periods ended June 30, 2016 and 2015 were $5,000 and $73,000 for the quarter and $114,000 and $244,000 year-to-date, 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 during the quarter or six months ended June 30, 2016 or 2015, respectively.

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:

Six months ended June 30,	**2016**	**2015**
Balance, beginning of period	$1,153	$1,153
Reductions: gain on payoff	-	-
Additions:		
Initial credit impairments	-	-
Subsequent credit impairments	-	-
Balance, end of period	$1,153	$1,153

The amortized cost and estimated fair values of investment securities held-to-maturity at June 30, 2016 and December 31, 2015 were as follows:

Held-To-Maturity

	June 30, 2016				**December 31, 2015**			
	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	$147	$ 2	$ -	$149	$147	$ 4	$ -	$151

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7. INVESTMENT SECURITIES (continued)

The amortized cost and estimated fair value of securities held-to-maturity by contractual maturity at June 30, 2016 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.

June 30, 2016	**Fair value**	**Amortized cost**
Due in one year or less	$ 149	$ 147
Due after one year through five years	-	-
Due after five years through ten years	-	-
Due after ten years	-	-
Total investment securities held-to-maturity	$ 149	$ 147

There were no sales of investment securities classified as held-to-maturity during the three and six months ended June 30, 2016 or 2015.

The following table indicates the length of time individual securities have been in a continuous unrealized loss position at June 30, 2016 and December 31, 2015:

June 30, 2016

		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	2	$2,000	$ (1)	-	-	$2,000	$ (1)
State and municipal	3	893	(6)	$503	$ (1)	1,396	(7)

U.S. Government agencies and sponsored enterprises (GSEs):							
Collateralized mortgage obligations (CMOs)	19	1,796	(16)	17,362	(150)	19,158	(166)
Pooled trust preferred	5	-	-	2,024	(942)	2,024	(942)
Corporate debt	1	-	-	994	(17)	994	(17)
Equity	15	2,408	(135)	1,014	(174)	3,422	(309)
Total	45	$7,097	$ (158)	$21,897	$ (1,284)	$28,994	$ (1,442)

December 31, 2015

		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	32	$40,949	$ (418)	$4,426	$ (72)	$45,375	$ (490)
State and municipal	20	6,646	(19)	1,555	(12)	8,201	(31)
U.S. Government agencies and sponsored enterprises (GSEs):							
Mortgage-backed	62	90,796	(871)	1,403	(49)	92,199	(920)
Collateralized mortgage obligations (CMOs)	49	28,372	(261)	26,354	(917)	54,726	(1,178)
Pooled trust preferred	5	-	-	2,193	(897)	2,193	(897)
Corporate debt	6	5,988	(95)	-	-	5,988	(95)
Equity	19	4,035	(695)	193	(75)	4,228	(770)
Total	193	$176,786	$ (2,359)	$36,124	$ (2,022)	$212,910	$ (4,381)

Management evaluates debt securities, which are comprised of U.S. Government agencies, state 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 bond rating of each security. The unrealized losses at June 30, 2016 in U.S. Government securities, state and municipal securities, mortgage-backed securities, CMOs and corporate debt securities are primarily the result of interest rate fluctuations. If held to maturity, these bonds will mature at par, and QNB will not realize a loss. The Company has the intent to hold the securities and does not believe it will be required to sell the securities before recovery occurs.

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7. INVESTMENT SECURITIES (continued)

The Company's investment in marketable equity securities primarily consists of investments in large cap stock companies. These equity securities are analyzed for impairment on an ongoing basis. Management believes these equity securities will recover in the foreseeable future. QNB evaluated the near-term prospects of the issuers in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold those securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider these equity securities to be other-than-temporarily impaired.

QNB holds six pooled trust preferred securities as of June 30, 2016. These securities have a total amortized cost of approximately $3,094,000 and a fair value of $2,400,000. Five of the six 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 June 30, 2016:

Deal	Class	Book value	Fair value	Unreal-ized gains (losses)	Realized OTTI credit loss (YTD 2016)	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	$190	$(53)	$ -	$(1)	B1/BB	5	-	18.0 %	141.1 %
PreTSL XVII	Mezzanine	614	467	(147)	-	(222)	C/CC	34	5	21.6	99.3

PreTSL XIX	Mezzanine	932	545	(387)	-	-	Caa1/CC	40	12	11.3	97.2
PreTSL XXV	Mezzanine	766	485	(281)	-	(222)	Ca/C	45	5	26.8	89.1
PreTSL XXVI	Mezzanine	412	337	(75)	-	(270)	Caa3/C	43	7	20.4	96.5
PreTSL XXVI	Mezzanine	127	376	249	-	(438)	Caa3/C	43	7	20.4	96.5
		$3,094	$2,400	$ (694)	$ -	$ (1,153)					

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

On January 14, 2014, Regulators released a final rule authorizing retention of pooled trust preferred securities backed primarily by bank-issued trust preferred securities which included the PreTSLs held by QNB. Due to the uncertainty invoked between the original release of the Volcker Rule and the final rule, there was a noticeable increase in trading activity. However, we believe most of these trades occurred under distress and do not represent trades made in an orderly market. Despite the trades that took place as discussed previously, the market for these securities at June 30, 2016 was not active and markets for similar securities also are not active. The new issue market is also inactive and the market values for these securities are depressed relative to historical levels. 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 previous table, 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, except for PreTSL IV which represents the senior-most obligation of the trust.

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7. INVESTMENT SECURITIES (continued)

On a quarterly basis we evaluate our debt securities for other-than-temporary impairment (OTTI), which involves the use of a third-party valuation firm to assist management with the valuation. When evaluating these investments a credit-related portion and a non-credit related portion of impairment 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 three and six months ended June 30, 2016 and 2015, 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 of 1% were forecasted. In addition to the base prepayment assumption, due to the enactment of the Dodd-Frank Act's revised Tier 1 capital treatment, additional prepayment analysis was performed. 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 U.S. bank holding company with an investment grade credit rating and any foreign banking organization would prepay their issuance as soon as possible. For those institutions rated below investment grade we assumed that any holding company that could refinance for a cost savings of more than 2 percent when compared to the approximate cost of long-term funding given their rating and marketplace interest rates, will refinance as soon as possible. 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.

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 any available evidence and focuses on capitalization, asset quality, profitability, liquidity, stock price performance, whether the institution has received TARP funding, whether the TARP funding was redeemed or resold through a Treasury Department auction at a premium or discount, and whether the institution has shown the ability to generate additional capital either internally or externally.

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7. INVESTMENT SECURITIES (continued)

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 2015 were approximately 0.37%. Thus, in addition to the specific bank default assumptions used for the near term, for future defaults on the individual banks in the analysis for 2016 and beyond the rate used is calculated based on historic default averages 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. Default factors used in the cash flow analysis range from 0.25% to 0.53%.

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. Based on information from various published studies, a 95% severity of loss was utilized for defaults projected in 2016 and thereafter.

Based upon the analysis performed by management as of June 30, 2016, it is probable that we will collect all contractual principal and interest payments on one of our six pooled trust preferred securities, PreTSL XIX. The expected principal shortfall on the remaining pooled trust preferred securities has resulted in credit related other-than-temporary impairment charges in previous years. All of these pooled trust preferred securities held by QNB could be subject to additional writedowns in the future if additional deferrals and defaults occur.

8. LOANS & ALLOWANCE FOR LOAN LOSSES

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

Loans held-for-sale 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:

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

1. Lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices.
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.

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Major classes of loans are as follows:

	June 30, 2016	December 31, 2015
Commercial:		
Commercial and industrial	$114,894	$124,397
Construction	33,527	27,372
Secured by commercial real estate	225,154	235,171
Secured by residential real estate	63,489	63,164
State and political subdivisions	40,844	40,285
Indirect lease financing	9,567	10,371
Retail:		
1-4 family residential mortgages	44,611	42,833
Home equity loans and lines	67,910	67,384
Consumer	4,413	4,286
Total loans	604,409	615,263
Net unearned costs	69	7
Loans receivable	$604,478	$615,270

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 June 30, 2016 and December 31, 2015, overdrafts were approximately $202,000 and $203,000, 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 June 30, 2016, there were no concentrations of loans exceeding 10% of total loans.

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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

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

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

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

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

The Company employs an eight (8) grade risk rating system related to the credit quality of commercial loans, loans to state and political subdivisions and indirect lease financing of which the first four categories are pass categories (credits not adversely rated). The following is a description of the internal risk ratings and the likelihood of loss related to each risk rating.

1 - Excellent - no apparent risk

2 - Good - minimal risk

3 - Acceptable - average risk

4 - Watch List - greater than average risk

5 - Special Mention - potential weaknesses

6 - Substandard - well defined weaknesses

7 - Doubtful - full collection unlikely

8 - Loss - considered uncollectible

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of June 30, 2016 and December 31, 2015:

June 30, 2016	**Pass**	**Special mention**	**Substandard**	**Doubtful**	**Total**
Commercial:					
Commercial and industrial	$107,242	$ 4	$ 7,648	$ -	$114,894
Construction	33,514	-	13	-	33,527
Secured by commercial real estate	212,632	808	11,714	-	225,154
Secured by residential real estate	60,725	-	2,764	-	63,489
State and political subdivisions	39,624	-	1,220	-	40,844
Indirect lease financing	9,450	-	117	-	9,567
	$463,187	$ 812	$ 23,476	$ -	$487,475

December 31, 2015	**Pass**	**Special**	**Substandard**	**Doubtful**	**Total**

		mention			
Commercial:					
Commercial and industrial	$117,246	-	$ 7,151	$ -	$124,397
Construction	27,355	-	17	-	27,372
Secured by commercial real estate	218,958	$ 361	15,852	-	235,171
Secured by residential real estate	60,286	34	2,844	-	63,164
State and political subdivisions	39,027	-	1,258	-	40,285
Indirect lease financing	10,168	-	203	-	10,371
	$473,040	$ 395	$ 27,325	$ -	$500,760

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

For retail loans, the Company evaluates credit quality based on the performance of the individual credits. The following tables present the recorded investment in the retail classes of the loan portfolio based on payment activity as of June 30, 2016 and December 31, 2015:

June 30, 2016	**Performing**	**Non-performing**	**Total**
Retail:			
1-4 family residential mortgages	$ 44,335	$ 276	$44,611
Home equity loans and lines	67,805	105	67,910
Consumer	4,413	-	4,413
	$ 116,553	$ 381	$116,934

December 31, 2015	**Performing**	**Non-performing**	**Total**
Retail:			
1-4 family residential mortgages	$ 42,546	$ 287	$42,833
Home equity loans and lines	67,257	127	67,384
Consumer	4,286	-	4,286
	$ 114,089	$ 414	$114,503

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 June 30, 2016 and December 31, 2015:

June 30, 2016	**30-59 days**	**60-89 days**	**90 days or**	**Total past**	**Current**	**Total loans receivable**

	past due	past due	more past due	due loans		
Commercial:						
Commercial and industrial	$75	-	-	$75	$114,819	$114,894
Construction	-	-	-	-	33,527	33,527
Secured by commercial real estate	1,703	$56	$863	2,622	222,532	225,154
Secured by residential real estate	37	58	371	466	63,023	63,489
State and political subdivisions	-	-	-	-	40,844	40,844
Indirect lease financing	29	159	162	350	9,217	9,567
Retail:						
1-4 family residential mortgages	-	-	-	-	44,611	44,611
Home equity loans and lines	328	53	-	381	67,529	67,910
Consumer	25	4	-	29	4,384	4,413
	$2,197	$330	$1,396	$3,923	$600,486	$604,409

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

December 31, 2015	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	$95	-	-	$95	$124,302	$124,397
Construction	63	-	-	63	27,309	27,372
Secured by commercial real estate	443	-	$935	1,378	233,793	235,171
Secured by residential real estate	-	$97	369	466	62,698	63,164
State and political subdivisions	-	-	-	-	40,285	40,285
Indirect lease financing	320	53	130	503	9,868	10,371
Retail:						
1-4 family residential mortgages	641	234	-	875	41,958	42,833
Home equity loans and lines	272	-	45	317	67,067	67,384
Consumer	12	10	-	22	4,264	4,286
	$1,846	$394	$1,479	$3,719	$611,544	$615,263

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 June 30, 2016 and December 31, 2015:

June 30, 2016	90 days or more past due (still accruing)	Non-accrual

Commercial:		
Commercial and industrial	-	$ 3,060
Construction	-	-
Secured by commercial real estate	-	3,399
Secured by residential real estate	-	1,735
State and political subdivisions	-	-
Indirect lease financing	$ 65	110
Retail:		
1-4 family residential mortgages	-	276
Home equity loans and lines	-	105
Consumer	-	-
	$ 65	$ 8,685

QNB CORP. AND SUBSIDIARY

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(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

December 31, 2015	**90 days or more past due (still accruing)**	**Non-accrual**
Commercial:		
Commercial and industrial	-	$ 3,433
Construction	-	-
Secured by commercial real estate	-	3,627
Secured by residential real estate	-	1,803
State and political subdivisions	-	-
Indirect lease financing	$ 11	143
Retail:		
1-4 family residential mortgages	-	287
Home equity loans and lines	-	127
Consumer	-	-
	$ 11	$ 9,420

Activity in the allowance for loan losses for the three months ended June 30, 2016 and 2015 are as follows:

Three months ended June 30, 2016	**Balance, beginning of period**	**Provision for (credit to)**	**Charge-offs**	**Recoveries**	**Balance, end of period**

		loan losses			
Commercial:					
Commercial and industrial	$ 1,334	$ 6	-	$ 10	$ 1,350
Construction	352	77	-	-	429
Secured by commercial real estate	2,292	(63)	-	2	2,231
Secured by residential real estate	1,690	(162)	$ (20)	42	1,550
State and political subdivisions	196	8	-	-	204
Indirect lease financing	208	52	(43)	9	226
Retail:					
1-4 family residential mortgages	352	(54)	-	-	298
Home equity loans and lines	352	(14)	-	5	343
Consumer	69	15	(16)	5	73
Unallocated	711	135	N/A	N/A	846
	$ 7,556	$ -	$ (79)	$ 73	$ 7,550

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Three months ended June 30, 2015	**Balance, beginning of period**	**Provision for (credit to) loan losses**	**Charge-offs**	**Recoveries**	**Balance, end of period**
Commercial:					
Commercial and industrial	$ 1,875	$ (251)	$ (30)	$ 9	$ 1,603
Construction	285	(136)	-	-	149
Secured by commercial real estate	2,569	141	(57)	2	2,655
Secured by residential real estate	1,666	266	(313)	16	1,635
State and political subdivisions	253	(21)	-	-	232
Indirect lease financing	95	25	-	1	121
Retail:					
1-4 family residential mortgages	308	5	-	-	313
Home equity loans and lines	479	(12)	-	7	474
Consumer	85	4	(23)	5	71
Unallocated	363	39	N/A	N/A	402
	$ 7,978	$ 60	$ (423)	$ 40	$ 7,655

Activity in the allowance for loan losses for the six months ended June 30, 2016 and 2015 are as follows:

Six months ended June 30, 2016	**Balance, beginning of period**	**Provision for (credit to) loan losses**	**Charge-offs**	**Recoveries**	**Balance, end of period**
Commercial:					

Commercial and industrial	$ 1,521	$ (50)	$ (140)	$ 19	$ 1,350
Construction	286	143	-	-	429
Secured by commercial real estate	2,411	(184)	-	4	2,231
Secured by residential real estate	1,812	(302)	(20)	60	1,550
State and political subdivisions	222	(18)	-	-	204
Indirect lease financing	164	105	(52)	9	226
Retail:					
1-4 family residential mortgages	350	(52)	-	-	298
Home equity loans and lines	428	(95)	-	10	343
Consumer	76	16	(33)	14	73
Unallocated	284	562	N/A	N/A	846
	$ 7,554	$ 125	$ (245)	$ 116	$ 7,550

QNB CORP. AND SUBSIDIARY

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(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

Six months ended June 30, 2015	**Balance, beginning of period**	**Provision for (credit to) loan losses**	**Charge-offs**	**Recoveries**	**Balance, end of period**
Commercial:					
Commercial and industrial	$ 1,892	$ (278)	$ (30)	$ 19	$ 1,603
Construction	297	(148)	-	-	149
Secured by commercial real estate	2,700	36	(85)	4	2,655
Secured by residential real estate	1,630	304	(317)	18	1,635
State and political subdivisions	221	11	-	-	232
Indirect lease financing	93	26	(8)	10	121
Retail:					
1-4 family residential mortgages	312	1	-	-	313
Home equity loans and lines	453	9	-	12	474
Consumer	85	15	(41)	12	71
Unallocated	318	84	N/A	N/A	402
	$ 8,001	$ 60	$ (481)	$ 75	$ 7,655

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

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

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

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

From time to time, QNB may extend, restructure, or otherwise modify the terms of existing loans, on a case-by-case basis, to remain competitive and retain certain customers, as well as assist other customers 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.

Performing TDRs (not reported as non-accrual or past due 90 days or more and still accruing) totaled $1,433,000 and $1,288,000 as of June 30, 2016 and December 31, 2015, respectively. Non-performing TDRs totaled $2,279,000 and $990,000 as of June 30, 2016 and December 31, 2015, respectively. All TDRs are included in impaired loans.

The following table illustrates the specific reserve for loan losses allocated to loans modified as TDRs. These specific reserves are included in the allowance for loan losses for loans individually evaluated for impairment.

	June 30, 2016		December 31, 2015	
	Unpaid principal balance	**Related allowance**	**Unpaid principal balance**	**Related allowance**
TDRs with no specific allowance recorded	$2,924	-	$1,787	-
TDRs with an allowance recorded	788	$ 428	491	$ 491
	$3,712	$ 428	$2,278	$ 491

The TDR concessions made during the six months ended June 30, 2016 involved extension of a maturity date, renewal of a line of credit and concessions to lower monthly payments. As of June 30, 2016 and December 31, 2015, QNB had commitments of $1,751,000 and $1,919,000, respectively, to lend additional funds to customers with loans whose terms have been modified in troubled debt restructurings. There were no charge-offs during the six months ended June 30, 2016 and 2015, resulting from loans previously modified as TDRs.

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

The following tables present loans by loan class modified as TDRs during the three and six months ended June 30, 2016 and 2015. The pre-modification and post-modification outstanding recorded investments disclosed in the tables below represent carrying amounts immediately prior to the modification and at June 30, 2016.

Three months ended June 30,	**2016**			**2015**		
	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 residential real estate	1	$ 41	$ 41	-	$ -	$ -
	1	$ 41	$ 41	-	$ -	$ -

Six months ended June 30,	**2016**			**2015**		
	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	6	$	1,074	$	1,069	-	$	-	$	-
Secured by residential real estate	4		524		512	-		-		-
	10	$	1,598	$	1,581	-	$	-	$	-

There no loans modified as TDRs within 12 months prior to June 30, 2016 and 2015 for which there was a payment default (60 days or more past due) during the three and six months ended June 30, 2016 and 2015.

The Company has five mortgage loans secured by residential real estate for which foreclosure proceedings are in process at June 30, 2016. The recorded investment is $136,000.

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

The following tables present the balance in the allowance for loan losses at June 30, 2016 and December 31, 2015 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**		
June 30, 2016	**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	$1,350	$ 518	$ 832	$114,894	$ 4,142	$ 110,752
Construction	429	-	429	33,527	508	33,019
Secured by commercial real estate	2,231	60	2,171	225,154	6,170	218,984
Secured by residential real estate	1,550	158	1,392	63,489	1,978	61,511
State and political subdivisions	204	-	204	40,844	-	40,844
Indirect lease financing	226	45	181	9,567	110	9,457
Retail:						
1-4 family residential mortgages	298	22	276	44,611	568	44,043
Home equity loans and lines	343	-	343	67,910	128	67,782
Consumer	73	-	73	4,413	-	4,413
Unallocated	846	N/A	N/A	N/A	N/A	N/A
	$7,550	$ 803	$ 5,901	$604,409	$ 13,604	$ 590,805

	Allowance for Loan Losses			Loans Receivable		
December 31, 2015	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	$ 1,521	$ 712	$ 809	$ 124,397	$ 4,586	$ 119,811
Construction	286	-	286	27,372	364	27,008
Secured by commercial real estate	2,411	14	2,397	235,171	6,998	228,173
Secured by residential real estate	1,812	203	1,609	63,164	2,113	61,051
State and political subdivisions	222	-	222	40,285	-	40,285
Indirect lease financing	164	20	144	10,371	146	10,225
Retail:						
1-4 family residential mortgages	350	25	325	42,833	583	42,250
Home equity loans and lines	428	-	428	67,384	151	67,233
Consumer	76	-	76	4,286	-	4,286
Unallocated	284	N/A	N/A	N/A	N/A	N/A
	$ 7,554	$ 974	$ 6,296	$ 615,263	$ 14,941	$ 600,322

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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 June 30, 2016 and December 31, 2015:

	June 30, 2016			**December 31, 2015**		
	Recorded investment (after charge-offs)	**Unpaid principal balance**	**Related allowance**	**Recorded investment (after charge-offs)**	**Unpaid principal balance**	**Related allowance**
<u>With no specific allowance recorded:</u>						
Commercial:						
Commercial and industrial	$3,436	$ 3,772	$ -	$3,629	$ 3,923	$ -
Construction	508	540	-	364	364	-
Secured by commercial real estate	5,360	5,766	-	6,932	7,416	-
Secured by residential real estate	1,009	1,537	-	942	1,653	-
State and political subdivisions	-	-	-	-	-	-
Indirect lease financing	13	23	-	3	3	-
Retail:						
1-4 family residential mortgages	385	401	-	393	406	-
Home equity loans and lines	128	185	-	151	201	-
Consumer	-	-	-	-	-	-
	$10,839	$ 12,224	$ -	$12,414	$ 13,966	$ -
<u>With an allowance recorded:</u>						
Commercial:						
Commercial and industrial	$706	$ 848	$ 518	$957	$ 1,086	$ 712
Construction	-	-	-	-	-	-
Secured by commercial real estate	810	957	60	66	66	14
Secured by residential real estate	969	1,097	158	1,171	1,279	203
State and political subdivisions	-	-	-	-	-	-

Indirect lease financing	97	98	45	143	145	20
Retail:						
1-4 family residential mortgages	183	195	22	190	197	25
Home equity loans and lines	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
	$2,765	$ 3,195	$ 803	$2,527	$ 2,773	$ 974
Total:						
Commercial:						
Commercial and industrial	$4,142	$ 4,620	$ 518	$4,586	$ 5,009	$ 712
Construction	508	540	-	364	364	-
Secured by commercial real estate	6,170	6,723	60	6,998	7,482	14
Secured by residential real estate	1,978	2,634	158	2,113	2,932	203
State and political subdivisions	-	-	-	-	-	-
Indirect lease financing	110	121	45	146	148	20
Retail:						
1-4 family residential mortgages	568	596	22	583	603	25
Home equity loans and lines	128	185	-	151	201	-
Consumer	-	-	-	-	-	-
	$13,604	$ 15,419	$ 803	$14,941	$ 16,739	$ 974

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. LOANS & ALLOWANCE FOR LOAN LOSSES (continued)

	Six Months Ended June 30, 2016		Year Ended December 31, 2015	
	Average recorded investment	**Interest income recognized**	**Average recorded investment**	**Interest income recognized**
Commercial:				
Commercial and industrial	$4,370	$ 35	$6,108	$ 169
Construction	429	10	396	20
Secured by commercial real estate	6,426	67	7,370	149
Secured by residential real estate	2,013	7	1,544	-
State and political subdivisions	-	-	-	-
Indirect lease financing	112	-	43	1
Retail:				
1-4 family residential mortgages	576	5	448	6
Home equity loans and lines	139	1	135	1
Consumer	-	-	2	-
	$14,065	$ 125	$16,046	$ 346

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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.

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 June 30, 2016:

June 30, 2016	**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				
Trading Securities				
State and municipal securities	-	$ 3,459	-	$3,459

Securities available-for-sale				
U.S. Government agency securities	-	60,510	-	60,510
State and municipal securities	-	73,888	-	73,888
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	-	129,027	-	129,027
Collateralized mortgage obligations (CMOs)	-	62,545	-	62,545
Pooled trust preferred securities	-	-	$ 2,400	2,400
Corporate debt securities	-	8,110	-	8,110
Equity securities	$ 7,773	-	-	7,773
Total securities available-for-sale	$ 7,773	$ 334,080	$ 2,400	$ 344,253
Total recurring fair value measurements	$ 7,773	$ 337,539	$ 2,400	$ 347,712
Nonrecurring fair value measurements *				
Impaired loans	$ -	$ -	$ 1,962	$ 1,962
Mortgage servicing rights	-	-	45	45
Total nonrecurring fair value measurements	$ -	$ -	$ 2,007	$ 2,007

** impairment*

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the six months ended June 30, 2016. 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 six-month period ended June 30, 2016.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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, 2015:

December 31, 2015	**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				
Trading Securities				
State and municipal securities	-	$ 4,189	-	$4,189
Securities available-for-sale				
U.S. Government agency securities	-	61,779	-	61,779
State and municipal securities	-	78,954	-	78,954
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	-	136,681	-	136,681
Collateralized mortgage obligations (CMOs)	-	65,610	-	65,610
Pooled trust preferred securities	-	-	$ 2,653	2,653
Corporate debt securities	-	9,004	-	9,004
Equity securities	$ 7,234	-	-	7,234
Total securities available-for-sale	$ 7,234	$ 352,028	$ 2,653	$361,915
Total recurring fair value measurements	$ 7,234	$ 356,217	$ 2,653	$366,104
Nonrecurring fair value measurements *				
Impaired loans	$ -	$ -	$ 1,698	$1,698

Mortgage servicing rights	-	-	133	133
Total nonrecurring fair value measurements	$ -	$ -	$ 1,831	$1,831

** impairment*

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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					
June 30, 2016	**Fair value**	**Valuation techniques**	**Unobservable input**	**Value or range of values**		
Impaired loans	$972	Appraisal of collateral (1)	Appraisal adjustments (2)	-10%	to	-70%
			Liquidation expenses (3)		-10%	
Impaired loans	115	Used commercial vehicle and equipment guides	Guide value discounts (4)	0%	to	-40%
Impaired loans	125	Financial statement values for UCC collateral	Financial statement value discounts (5)		-25%	
Impaired loans	750	Agreement of sale (6)				
Mortgage servicing rights	45	Discounted cash flow	Remaining term	3	-	27yrs
			Discount rate	10%	to	12%

	Quantitative information about Level 3 fair value measurements					
December 31, 2015	**Fair value**	**Valuation techniques**	**Unobservable input**	**Value or range of values**		
Impaired loans	$1,331	Appraisal of collateral (1)	Appraisal adjustments (2)	-15%	to	-80%
			Liquidation expenses (3)		-10%	
Impaired loans	199	Used commercial vehicle and equipment guides	Guide value discounts (4)	0%	to	-30%
Impaired loans	168	Financial statement values for UCC collateral	Financial statement value discounts (5)	-25%	to	-70%
Mortgage servicing rights	133	Discounted cash flow	Remaining term	3	-	28yrs
			Discount rate	10%	to	12%

(1) Fair value is primarily determined through appraisals of the underlying collateral by independent parties, which generally include various level 3 inputs which are not always identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and the age of the appraisal. The range is presented as a percent of the initial appraised value.
(3) Appraisals and pending agreements of sale are adjusted by management for estimated liquidation expenses. The range is presented as a percent of the initial appraised value.
(4) If lendable value (lower than wholesale) is utilized then no additional discounts are taken. If lendable value is not provided then additional discounts are applied.
(5) Values obtained from financial statements for UCC collateral (fixed assets and inventory) are discounted to estimated realizable liquidation value.
(6) Fair value is determined by the estimated net proceeds.

QNB CORP. AND SUBSIDIARY

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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 six months ended June 30, 2016:

	Fair value measurements using significant unobservable inputs (Level 3)
Balance, January 1, 2016	$ 2,653
Payments received	(197)
Total gains or losses (realized/unrealized):	
Included in earnings	-
Included in other comprehensive income (loss)	(56)
Transfers in and/or out of Level 3	-
Balance, June 30, 2016	$ 2,400

The Level 3 securities consist of six collateralized debt obligation securities, PreTSL securities, which are backed by trust preferred securities issued by banks, thrifts, and insurance companies. As discussed in Note 7, despite the fact that there were some trades over the past few years, the market for these securities at June 30, 2016 was 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 June 30, 2016;
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. Default rates are 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. The base loss severity assumption and long-term loss severity assumptions are modeled at 95%. The severity factor for near-term default 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 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. 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.

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

The internal rate of return is the pre-tax yield used to discount the best estimate of future cash flows after credit losses. The cash flows have been discounted using estimated market discount rates of 3-month LIBOR plus spreads ranging from 4.79% to 7.55%. 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. For a further discussion of PreTSL valuation, see Note 7, Investment Securities.

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 June 30, 2016 and December 31, 2015:

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

<u>Investment securities - trading (carried at fair value), available for sale (carried at fair value) and held-to-maturity (carried at amortized cost):</u> 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 Community Bankers Bank and the Federal Home Loan Bank is the carrying amount, based on redemption provisions, and considers the limited marketability of such securities.

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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

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

Impaired Loans (generally carried at fair value): Impaired loans are loans, in which the Company has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. Included in the fair value of impaired loans at December 31, 2015 were $145,000 of loans that had no specific reserves required at year end; however, were partially charged-off at year end. There were no such loans at June 30, 2016.

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 2 inputs based on observable market data.

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

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

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.

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

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		
June 30, 2016	**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	$57,949	$57,949	$57,949	-	-
Investment securities:					
Trading	3,459	3,459	-	$ 3,459	-
Available-for-sale	344,253	344,253	7,773	334,080	$ 2,400
Held-to-maturity	147	149	-	149	-
Restricted investment in bank stocks	522	522	-	522	-
Loans held-for-sale	184	191	-	191	-

Net loans	596,928	607,603	-	-	607,603
Mortgage servicing rights	495	578	-	-	578
Accrued interest receivable	2,376	2,376	-	2,376	-
Financial liabilities					
Deposits with no stated maturities	$664,912	$664,912	$664,912	-	$ -
Deposits with stated maturities	228,373	231,803	-	$ 231,803	-
Short-term borrowings	36,693	36,693	36,693	-	-
Accrued interest payable	330	330	-	330	-
Off-balance sheet instruments					
Commitments to extend credit	$-	$-	$-	$ -	$ -
Standby letters of credit	-	-	-	-	-

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9. FAIR VALUE MEASUREMENTS AND DISCLOSURES (continued)

			Fair value measurements		
December 31, 2015	**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	$16,991	$16,991	$16,991	-	-
Investment securities:					
Trading	4,189	4,189	-	$4,189	-
Available-for-sale	361,915	361,915	7,234	352,028	$2,653
Held-to-maturity	147	151	-	151	-
Restricted investment in bank stocks	508	508	-	508	-
Loans held-for-sale	987	1,004	-	1,004	-
Net loans	607,716	610,315	-	-	610,315
Mortgage servicing rights	504	642	-	-	642
Accrued interest receivable	2,562	2,562	-	2,562	-
Financial liabilities					
Deposits with no stated maturities	$662,410	$662,410	$662,410	-	$ -
Deposits with stated maturities	227,376	227,862	-	$227,862	-
Short-term borrowings	37,163	37,163	37,163	-	-
Accrued interest payable	330	330	-	330	-
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:

	June 30, 2016	**December 31, 2015**
Commitments to extend credit and unused lines of credit	$274,378	$232,492
Standby letters of credit	11,954	9,493
Total financial instrument commitments	$286,332	$241,985

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 June 30, 2016 and December 31, 2015 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 June 30, 2016, 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		**Minimum required**		**Well capitalized**	
As of June 30, 2016	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total risk-based capital (to risk-weighted assets):						
Consolidated	$101,748	13.13%	$61,978	8.00 %	$77,473	10.00%
Bank	93,948	12.50	60,132	8.00	75,165	10.00
Tier I capital (to risk-weighted assets):						
Consolidated	94,128	12.15	46,484	6.00	46,484	6.00
Bank	86,339	11.49	45,099	6.00	60,132	8.00
Common equity tier 1 capital (to risk-weighted assets):						
Consolidated	94,128	12.15	34,863	4.50	N/A	N/A
Bank	86,339	11.49	33,824	4.50	48,857	6.50
Tier I capital (to average assets):						
Consolidated	94,128	9.35	40,281	4.00	N/A	N/A
Bank	86,339	8.64	39,962	4.00	49,952	5.00

	Capital levels					
	Actual		**Minimum required**		**Well capitalized**	
As of December 31, 2015	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total risk-based capital (to risk-weighted assets):						
Consolidated	$98,432	12.58%	$62,613	8.00 %	$78,266	10.00%
Bank	91,091	11.97	60,874	8.00	76,093	10.00
Tier I capital (to risk-weighted assets):						
Consolidated	90,819	11.60	46,960	6.00	46,960	6.00
Bank	83,478	10.97	45,656	6.00	60,874	8.00
Common equity tier 1 capital (to risk-weighted assets):						
Consolidated	90,819	11.60	35,220	4.50	N/A	N/A
Bank	83,478	10.97	34,242	4.50	49,460	6.50

Tier I capital (to average assets):						
Consolidated	90,819	8.87	40,934	4.00	N/A	N/A
Bank	83,478	8.22	40,632	4.00	50,790	5.00

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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

QNB Corp. is a bank holding company headquartered in Quakertown, Pennsylvania. QNB Corp., through its wholly-owned subsidiary, the Bank, has been serving the residents and businesses of upper Bucks, northern Montgomery and southern Lehigh counties in Pennsylvania since 1877. Due to its limited geographic area, growth is pursued through expansion of existing customer relationships and building new relationships by stressing a consistent high level of service at all points of contact. 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 2015 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 QNB’s business; 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. As a result of prolonged declines in some equity securities’ fair values, $122,000 and $192,000 of other-than-temporary impairment charges were recorded during the second quarter and first six months of 2016, respectively.

The Company follows accounting guidance related to the recognition and presentation of other-than-temporary impairment that specifies (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security. There were no credit-related other-than-temporary impairment charges in the second quarter and first six months of 2016 or 2015.

Allowance for Loan Losses

The determination of the allowance for loan losses involves a higher degree of judgment and complexity than the Company's 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.

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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 second quarter of 2016 of $2,098,000, or $0.62 per share on a diluted basis, compared to net income of $1,934,000, or $0.58 per share on a diluted basis, for the same period in 2015. For the six month period ended June 30, 2016, QNB reported net income of $4,363,000, or $1.29 per share on a diluted basis. This compares to net income of $4,070,000, or $1.22 per share on a diluted basis, reported for the six month period ended June 30, 2015.

Net income expressed as an annualized rate of return on average assets and average shareholders' equity was 0.84% and 9.01%, respectively, for the quarter ended June 30, 2016 compared with 0.81% and 8.83%, respectively, for the quarter ended June 30, 2015. For the comparative six month periods the annualized rate of return on average assets and average shareholders' equity was 0.87% and 9.44%, respectively, for 2016 compared with 0.85% and 9.41%, respectively, for 2015.

Total assets as of June 30, 2016 were $1,030,238,000, compared with $1,020,936,000 at December 31, 2015. Loans receivable at June 30, 2016 were $604,478,000, compared with $615,270,000 at December 31, 2015, a decrease of $10,792,000, or 1.8%. Total deposits of $893,285,000 at June 30, 2016 increased $3,499,000 compared with total deposits of $889,786,000 at December 31, 2015.

Results for the three and six months ended June 30, 2016 include the following significant components:

Net interest income increased $377,000, or 5.7%, to $7,019,000 and $811,000, or 6.1%, to $14,140,000 for the three and six months ended June 30, 2016, respectively.

Net interest margin on a tax-equivalent basis increased two basis points for the quarter and four basis points year-to-date, to 3.08% and 3.11%, respectively.

QNB recorded no provision for loan losses for the second quarter and $125,000 first six months of 2016 compared with $60,000 in provisions recorded for second quarter and first six months of 2015.

Non-interest income decreased $225,000, or 14.1%, to $1,374,000 for the second quarter and $326,000, or 10.0%, to $2,950,000 for year-to-date 2016, compared to the same periods in 2015.

Non-interest expense decreased $71,000 to $5,593,000 for the second quarter and $79,000, to $11,112,000 year-to-date 2016, compared to the same periods in 2015.

Total non-performing loans were $10,183,000, or 1.68% of loans receivable at June 30, 2016, compared to $10,719,000, or 1.74% of loans receivable at December 31, 2015. Loans on non-accrual status were $8,685,000 at June 30, 2016 compared with $9,420,000 at December 31, 2015. Net charge-offs for the first six months of 2016 were $129,000, or 0.04% annualized of average total loans, as compared with $406,000, or 0.14% annualized of average total loans for the first six months of 2015.

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

NET INTEREST INCOME

QNB Corp. earns its net income primarily through its subsidiary, the Bank. Net interest income, or the spread between the interest, dividends and fees earned on loans and investment securities and the expense incurred on deposits and other interest-bearing liabilities, is the primary source of operating income for QNB. QNB seeks to achieve sustainable and consistent earnings growth while maintaining adequate levels of capital and liquidity and limiting its exposure to credit and interest rate risk levels approved by the Board of Directors.

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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 six month periods ended June 30, 2016 and 2015.

	Three months ended June 30,		**Six months ended June 30,**	
	2016	**2015**	**2016**	**2015**
Total interest income	$8,184	$7,746	$16,464	$15,553
Total interest expense	1,165	1,104	2,324	2,224
Net interest income	7,019	6,642	14,140	13,329
Tax-equivalent adjustment	412	434	848	879
Net interest income (fully taxable-equivalent)	$7,431	$7,076	$14,988	$14,208

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.

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

	Three Months Ended					
	June 30, 2016			**June 30, 2015**		
	Average Balance	**Average Rate**	**Interest**	**Average Balance**	**Average Rate**	**Interest**
Assets						
Trading securities	$3,899	4.67 %	$46	$4,162	5.88 %	$61
Investment securities (AFS & HTM):						
U.S. Government agencies	53,551	1.84 %	247	44,714	1.62 %	181
State and municipal	73,191	4.05 %	741	68,481	4.18 %	715
Mortgage-backed and CMOs	192,598	1.99 %	957	205,451	1.96 %	1,008
Pooled trust preferred securities	3,216	0.22 %	2	3,517	0.57 %	5
Corporate debt securities	8,186	1.97 %	40	6,009	1.15 %	17
Equities	7,491	3.28 %	61	7,174	3.22 %	58
Total investment securities	338,233	2.42 %	2,048	335,346	2.37 %	1,984
Loans:						
Commercial real estate	326,670	4.44 %	3,607	290,608	4.44 %	3,215
Residential real estate	44,600	3.93 %	438	38,665	3.99 %	386
Home equity loans	62,457	3.74 %	580	57,042	3.56 %	507
Commercial and industrial	112,393	4.24 %	1,185	128,940	4.07 %	1,309
Indirect lease financing	9,927	8.76 %	218	8,921	8.98 %	200
Consumer loans	4,367	5.21 %	57	3,888	5.42 %	52
Tax-exempt loans	40,347	3.74 %	375	45,702	3.95 %	450
Total loans, net of unearned income*	600,761	4.32 %	6,460	573,766	4.28 %	6,119
Other earning assets	28,900	0.59 %	42	14,677	0.45 %	16
Total earning assets	971,793	3.56 %	8,596	927,951	3.54 %	8,180
Cash and due from banks	14,197			11,704		
Allowance for loan losses	(7,627)			(7,956)		
Other assets	28,673			29,378		
Total assets	$1,007,036			$961,077		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing demand	$153,457	0.23 %	$87	$134,941	0.22 %	$75
Municipals	86,770	0.35 %	76	91,989	0.34 %	79

Money market	69,558	0.27 %	47	65,287	0.24 %	38
Savings	230,086	0.40 %	229	216,598	0.37 %	200
Time	133,832	1.11 %	371	144,263	1.08 %	389
Time of $100,000 or more	94,052	1.36 %	319	92,694	1.28 %	295
Total interest-bearing deposits	767,755	0.59 %	1,129	745,772	0.58 %	1,076
Short-term borrowings	38,208	0.38 %	36	30,378	0.36 %	28
Total interest-bearing liabilities	805,963	0.58 %	1,165	776,150	0.57 %	1,104
Non-interest-bearing deposits	103,624			93,814		
Other liabilities	3,761			3,310		
Shareholders' equity	93,688			87,803		
Total liabilities and shareholders' equity	$1,007,036			$961,077		
Net interest rate spread		2.98 %			2.97 %	
Margin/net interest income		3.08 %	$ 7,431		3.06 %	$ 7,076

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*)

	Six Months Ended June 30, 2016				**June 30, 2015**			
	Average Balance	**Average Rate**		**Interest**	**Average Balance**	**Average Rate**		**Interest**
Assets								
Trading securities	$3,883	5.48	%	$106	$4,160	5.94	%	$124
Investment securities (AFS & HTM):								
U.S. Government agencies	55,290	1.84	%	508	50,461	1.61	%	407
State and municipal	74,705	4.08	%	1,523	69,388	4.19	%	1,452
Mortgage-backed and CMOs	196,511	2.00	%	1,963	212,151	1.95	%	2,066
Pooled trust preferred securities	3,250	0.21	%	3	3,518	0.37	%	6
Corporate debt securities	8,634	1.78	%	77	6,008	1.14	%	34
Equities	7,507	3.48	%	130	7,075	3.16	%	111
Total investment securities	345,897	2.43	%	4,204	348,601	2.34	%	4,076
Loans:								
Commercial real estate	325,929	4.45	%	7,209	287,807	4.51	%	6,433
Residential real estate	43,862	3.89	%	852	37,861	4.08	%	772
Home equity loans	62,262	3.77	%	1,166	57,217	3.59	%	1,019
Commercial and industrial	113,858	4.21	%	2,386	124,615	4.10	%	2,531
Indirect lease financing	10,168	9.02	%	458	8,382	9.03	%	379
Consumer loans	4,376	5.27	%	115	4,009	5.43	%	108
Tax-exempt loans	40,330	3.77	%	757	46,130	4.00	%	916
Total loans, net of unearned income*	600,785	4.33	%	12,943	566,021	4.33	%	12,158
Other earning assets	19,687	0.60	%	59	14,623	1.02	%	74
Total earning assets	970,252	3.59	%	17,312	933,405	3.55	%	16,432
Cash and due from banks	12,818				11,259			
Allowance for loan losses	(7,618)				(8,025)			
Other assets	28,661				29,565			
Total assets	$1,004,113				$966,204			
Liabilities and Shareholders' Equity								
Interest-bearing deposits:								
Interest-bearing demand	$149,242	0.21	%	$157	$132,182	0.22	%	$145
Municipals	90,878	0.35	%	158	104,478	0.34	%	175

Money market	69,844	0.27 %	94	62,489	0.24 %	74
Savings	227,579	0.40 %	455	215,371	0.37 %	396
Time	134,251	1.11 %	744	146,006	1.08 %	785
Time of $100,000 or more	93,728	1.37 %	637	92,673	1.28 %	590
Total interest-bearing deposits	765,522	0.59 %	2,245	753,199	0.58 %	2,165
Short-term borrowings	40,638	0.39 %	79	32,127	0.37 %	59
Total interest-bearing liabilities	806,160	0.58 %	2,324	785,326	0.57 %	2,224
Non-interest-bearing deposits	101,287			90,332		
Other liabilities	3,696			3,317		
Shareholders' equity	92,970			87,229		
Total liabilities and shareholders' equity	$1,004,113			$966,204		
Net interest rate spread		3.01 %			2.98 %	
Margin/net interest income		3.11 %	$14,988		3.07 %	$14,208

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 June 30, 2016 compared to June 30, 2015			**Six Months Ended June 30, 2016 compared to June 30, 2015**		
	Total	Due to change in:		Total	Due to change in:	
	Change	Volume	Rate	Change	Volume	Rate
Interest income:						
Trading securities	$(15)	$(3)	$(12)	$(18)	$(9)	$(9)
Investment securities (AFS & HTM):						
U.S. Government agencies	66	36	30	101	38	63
State and municipal	26	50	(24)	71	112	(41)
Mortgage-backed and CMOs	(51)	(64)	13	(103)	(152)	49
Pooled trust preferred securities	(3)	-	(3)	(3)	-	(3)
Corporate debt securities	23	6	17	43	15	28
Equities	3	2	1	19	7	12
Total Investment securities (AFS & HTM)	64	30	34	128	20	108
Loans:						
Commercial real estate	392	389	3	776	873	(97)
Residential real estate	52	59	(7)	80	122	(42)
Home equity loans	73	46	27	147	93	54
Commercial and industrial	(124)	(172)	48	(145)	(211)	66
Indirect lease financing	18	24	(6)	79	80	(1)
Consumer loans	5	7	(2)	7	11	(4)
Tax-exempt loans	(75)	(54)	(21)	(159)	(113)	(46)
Total Loans	341	299	42	785	855	(70)
Other earning assets	26	16	10	(15)	26	(41)
Total interest income	416	342	74	880	892	(12)
Interest expense:						
Interest-bearing deposits:						

Interest-bearing demand	12	10	2	12	19	(7)
Municipals	(3)	(5)	2	(17)	(22)	5
Money market	9	3	6	20	9	11
Savings	29	12	17	59	24	35
Time	(18)	(28)	10	(41)	(61)	20
Time of $100,000 or more	24	4	20	47	9	38
Total interest-bearing deposits	53	(4)	57	80	(22)	102
Short-term borrowings	8	7	1	20	16	4
Total interest expense	61	3	58	100	(6)	106
Net interest income	$355	$339	$16	$780	$898	$(118)

Net Interest Income and Net Interest Margin – quarter to quarter comparison

Net interest income for the quarter ended June 30, 2016 totaled $7,019,000, an increase of $377,000, or 5.7%, over the same period in 2015. When compared to the first quarter of 2016, net interest income decreased $102,000 from the $7,121,000 reported.

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Average earning assets for the second quarter 2016 were $971,793,000, an increase of $43,842,000 for the quarter, compared with the same period in 2015. Average loans increased $26,995,000, or 4.7%, for the quarter and average investment securities increased $2,624,000 over the comparable period of 2015. Growth in the loan portfolio mitigates the impact of the low rate environment on net interest income and the net interest margin as loans generally earn a higher yield than investment securities. Average loans as a percent of average earning assets grew to 61.9% for the six months ended June 30, 2016 compared to 60.6% for the same period in 2015. On the funding side, average deposits increased $31,793,000, or 3.8%, for second quarter and $23,278,000, or 2.8%, for the six months, compared to the same periods in 2015. Customers continue to reinvest funds into non-time deposits, as the yield on time deposits remains low and customers prefer to keep their funds liquid to capitalize on rising rates. Average short-term borrowings, which consist primarily of commercial repurchase agreements, increased $7,830,000 for the second quarter 2016 compared to the second quarter 2015.

The low interest rate environment and loan rate competition continues to exert pressure on asset yields and the net interest margin as longer term assets reprice to lower interest rate levels while funding costs are near their implied floors. The net interest margin for the second quarter 2016 was 3.08% compared to 3.06% for same period in 2015 and 3.14% reported for the first quarter of 2016.

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 increased $416,000, or 5.1%, to $8,596,000 for the second quarter of 2016; total interest expense increased 5.5% to $1,165,000. Growth in earning assets and improved yields contributed to the increase in interest income. All categories of interest-bearing deposits experienced higher rates in the second quarter 2016 compared to second quarter 2015, due to the increase in balances in tiered-pricing accounts and a five basis point rate increase to the eSavings product in late 2015.

The yield on earning assets on a tax-equivalent basis improved two basis points from 3.54% for the second quarter of 2015, to 3.56% for the second quarter of 2016 and declined six basis points from the 3.62% reported for the first quarter of 2016. The rate paid on interest-bearing liabilities increased one basis point to 0.58% for the second quarter of 2016 compared to the same period in 2015 and remained equal to the funding rate reported for the quarter ended March 31, 2016.

Interest income on investment securities (trading, available-for-sale and held-to-maturity) increased $49,000 when comparing the quarters ended June 30, 2016 and 2015, primarily as a result of a four basis point increase in average yield. The average yield on the investment portfolio was 2.45% for the second quarter of 2016 compared with 2.41% for the second quarter of 2015. The yield on the investment portfolio improved largely due to the increase in average balances of U.S. Government agency and municipal bonds, which have both longer maturities and higher rates compared to amortizing Government Agencies and mortgage-backed securities. The current market has provided little opportunity to invest the cash flow from calls and prepayments in the portfolio in bonds with better yields than the securities being called and repaid. During the first six months of 2016, the cash flows from calls and principal and interest payments on mortgage backed securities funded seasonal deposit withdrawals by municipalities.

Income on Government agency securities increased $66,000, as the $8,837,000, or 19.8%, increase in average balances increased interest income by $36,000. This sector experienced a 22 basis point increase in the yield from 1.62% for the second quarter of 2015 to 1.84% for the same period in 2016 and contributed an additional $30,000.

Interest income on tax-exempt municipal securities increased $26,000 with the increased volume contributing $50,000 of the total increase. The yield on the municipal portfolio was 4.05% for the second quarter 2016 compared to 4.18% for same period in 2015. 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 7-10 years with call dates between 2-5 years. The yield on this portfolio is expected to continue to decline as additional higher yielding municipal bonds are expected to be called or mature during 2016. The current yield on replacement bonds is well below the yield of the bonds being called or maturing.

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Interest income on mortgage-backed securities and CMOs decreased $51,000 with an increase in average yield mitigating the impact of lower average balances. Average balances decreased $12,853,000, or 6.3%, to $192,598,000 when comparing the two periods and contributed a $64,000 decrease in income. The yield on the mortgage-backed and CMO portfolio increased three basis points from 1.96% for the second quarter of 2015 to 1.99% for the second quarter of 2016, resulting in a $13,000 increase in interest income. This portfolio generally 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.

Income on loans increased $341,000 to $6,460,000 when comparing the second quarters of 2016 and 2015, with a 4.7% growth in average balances contributing $299,000. The yield on the loan portfolio improved four basis points to 4.32% and contributed $42,000 when comparing the same periods. As a result of the interest rate environment and competitive pressures, new loans are being originated at lower rates, variable rate loans are repricing lower and many customers with fixed rates are requesting modifications for lower 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 increased $392,000 due to the 12.4% increase in average balances. Average balances increased $36,062,000, to $326,670,000 for the quarter ended June 30, 2016 compared with the same quarter in 2015. The yield on commercial real estate loans was 4.44% for both periods.

Income on commercial and industrial loans, the second largest category, decreased $124,000 as average commercial and industrial loan balances decreased $16,547,000, or 12.8%, to $112,393,000 for the second quarter of 2016 resulting a $172,000 decrease in income. The average yield on these loans increased 17 basis points to 4.24% resulting in an increase in income of $48,000. Many of the loans in this category are indexed to the prime interest rate, which increased by one quarter of one percent in late December 2015.

Tax-exempt loan income was $375,000 for the second quarter of 2016, a decrease of $75,000 from the same period in 2015. With the decline in market interest rates many municipalities have refinanced existing debt or taken on new debt. While QNB has been successful in winning some of these bids, average balances have decreased $5,355,000, or 11.7%, to $40,347,000 for the second quarter of 2016, resulting in a decrease of $54,000 in income. The rate renegotiation or bidding on these loans has resulted in a $21,000 decline in interest income as the average yield on the tax-exempt loan portfolio declined from 3.95% for the second quarter of 2015 to 3.74% for the second quarter of 2016.

QNB desires to become the “local consumer lender of choice” and to affect this QNB focused its retail lending efforts, adding new product offerings and increasing marketing and promotion. The positive impact of this focus has been year-over-year growth in balances in all three categories of retail lending: residential mortgage, home equity and consumer loans. Average residential mortgage loans secured by first lien 1-4 family residential mortgages increased by $5,935,000, or 15.4%, to $44,600,000 for the second quarter of 2016 compared to the same period in 2015. Over this same timeframe, the average yield on the portfolio declined by six basis points to 3.93% for the second quarter of 2016. The net result was an increase in interest income of $52,000. Average home equity loans increased $5,415,000, or 9.5%, to $62,457,000 while the average yield increased 18 basis points to 3.74% resulting in an increase in interest income of $73,000. Average consumer loans increased $479,000, or 12.3%, to $4,367,000 while the yield on the portfolio decreased 21 basis points to 5.21% for the second quarter of 2016 resulting in a $5,000 increase in interest income.

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For the most part, earning assets are funded by deposits, which increased 3.8% when comparing the second quarters of 2016 and 2015. Interest expense on total deposits and borrowed funds increased $53,000 and $8,000, respectively, when comparing the two quarters. The rate paid on interest-bearing deposits increased one basis point comparing the second quarters of 2016 and 2015. Deposit rates may continue to increase as short-term interest rates begin to increase and competition for deposits increases.

The growth in average deposits continues to be centered in accounts with greater liquidity, such as non-interest and interest-bearing demand, money market, and savings deposits. Average non-interest-bearing demand accounts increased $9,810,000, or 10.5%, to $103,624,000 for the second quarter of 2016. QNB has been successful in increasing business checking accounts as average balances in these accounts have increased by $7,990,000, or 10.6%, when comparing the quarters. Average interest-bearing demand accounts increased $18,516,000, or 13.7%, to $153,457,000 for the second quarter of 2016. Interest expense on interest-bearing demand accounts increased $12,000 to $87,000 for the same period, as the average rate paid increased by one basis point to 0.23% for the second quarter of 2016. Included in this category is QNB-Rewards checking, a higher-rate checking account product that pays 1.00% on balances up to $25,000 and 0.25% for balances over $25,000. 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 second quarter of 2016, the average balance in this product was $45,528,000 and the related interest expense was $71,000 for an average yield of 0.63%. In comparison, the average balance of the QNB-Rewards accounts for the second quarter of 2015 was $41,406,000 with a related interest expense of $62,000 and an average rate paid of 0.60%. 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 $93,535,000 for the second quarter of 2015 to $107,929,000 for the second quarter of 2016. The average rate paid on these balances was 0.06% for both periods.

Interest expense on municipal interest-bearing demand accounts decreased $3,000 to $76,000 for the second quarter of 2016. The average balance of municipal interest-bearing demand accounts decreased $5,219,000, or 5.7%, to $86,770,000, with the average interest rate paid on these accounts increasing slightly to 0.35% for the second quarter of 2016. The decrease in balances in 2016 may be attributable to school districts’ need for funds, as state funding has been delayed due to the state budget impasse. Many of these accounts are indexed to the Federal funds rate with rate floors between 0.25% and 0.50%, therefore the increase in the Federal funds rate by one quarter of one percent in late December 2015 had minimal effect on the yield of these deposits. These deposits are seasonal in nature and are received during the third quarter as tax receipts are collected and are withdrawn over the course of the next year. It is anticipated that these balances will increase during the third quarter of 2016.

Average money market accounts increased $4,271,000, or 6.5%, to $69,558,000 for the second quarter of 2016 compared with the same period in 2015. Interest expense on money market accounts increased $9,000 to $47,000 and the average interest rate paid on money market accounts increased from 0.24% for the second quarter of 2015 to 0.27% for the second quarter of 2016. The majority of balances in this category are in a product that pays a tiered rate based on account balances.

Interest expense on savings accounts increased $29,000 when comparing the second quarter of 2016 to the second quarter of 2015, and the average rate increased three basis points to 0.40% when comparing both periods. When comparing these same periods average savings accounts increased $13,488,000, or 6.2%, to $230,086,000 for the second quarter of 2016 with both the statement savings and e-Savings products accounting for the growth in savings balances. QNB's online e-Savings product is the largest category of savings deposits, with average balances for the second quarter of 2016 of $167,987,000. This product has grown successfully since its introduction in the second quarter of 2009. The average yield paid on these accounts was 0.50% for the second quarter of 2016 and 0.46% for the same period in 2015. Traditional statement savings accounts, passbook savings and club accounts are also included in the savings category and average balances in these types of savings accounts increased $6,454,000, or 11.6%, when comparing the second quarter 2016 average to the same 2015 quarter.

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Total interest expense on time deposits increased $6,000 to $690,000 for the second quarter of 2016. Average total time deposits decreased by $9,073,000 to $227,884,000 for the second quarter of 2016. 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. The average rate paid on time deposits increased six basis points from 1.16% to 1.22% when comparing the second quarter of 2015 to the same period in 2016.

Approximately $88,476,000, or 38.7%, of time deposits at June 30, 2016 will mature over the next 12 months. The average rate paid on these time deposits is approximately 0.77%. The yield on the time deposit portfolio may change 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 or if customers select higher paying longer-term time deposits.

Short-term borrowings are comprised of sweep accounts structured as repurchase agreements with our commercial customers. Interest expense on short-term borrowings increased $8,000 for the second quarter of 2016 to $36,000 when compared to the same period in 2015. When comparing these same periods average balances increased from $30,378,000 to $38,208,000 while the average rate paid increased two basis points to 0.38%.

Six Month Comparison

For the six month period ended June 30, 2016 net interest income was $14,140,000, an increase of $811,000, or 6.1%, higher than the $13,329,000 reported for the first half of 2015. For the six month period ending June 30, 2016 average earning assets increased $36,847,000, or 3.9%, to $970,252,000, with average loans increasing 6.1% and average investment securities decreasing by $2,981,000. Average total deposits increased $23,278,000, or 2.8%, to $866,809,000 for the six-month period ended June 30, 2016 compared to the same period in 2015. The net interest margin on a tax-equivalent basis was 3.11% for the six-month period ended June 30, 2016, a four basis point increase from the same period in 2015.

Total interest income on a tax-equivalent basis increased $880,000, or 5.4%, from $16,432,000 to $17,312,000, when comparing the six-month periods ended June 30, 2015 and June 30, 2016 as the additional interest income generated from the growth in earning assets combined with the impact of improved yields on some of those assets. Interest income increased $892,000 as a result of volume increases but declined $12,000 as a result of lower yields. The analysis of the six-month comparison periods is similar to what was described in the quarterly analysis.

The yield on earning assets increased from 3.55% to 3.59% for the six-month periods with the yield on loans remaining unchanged at 4.33%. QNB continues to feel the on yields of historically low levels of interest rates over the past several years and competitive pressures on loan pricing. The yield on investments, including trading securities, increased eight basis points from 2.38% to 2.46% when comparing the six-month periods.

Total interest expense increased $100,000 for the six-month period ended June 30, 2016 compared with the same period in 2015, attributable to the increase in deposits into higher-earning tiered money markets and interest-bearing DDA, as well as a five basis point increase in the eSavings rate in late 2015. The average rate paid on interest bearing deposits increased one basis point to 0.59% for the six month period ended June 30, 2016 versus the first half of 2015.

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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. Based on this analysis, QNB recorded no provision for loan losses in the second quarter and $125,000 for the six months ended June 30, 2016, while a $60,000 provision was recorded in the same periods in 2015. QNB's allowance for loan losses of $7,550,000 represents 1.25% of loans receivable at June 30, 2016 compared to an allowance for loan losses of $7,554,000, or 1.23% of loans receivable, at December 31, 2015, and $7,655,000, or 1.32% of loans receivable at June 30, 2015. The allowance for loan losses at June 30, 2016 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.

Net charge-offs were $6,000 for the second quarter of 2016. This compares with net loan charge-offs of $383,000 for the second quarter of 2015. For the six month periods ended June 30, 2016 and 2015 net loan charge-offs were $129,000 and $406,000, respectively.

Non-performing assets of $12,583,000 at June 30, 2016 compares favorably with $13,372,000 as of December 31, 2015 and $15,019,000 as of June 30, 2015. 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 restructured loans were $10,183,000, or 1.68% of loans receivable, at June 30, 2016 compared with $10,719,000, or 1.74% receivable, at December 31, 2015 and $12,090,000, or 2.09% of loans receivable, at June 30, 2015. 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. At June 30, 2016, $6,319,000, or approximately 73% of the loans classified as non-accrual are current or past due less than 30 days. In addition to the decline in total non-performing loans when comparing the second quarter of 2016 with the same quarter of the prior year, loans classified as substandard or doubtful, which include non-performing loans, also improved. At June 30, 2016 commercial loans rated substandard or doubtful totaled $23,476,000 a reduction of $5,885,000, or 20.0%, from the $29,361,000 reported as of June 30, 2015, and a decrease of $3,849,000, or 14.1%, from the $27,325,000 reported at December 31, 2015.

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QNB had $65,000, $11,000, and $90,000 of loans past due 90 days or more and still accruing interest at June 30, 2016, December 31, 2015, and June 30, 2015, respectively, consisting of indirect lease financing balances. Total loans 30 days or more past due, which includes non-accrual loans by actual number of days delinquent, represented 0.65% of loans receivable at June 30, 2016 compared with 0.60% at December 31, 2015 and 0.61% at June 30, 2015.

Troubled debt restructured loans, not classified as non-accrual loans or loans past due 90 days or more, were $1,433,000 at June 30, 2016 compared with $1,288,000 at December 31, 2015 and $2,177,000 at June 30, 2015. There were nine new troubled debt relationships and fourteen loans restructured since June 2015. QNB had no other real estate owned at June 30, 2016 or December 31, 2015, compared to three residential properties with a carrying value of $198,000 as of June 30, 2015. Non-accrual pooled trust preferred securities are carried at fair value of $2,400,000, $2,653,000, and $2,694,000 at June 30, 2016, December 31, 2015 and June 30, 2015, respectively. The decrease in the carrying value of these securities reflects a combination of payments received and a decrease in their fair value.

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 June 30, 2016 and December 31, 2015, the recorded investment in loans for which impairment has been identified totaled $13,604,000 and $14,941,000 of which $10,839,000 and $12,414,000, respectively, required no specific allowance for loan loss. The recorded investment in impaired loans requiring an allowance for loan losses was $2,765,000 and $2,527,000 at June 30, 2016 and December 31, 2015, respectively. At June 30, 2016 and December 31, 2015, the related allowance for loan losses associated with these loans was $803,000 and $974,000, 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:

	June 30, 2016	**December 31, 2015**	**June 30, 2015**
Non-accrual loans	$8,685	$9,420	$9,823
Loans past due 90 days or more and still accruing interest	65	11	90
Troubled debt restructured loans (not already included above)	1,433	1,288	2,177
Total non-performing loans	10,183	10,719	12,090
Other real estate owned and repossessed assets	-	-	235
Non-accrual investment securities	2,400	2,653	2,694
Total non-performing assets	$12,583	$13,372	$15,019
Total loans (excluding loans held-for-sale):			
Average total loans (YTD)	$600,601	$574,015	$565,584
Total loans	604,478	615,270	578,256
Allowance for loan losses	7,550	7,554	7,655
Allowance for loan losses to:			
Non-performing loans	74.14 %	70.48 %	63.32 %
Total loans (excluding held-for-sale)	1.25 %	1.23 %	1.32 %
Average total loans	1.26 %	1.32 %	1.35 %
Non-performing loans / total loans (excluding held-for-sale)	1.68 %	1.74 %	2.09 %
Non-performing assets / total assets	1.22 %	1.31 %	1.57 %

An analysis of loan charge-offs for the three and six months ended June 30, 2016 compared to 2015 is as follows:

	Three months ended	**Six months ended**
	June 30,	**June 30,**

	2016	2015	2016	2015
Net charge-offs	$6	$383	$129	$406
Net charge-offs (annualized) to:				
Total loans (excluding held-for-sale)	0.00%	0.27 %	0.04%	0.14 %
Average total loans (excluding held-for-sale)	0.00%	0.27 %	0.04%	0.14 %
Allowance for loan losses	0.29%	20.06%	3.45%	10.69%

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NON-INTEREST INCOME

Non-Interest Income Comparison

	Three months ended June 30,		Change from prior year		Six months ended June 30,		Change from prior year	
	2016	2015	Amount	Percent	2016	2015	Amount	Percent
Net gain on investment securities	$15	$214	$(199)	-93.0 %	$334	$717	$(383)	-53.4 %
Net (loss) gain on trading activity	52	(34)	86	252.9 %	86	(19)	105	552.6 %
Fees for services to customers	397	404	(7)	-1.7 %	780	806	(26)	-3.2 %
ATM and debit card	422	394	28	7.1 %	810	756	54	7.1 %
Retail brokerage and advisory income	126	204	(78)	-38.2 %	296	377	(81)	-21.5 %
Bank-owned life insurance	73	72	1	1.4 %	144	142	2	1.4 %
Merchant income	83	81	2	2.5 %	156	151	5	3.3 %
Net gain on sale of loans	71	119	(48)	-40.3 %	120	182	(62)	-34.1 %
Other	135	145	(10)	-6.9 %	224	164	60	36.6 %
Total	$1,374	$1,599	$(225)	-14.1 %	$2,950	$3,276	$(326)	-10.0 %

Quarter to Quarter Comparison

Total non-interest income for the second quarter of 2016 was $1,374,000, a decrease of $225,000, compared to $1,599,000 for the second quarter of 2015. Excluding net gains on investment securities, trading activities and sale of loans for both periods, total non-interest income was $1,236,000 and $1,300,000, respectively, a decrease of $64,000, or 4.9%.

Net gains on investment securities declined $199,000, or 93.0%, from $214,000 in second quarter 2015 to $15,000 in second quarter 2016. During the second quarter of 2016, QNB recorded $122,000 of other-than-temporary impairment charges for an equity security, resulting from of a prolonged decline in its fair value and gains on securities sales declined $77,000 compared to the 2015 second quarter. There were no OTTI charges taken in the same period in 2015. Retail brokerage and advisory fees declined $78,000, or 38.2%, to $126,000 for the second quarter 2016 compared to the same period in 2015. Fees for services to customers decreased $7,000, or 1.7%, from $404,000 for the 2015 second quarter to $397,000 for the 2016 quarter, due primarily to a decrease in net overdraft income and the elimination of an ATM network service charge in September 2015. QNB originates residential mortgage loans for sale in the secondary market. Net gains on sale of loans decreased $48,000, or 40.3%, from $119,000 during the second quarter of 2015 to $71,000 during the second quarter 2016 due to a decline in residential mortgage activity.

These reductions in fee income were offset in part by a $28,000, or 7.1%, increase in ATM and debit card income to $422,000 for the second quarter 2016, due to increases in card-based transactions and expansion of checking account households. The net gain from trading activity of $52,000 for the second quarter of 2016 increased $86,000 compared to the net loss of $34,000 for the second quarter of 2015.

Six-Month Comparison

Total non-interest income for the six month periods ended June 30, 2016 and 2015 was $2,950,000 and $3,276,000, respectively, a decrease of $326,000, or 10.0%. Excluding net gains on investment securities, trading activities and loans for both periods total non-interest income was $2,410,000 and $2,396,000, an increase of $14,000.

Net investment securities gains decreased $383,000, or 53.4%, to $334,000 for the six months ended June 30, 2016 compared to $717,000 for the comparable six months in 2015. During the first half of 2016, QNB recorded $192,000 of other-than-temporary impairment charges in two equity securities, as a result of a prolonged decline in their fair values. There were no OTTI charges taken in the first half of 2015. Gains on sales of securities were $526,000 in the 2016 period versus $717,000 in the 2015 period.

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Fees for services to customers decreased $26,000 in the first six months of 2016 compared to 2015. Overdraft income net of waived charges, representing approximately 73% of total fees for services to customers during the second half of 2016, decreased by $24,000. The decrease in overdraft income reflects a decrease in the volume of overdrafts. This decrease was offset by a $54,000, or 7.1%, increase in ATM and debit card income to $810,000 due to increased purchases by cardholders during the period.

Although assets under management grew $16,000,000 to $86,000,000 at June 30, 2016, retail brokerage and advisory income was $296,000 for the first half of 2016 compared to $377,000 for the first half of 2015, a decrease of $81,000, or 21.5%.

Net gains on the sale of loans decreased $62,000, or 34.1%, when comparing the six months ended June 30, 2016 to the same period in 2015. Proceeds from the sale of residential mortgages were $3,556,000 and $6,487,000 for the six-month periods ended June 30, 2016 and 2015, respectively.

Other non-interest income increased $60,000, or 36.6%, when comparing the six-month periods ended June 30, 2016 and 2015, due to net losses on the sale of OREO and repossessed assets recorded in 2015, which did not recur in 2016.

NON-INTEREST EXPENSE

Non-Interest Expense Comparison

	Three months ended June 30,		Change from prior year		Six months ended June 30,		Change from prior year	
	2016	**2015**	**Amount**	**Percent**	**2016**	**2015**	**Amount**	**Percent**
Salaries and employee benefits	$2,988	$3,053	$(65)	-2.1 %	$6,042	$6,049	$(7)	-0.1 %

Net occupancy	426	455	(29)	-6.4 %	867	909	(42)	-4.6 %
Furniture and equipment	440	432	8	1.9 %	865	861	4	0.5 %
Marketing	265	212	53	25.0 %	461	422	39	9.2 %
Third-party services	403	445	(42)	-9.4 %	806	846	(40)	-4.7 %
Telephone, postage and supplies	174	175	(1)	-0.6 %	360	369	(9)	-2.4 %
State taxes	141	173	(32)	-18.5 %	321	347	(26)	-7.5 %
FDIC insurance premiums	157	150	7	4.7 %	327	317	10	3.2 %
Other	599	569	30	5.3 %	1,063	1,071	(8)	-0.7 %
Total	$5,593	$5,664	$(71)	-1.3 %	$11,112	$11,191	$(79)	-0.7 %

Quarter to Quarter Comparison

Total non-interest expense was $5,593,000 for the second quarter of 2016, a decrease of $71,000, or 1.3%, compared to the second quarter of 2015.

Salaries and benefits comprise 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 second quarter of 2016 were $2,988,000, a decrease of $65,000, or 2.1%, from the $3,053,000 reported in the second quarter of 2015.

Net occupancy costs also decreased $29,000, or 6.4%, primarily due to decreased utilities and rent expenses. Marketing expense increased $53,000, or 25.0%, to $265,000 for the three month period ended June 30, 2016. This increase was due to a $50,000 charitable donation, which resulted in QNB receiving a shares tax credit.

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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 $42,000, or 9.4%, to $403,000 for the three months ended June 30, 2016 when compared to the same period in 2015, attributable primarily to a decrease in third party IT services.

FDIC insurance premium expense increased $7,000, or 4.7%, to $157,000, when comparing the three months ended June 30, 2016 to the same period in 2015, attributable to the growth in deposits.

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 $141,000 for the second quarter of 2016, a decrease of $32,000 compared to the same period in 2015. Year-to-date accrued shares tax was adjusted during the second quarter 2016 for a $37,500 shares tax credit related to a charitable donation.

Other non-interest expense increased $30,000, or 5.3%, to $599,000 for the second quarter of 2016.

Six-Month Comparison

Total non-interest expense was $11,112,000 for the six-month period ended June 30, 2016, a decrease of $79,000 compared to the first half of 2015.

Salaries and benefits expense decreased $7,000 to $6,042,000 for the six months ended June 30, 2016 compared to the same period in 2015. Salary expense decreased $48,000 during the period to $4,724,000 while benefits expense increased $41,000, to $1,318,000, related to medical premiums expenses and increased state unemployment expenses.

Net occupancy decreased $42,000, or 4.6% to $867,000, for the same reasons described in the quarter comparison.

Marketing expense increased $39,000, or 9.2%, to $461,000 for the six months ended June 30, 2016 for the same reason noted for the quarter.

State tax expense was $321,000 for the first half of 2016, a decrease of $26,000 compared to the same period in 2015 due to the increase in the Bank's equity capital for the period, offset by the tax credit described in the quarter comparison.

Third party services expense decreased $40,000, or 4.7%, to $806,000 for the six months ended June 30, 2016 when compared to the same period in 2015.

Other non-interest expense decreased $8,000 for the first half of 2016.

INCOME TAXES

QNB utilizes an asset and liability approach for financial accounting and reporting of income taxes. As of June 30, 2016, QNB's net deferred tax asset was $1,891,000. The primary components of deferred taxes are deferred tax assets of $2,567,000 relating to the allowance for loan losses, $519,000 related to non-accrual interest income, $99,000 generated by OTTI charges on equity securities and $392,000 related to OTTI charges on pooled trust preferred securities, offset by $1,584,000 in deferred tax liabilities related to unrealized gains on available for sale securities. As of December 31, 2015, QNB's net deferred tax asset was $3,673,000. The primary difference in the balance of net deferred tax assets when comparing June 30, 2016 to December 31, 2015 is the increase in deferred tax liability due to increased unrealized gains on available for sale securities.

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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.

Applicable income tax expense was $702,000 for the quarter and $1,490,000 for the six months ended June 30, 2016 compared to $583,000 and $1,284,000 for the same periods in 2015. The effective tax rate for the second quarter and year-to-date 2016 was 25.1% and 25.5%, compared with 23.2% and 24.0% for the same periods in 2015, respectively. This increase in effective tax rate in 2016 is due to the decreased proportion of tax-free income to total income, primarily municipal securities interest income, and increased state income taxes due to the depletion of a net loss carryforward at QNB Corp. in 2015.

FINANCIAL CONDITION ANALYSIS

Financial service organizations are challenged to demonstrate they can generate sustainable and consistent earnings growth in a dynamic operating environment. While the economy continues to improve, loan fundings remained lower than expected in the first half of 2016. The low level of interest rates and the extreme rate competition for quality loans is anticipated to continue through 2016. It is also anticipated that the rate competition for attracting and retaining deposits may increase in 2016 and into 2017 as short-term interest rates increase, which could result in a lower net interest margin and a decline in net interest income.

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. QNB is committed to make credit available to its customers.

Total assets at June 30, 2016 were $1,030,238,000 compared with $1,020,936,000 at December 31, 2015. Cash and cash equivalents increased $40,958,000 from $16,991,000 at December 31, 2015 to $57,949,000 at June 30, 2016, due in part to growth in deposit balances and delayed fundings for loan commitments, primarily commercial real estate projects granted in 2015 and 2016. The decline in total investment securities of $18,392,000 also contributed to the increase in cash at quarter-end.

Loans receivable declined $10,792,000 to $604,478,000 at June 30, 2016, compared to December 31, 2015, primarily due to a decline in commercial loan balances of $13,285,000. In addition to delayed loan fundings, QNB experienced large balance paydowns due to increased rate competition and sale of a commercial customer's business and reduction of commercial credit lines. Retail loan balances grew $2,431,000 to $116,934,000, when comparing June 30, 2016 to December 31, 2015. The Bank had several successful home equity loan promotions over the past year and has received a strong response to the product offering.

Total investment securities, including trading securities, available-for-sale securities and held-to-maturity securities were $347,859,000 at June 30, 2016 and $366,251,000 at December 31, 2015. Despite the overall decline in investment securities balances since year end, the composition of the portfolio is essentially unchanged since December 31, 2015. 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.

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QNB owns 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. In most cases QNB owns the mezzanine tranches of these securities, with the exception of one that now represents the senior-most obligation of the trust. 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 six of these securities with an amortized cost of $3,094,000 and a fair value of $2,400,000 at June 30, 2016. The company received principal and interest payments totaling $126,000 for the quarter and $197,000 year-to-date on three of these securities during 2016, which was recorded as a reduction to the amortized cost. There was no credit-related other-than-temporary impairment charge during the quarter or six months ended June 30, 2016 or 2015. 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.

Total deposits increased $3,499,000 to $893,285,000 at June 30, 2016 compared to the December 31, 2015 balances. Non-interest bearing demand balances increased $19,107,000 to $117,650,000 at June 30, 2016, due primarily to business deposits. Interest-bearing demand balances decreased $31,067,000 to $243,858,000 from December 31, 2015 to June 30, 2016. This decrease is primarily attributable to municipal deposits which decreased $37,394,000. Municipal deposits can be volatile depending on the timing of deposits and withdrawals, and the cash flow needs of the school districts or municipalities. Money market and savings balances increased $2,591,000 and $11,871,000, respectively, to $69,763,000 and $233,641,000, respectively. Time deposits increased $997,000, from $227,376,000 at December 31, 2015 to $228,373,000 at June 30, 2016, as QNB offered an attractive five-year rate to lock in low-cost funding, in anticipation of an eventual increase in interest rates. It is anticipated that total deposits will increase during the third quarter as tax money is received by the local school districts during September, and then flow out for the subsequent twelve months as the schools use the funds for operations. These deposits 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.

Short-term borrowings decreased slightly from $37,163,000 at December 31, 2015 to $36,693,000 at June 30, 2016. These balances are commercial sweep accounts which are also volatile based on businesses’ receipt and disbursement of funds.

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 June 30, 2016, the Bank had a maximum borrowing capacity with the FHLB of approximately $240,408,000. The maximum borrowing capacity changes as a function of qualifying collateral assets. QNB has no outstanding borrowings with the FHLB at June 30, 2016. In addition, the Bank maintains unsecured Federal funds lines with three correspondent banks totaling $41,000,000. At June 30, 2016, there were no outstanding borrowings under these lines. During the first quarter of 2016, QNB borrowed from the FHLB to fund short-term liquidity needs. Future availability under these lines is subject to the policies of the granting banks and may be withdrawn.

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Liquid sources of funds have increased $21,763,000, or 5.7%, since December 31, 2015. Total cash and cash equivalents, trading and available-for-sale investment securities and loans held-for-sale totaled $405,845,000 and $384,082,000 at June 30, 2016 and December 31, 2015, respectively, primarily due to increased cash provided by growth in deposits and declining loan and marketable securities. Management expects these liquid sources will be adequate to meet normal fluctuations in loan demand or deposit withdrawals. It is still anticipated that the investment portfolio will continue to provide sufficient liquidity, even in a rising rate environment, as municipal bonds and agency securities are called and as cash flow on mortgage-backed and CMO securities continues to be steady. In the event interest rates rise, the cash flow available from the investment portfolio could decrease.

Approximately $160,631,000 and $197,149,000 of available-for-sale securities at June 30, 2016 and December 31, 2015, respectively, were pledged as collateral for repurchase agreements and deposits of public funds. The decrease in the amount of pledged securities corresponds with the decrease in municipal deposits from December 31, 2015 to June 30, 2016.

As an additional source of liquidity, QNB is a member of the Certificate of Deposit Account Registry Services (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 June 30, 2016 was $97,207,000, or 9.44% of total assets, compared to shareholders' equity of $90,443,000, or 8.86% of total assets, at December 31, 2015. Shareholders’ equity at June 30, 2016 and December 31, 2015 included a positive adjustment of $3,074,000 and a negative adjustment $546,000, respectively, related to unrealized holding gains and losses, net of taxes, on investment securities available-for-sale.

Without these adjustments, shareholders' equity to total assets would have been 9.16% and 8.91% at June 30, 2016 and December 31, 2015, respectively.

Average shareholders' equity and average total assets were $92,970,000 and $1,004,113,000 for the first six months of 2016, an increase of 4.9% and 1.6%, respectively, from the averages for the year ended December 31, 2015. The ratio of average total equity to average total assets was 9.26% for the six months of 2016 compared to 8.97% for all of 2015.

Retained earnings at June 30, 2016 were impacted by six months of net income of $4,363,000 partially offset by cash dividends declared and paid of $2,027,000 for the same period. QNB offers 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 $477,000 and $453,000 to capital during the first six months of 2016 and 2015, respectively.

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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 June 30, 2016, 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.

QNB and the Bank are subject to various regulatory capital requirements as issued by Federal regulatory authorities. Regulatory capital is defined in terms of Tier 1 capital and Tier 2. 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. The final rules implementing the Basel Committee on Banking Supervision’s capital guidelines for U.S. banks (“Basel III”) became effective for QNB on January 1, 2015, with full compliance with all the of final rule’s requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019.

Under the final rules, minimum requirements increased for both the quantity and quality of capital. The rules included a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, required a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and required a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016, at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented. The final rules also revised the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets. QNB continues to monitor the effect of these new rules on the business, operations and capital levels of the Company and the Bank.

As of June 30, 2016, the capital levels for QNB and the Bank remained characterized as “well-capitalized” under the new rules.

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

Capital Analysis	**June 30, 2016**	**December 31, 2015**
Regulatory Capital		
Shareholders' equity	$97,207	$90,443
Net unrealized securities (gains) losses, net of tax	(3,074)	546
Net unrealized losses on available-for-sale equity securities, net of tax	-	(167)
Disallowed goodwill and other intangible assets	(5)	(3)
Common equity tier I capital	94,128	90,819
Tier I capital	94,128	90,819
Allowable portion: Allowance for loan losses and reserve for unfunded commitments	7,609	7,613
Net unrealized gains on equity securities, net of tax	11	-
Total regulatory capital	$101,748	$98,432
Risk-weighted assets	$774,729	$782,662
Quarterly average assets for leverage capital purposes	$1,007,031	$1,023,362

Capital Ratios	**June 30, 2016**	**December 31, 2015**
Common equity tier I capital / risk-weighted assets	12.15%	11.60%
Tier I capital / risk-weighted assets	12.15%	11.60%
Total regulatory capital / risk-weighted assets	13.13%	12.58%
Tier I capital / average assets (leverage ratio)	9.35%	8.87%

Under the requirements, at June 30, 2016 and December 31, 2015, QNB has a tier 1 capital ratio of 12.15% and 11.60%, a total regulatory capital ratio of 13.13% and 12.58%, and a leverage ratio of 9.35% and 8.87%, respectively. All ratios improved from December 31, 2015 as tier I capital and total regulatory capital increased and risk-weighted assets and quarterly average assets decreased when compared to the fourth quarter of 2015. The Company remains well-capitalized by all applicable regulatory requirements as of June 30, 2016.

MARKET RISK MANAGEMENT

Market risk reflects the risk of economic loss resulting from changes in interest rates and market prices. QNB's primary market risk exposure is interest rate risk and liquidity risk. QNB's liquidity position was discussed in a prior section.

QNB's largest source of revenue is net interest income, which is subject to changes in market interest rates. Interest rate risk management seeks to minimize the effect of interest rate changes on net interest margins and interest rate spreads and to provide growth in net interest income through periods of changing interest rates. QNB's Asset/Liability and Investment Management Committee (ALCO) is responsible for managing interest rate risk and for evaluating the impact of changing interest rate conditions on net interest income.

QNB uses computer simulation analysis to measure the sensitivity of projected earnings to changes in interest rates. Simulation takes into account current balance sheet volumes and the scheduled repricing dates, instrument level optionality, and maturities of assets and liabilities. It incorporates assumptions for growth, changes in the mix of assets and liabilities, prepayments, and average rates earned and paid. Based on this information, management uses the model to project net interest income under multiple interest rate scenarios.

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A balance sheet is considered liability sensitive when its liabilities (deposits and borrowings) reprice faster or to a greater extent than its earning assets (loans and securities). A liability sensitive balance sheet will produce relatively less net interest income when interest rates rise and more net interest income when they decline. Based on our simulation analysis, management believes QNB's interest sensitivity position at June 30, 2016 is liability sensitive. Management expects that market interest rates may gradually increase in the next 12 months, based on the economic environment and policy of the Board of Governors of the Federal Reserve System.

The following table shows the estimated impact of changes in interest rates on net interest income as of June 30, 2016 assuming instantaneous rate shocks, and consistent levels of assets and liabilities. Net interest income for the subsequent twelve months is projected to decrease when interest rates are higher than current rates.

Estimated Change in Net Interest Income		
Changes in Interest rates	**June 30,**	
(in basis points)	**2016**	**2015**
+300	-2.60 %	-12.88 %
+200	-1.48 %	-8.75 %
+100	-0.62 %	-4.90 %
-100	*N/A	*N/A

** Certain short-term interest are below 1%*

Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Interest rate shifts may not be parallel.

Changes in interest rates can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect QNB's interest rate sensitivity position. Additionally, credit risk may rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

QNB is not subject to foreign currency exchange or commodity price risk. At June 30, 2016 QNB did not have any hedging transactions in place such as interest rate swaps, caps or floors.

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.

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PART II. OTHER INFORMATION

JUNE 30, 2016

Item 1. Legal Proceedings

No material proceedings.

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, 2015.

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
April 1, 2016 through April 30, 2016	-	-	-	42,117

May 1, 2016 through May 31, 2016	-	-	-	42,117
June 1, 2016 through June 30, 2016	-	-	-	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 Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 13, 2015).
Exhibit 3(ii)	Bylaws of Registrant, as amended. (Incorporated by reference to Exhibit 3(ii) of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 13, 2015).
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.

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SIGNATURES

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

			QNB Corp.
Date:	August 8, 2016	By:	/s/ David W. Freeman David W. Freeman Chief Executive Officer
Date:	August 8, 2016	By:	/s/ Janice McCracken Erkes Janice McCracken Erkes Chief Financial Officer
Date:	August 8, 2016	By:	/s/ Phillip N. Geiger Phillip N. Geiger Chief Accounting Officer, QNB Bank