QNB CORP
Form 10-Q
August 08, 2017

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, 2017

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 | (I.R.S. Employer |
| Incorporation or Organization) | Identification No.) |

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

(215) 538-5600

Registrant's Telephone Number, Including Area Code

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 |
| Emerging growth company | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 31, 2017 |
|---|---|
| Common Stock, par value $0.625 | 3,433,240 |

QNB CORP. AND SUBSIDIARY

FORM 10-Q

QUARTER ENDED JUNE 30, 2017

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QNB Corp. and Subsidiary

CONSOLIDATED BALANCE SHEETS

| | (in thousands, except share data) (current period unaudited) June 30, 2017 | December 31, 2016 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $13,596 | $8,897 |
| Interest-bearing deposits in banks | 1,652 | 1,824 |
| Total cash and cash equivalents | 15,248 | 10,721 |
| | | |
| Investment securities | | |
| Trading | - | 3,596 |
| Available-for-sale (amortized cost $386,190 and $396,168) | 382,564 | 390,475 |
| Restricted investment in bank stocks | 1,974 | 1,017 |
| Loans held-for-sale | 530 | 789 |
| Loans receivable | 695,213 | 633,079 |
| Allowance for loan losses | (8,035) | (7,394) |
| Net loans | 687,178 | 625,685 |
| Bank-owned life insurance | 10,736 | 11,297 |
| Premises and equipment, net | 8,521 | 8,683 |
| Accrued interest receivable | 2,506 | 3,128 |
| Net deferred tax assets | 4,639 | 5,473 |
| Other assets | 6,627 | 2,277 |
| Total assets | $1,120,523 | $1,063,141 |
| | | |
| Liabilities | | |
| Deposits | | |
| Demand, non-interest bearing | $120,369 | $119,010 |
| Interest-bearing demand | 272,264 | 255,754 |
| Money market | 81,805 | 74,762 |
| Savings | 255,027 | 238,247 |
| Time | 127,970 | 131,370 |
| Time of $100 or more | 93,879 | 94,212 |
| Total deposits | 951,314 | 913,355 |
| Short-term borrowings | 66,907 | 52,660 |
| Accrued interest payable | 298 | 335 |
| Other liabilities | 3,254 | 3,224 |
| Total liabilities | 1,021,773 | 969,574 |

| | | |
|---|---|---|
| Shareholders' Equity | | |
| Common stock, par value $0.625 per share; authorized 10,000,000 shares; 3,597,809 shares and 3,576,270 shares issued; 3,433,240 and 3,411,701 shares outstanding | 2,249 | 2,235 |
| Surplus | 18,099 | 17,418 |
| Retained earnings | 83,271 | 80,147 |
| Accumulated other comprehensive loss, net of tax | (2,393) | (3,757) |
| Treasury stock, at cost; 164,569 shares | (2,476) | (2,476) |
| Total shareholders' equity | 98,750 | 93,567 |
| Total liabilities and shareholders' equity | $1,120,523 | $1,063,141 |

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, | |
| | 2017 | 2016 | 2017 | 2016 |
| Interest income | | | | |
| Interest and fees on loans | $7,115 | $6,332 | $14,187 | $12,684 |
| Interest and dividends on investment securities (AFS & HTM): | | | | |
| Taxable | 1,551 | 1,291 | 3,114 | 2,647 |
| Tax-exempt | 484 | 489 | 949 | 1,005 |
| Interest on trading securities | 16 | 30 | 45 | 70 |
| Interest on interest-bearing balances and other interest income | 26 | 42 | 33 | 58 |
| Total interest income | 9,192 | 8,184 | 18,328 | 16,464 |
| | | | | |
| Interest expense | | | | |
| Interest on deposits | | | | |
| Interest-bearing demand | 228 | 163 | 402 | 315 |
| Money market | 76 | 47 | 128 | 94 |
| Savings | 278 | 229 | 537 | 455 |
| Time | 372 | 371 | 740 | 744 |
| Time of $100 or more | 328 | 319 | 651 | 637 |
| Interest on short-term borrowings | 52 | 36 | 132 | 79 |
| Total interest expense | 1,334 | 1,165 | 2,590 | 2,324 |
| Net interest income | 7,858 | 7,019 | 15,738 | 14,140 |
| Provision for loan losses | 300 | — | 600 | 125 |
| Net interest income after provision for loan losses | 7,558 | 7,019 | 15,138 | 14,015 |
| | | | | |
| Non-interest income | | | | |
| Total other-than-temporary impairment loss on investment securities | — | (122 ) | — | (192 ) |
| Less: Portion of loss recognized in other comprehensive income (before taxes) | — | — | — | — |
| Net other-than temporary impairment losses on investment securities | — | (122 ) | — | (192 ) |
| Net gain on sale of investment securities | 115 | 137 | 864 | 526 |
| Net gain on investment securities | 115 | 15 | 864 | 334 |
| Net gain on trading activities | 10 | 52 | 27 | 86 |
| Fees for services to customers | 421 | 397 | 813 | 780 |
| ATM and debit card | 449 | 422 | 866 | 810 |
| Retail brokerage and advisory | 104 | 126 | 207 | 296 |
| Bank-owned life insurance | 120 | 73 | 191 | 144 |
| Merchant | 92 | 83 | 172 | 156 |
| Net gain on sale of loans | 201 | 71 | 251 | 120 |
| Other | 103 | 135 | 214 | 224 |
| Total non-interest income | 1,615 | 1,374 | 3,605 | 2,950 |

| | | | | |
|---|---|---|---|---|
| Non-interest expense | | | | |
| Salaries and employee benefits | 3,237 | 2,988 | 6,323 | 6,042 |
| Net occupancy | 425 | 426 | 876 | 867 |
| Furniture and equipment | 456 | 440 | 885 | 865 |
| Marketing | 307 | 265 | 536 | 461 |
| Third party services | 407 | 403 | 801 | 806 |
| Telephone, postage and supplies | 199 | 174 | 399 | 360 |
| State taxes | 155 | 141 | 348 | 321 |
| FDIC insurance premiums | 134 | 157 | 275 | 327 |
| Other | 622 | 599 | 1,087 | 1,063 |
| Total non-interest expense | 5,942 | 5,593 | 11,530 | 11,112 |
| Income before income taxes | 3,231 | 2,800 | 7,213 | 5,853 |
| Provision for income taxes | 845 | 702 | 1,967 | 1,490 |
| Net income | $2,386 | $2,098 | $5,246 | $4,363 |
| Earnings per share - basic | $0.70 | $0.62 | $1.53 | $1.29 |
| Earnings per share - diluted | $0.69 | $0.62 | $1.53 | $1.29 |
| Cash dividends per share | $0.31 | $0.30 | $0.62 | $0.60 |

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, | 2017 | | | 2016 | | |
| | Before tax amount | Tax expense (benefit) | Net of tax amount | Before tax amount | Tax expense (benefit) | Net of tax amount |
| Net income | $3,231 | $ 845 | $2,386 | $2,800 | $ 702 | $2,098 |
| Other comprehensive income: | | | | | | |
| Net unrealized holding gains on securities: | | | | | | |
| Unrealized holding gains arising during the period | 1,682 | 572 | 1,110 | 1,333 | 453 | 880 |
| Reclassification adjustment for gains included in net income | (115) | (40) | (75) | (15) | (5) | (10) |
| Other comprehensive income | 1,567 | 532 | 1,035 | 1,318 | 448 | 870 |
| Total comprehensive income | $4,798 | $ 1,377 | $3,421 | $4,118 | $ 1,150 | $2,968 |

| Six months ended June 30, | 2017 | | | 2016 | | |
|---|---|---|---|---|---|---|
| | Before tax amount | Tax expense (benefit) | Net of tax amount | Before tax amount | Tax expense (benefit) | Net of tax amount |
| Net income | $7,213 | $ 1,967 | $5,246 | $5,853 | $ 1,490 | $4,363 |
| Other comprehensive income: | | | | | | |
| Net unrealized holding gains on securities: | | | | | | |
| Unrealized holding gains arising during the period | 2,931 | 997 | 1,934 | 5,819 | 1,979 | 3,840 |
| Reclassification adjustment for gains included in net income | (864) | (294) | (570) | (334) | (114) | (220) |
| Other comprehensive income | 2,067 | 703 | 1,364 | 5,485 | 1,865 | 3,620 |
| Total comprehensive income | $9,280 | $ 2,670 | $6,610 | $11,338 | $ 3,355 | $7,983 |

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

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QNB Corp. and Subsidiary

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

Six months ended June 30, 2017 and 2016

| (unaudited)<br>(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, 2016 | 3,411,701 | $ 2,235 | $ 17,418 | $ 80,147 | $ (3,757 ) | $ (2,476 ) | $ 93,567 |
| Net income | | — | — | 5,246 | — | — | 5,246 |
| Other comprehensive income, net of tax | | — | — | — | 1,364 | — | 1,364 |
| Cash dividends declared ($0.62 per share) | | — | — | (2,122 ) | — | — | (2,122 ) |
| Stock issued in connection with dividend reinvestment and stock purchase plan | 13,579 | 9 | 503 | — | — | — | 512 |
| Stock issued for employee stock purchase plan | 1,318 | 1 | 41 | — | — | — | 42 |
| Stock issued for options exercised | 6,642 | 4 | 86 | — | — | — | 90 |
| Stock-based compensation expense | | — | 51 | — | — | — | 51 |
| Balance, June 30, 2017 | 3,433,240 | $ 2,249 | $ 18,099 | $ 83,271 | $ (2,393 ) | $ (2,476 ) | $ 98,750 |

| (unaudited)<br>(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 | 16,314 | 10 | 467 | — | — | — | 477 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| reinvestment and stock purchase plan | | | | | | | |
| 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 |

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, | 2017 | 2016 |
| Operating Activities | | |
| Net income | $5,246 | $4,363 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 403 | 449 |
| Provision for loan losses | 600 | 125 |
| Net gain on investment securities available-for-sale | (864) | (334) |
| Net gain on sale of other real estate owned, repossessed assets and premises and equipment | (1) | (1) |
| Gain on sale of loan held for investment | (99) | - |
| Net gain on sale of loans | (152) | (120) |
| Proceeds from sales of residential mortgages held-for-sale | 4,675 | 3,556 |
| Origination of residential mortgages held-for-sale | (4,264) | (2,633) |
| Income on bank-owned life insurance | (191) | (144) |
| Stock-based compensation expense | 51 | 42 |
| Net decrease in trading securities | 3,596 | 730 |
| Deferred income taxes | 130 | (83) |
| Net (decrease) increase in income taxes payable | (601) | 6 |
| Net decrease in accrued interest receivable | 622 | 186 |
| Amortization of mortgage servicing rights and change in valuation allowance | 47 | 36 |
| Net amortization of premiums and discounts on investment securities | 839 | 940 |
| Net decrease in accrued interest payable | (37) | — |
| Increase in other assets | (1,203) | (493) |
| Increase (decrease) in other liabilities | 36 | (27) |
| Net cash provided by operating activities | 8,833 | 6,598 |
| Investing Activities | | |
| Proceeds from payments, maturities and calls of investment securities available-for-sale | 27,255 | 51,888 |
| Proceeds from the sale of investment securities available-for-sale | 24,620 | 28,814 |
| Purchases of investment securities available-for-sale | (44,470) | (58,655) |
| Proceeds from redemption of investment in restricted bank stock | 2,977 | 1,482 |
| Purchase of restricted bank stock | (3,934) | (1,496) |
| Net (increase) decrease in loans | (62,093) | 10,663 |
| Proceeds from the sale of loan held for investment | 99 | — |
| Net purchases of premises and equipment | (241) | (105) |
| Redemption of bank-owned life insurance | 752 | — |
| Proceeds from sales of other real estate owned and repossessed assets | 1 | 1 |
| Net cash (used in) provided by investing activities | (55,034) | 32,592 |
| Financing Activities | | |
| Net increase in non-interest bearing deposits | 1,359 | 19,107 |
| Net increase (decrease) in interest-bearing deposits | 36,600 | (15,608) |

| | | |
|---|---|---|
| Net increase (decrease) in short-term borrowings | 14,247 | (470 ) |
| Tax benefit from exercise of stock options | — | 12 |
| Cash dividends paid, net of reinvestment | (1,858 ) | (1,772 ) |
| Proceeds from issuance of common stock | 380 | 499 |
| Net cash provided by financing activities | 50,728 | 1,768 |
| Increase in cash and cash equivalents | 4,527 | 40,958 |
| Cash and cash equivalents at beginning of year | 10,721 | 16,991 |
| Cash and cash equivalents at end of period | $15,248 | $57,949 |
| Supplemental Cash Flow Disclosures | | |
| Interest paid | $2,627 | $2,324 |
| Income taxes paid | 2,434 | 1,555 |
| Non-cash transactions: | | |
| Unsettled trades to sell securities | (2,598 ) | — |

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 2016 Annual Report incorporated in the Form 10-K. Operating results for the three and six-month periods ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017.

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, 2017, 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 guidance does not apply to revenue associated with financial instruments, including loans, securities, and derivatives that are accounted for under other U.S. GAAP guidance. For that reason, we do not expect it to have a material impact on our consolidated results of operations for elements of the statement of income associated with financial instruments, including securities gains, interest income and interest expense. However, we do believe the new standard will result in new disclosure requirements. We are currently in the process of reviewing contracts to assess the impact of the new guidance on our service offerings that are in the scope of the guidance, included in non-interest income such as insurance commission fees, service charges, payment processing fees, trust services fees, and brokerage services fees. The Company is continuing to evaluate the effect of the new guidance on revenue sources other than financial instruments on our financial position and consolidated results of operations. The guidance is effective for the QNB's financial statements beginning January 1, 2018. The guidance allows an entity to apply the new standard either retrospectively or through a cumulative effect adjustment as of January 1, 2018.

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.
- 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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 on June 30, 2017 it would have resulted in a decrease in net income of approximately $116,000. There would have been no impact on shareholder's equity as the equity securities held by QNB are currently 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 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 adopted this standard effective January 1, 2017. It did not have a material impact on its consolidated financial statements; however, the most significant impact relates to how tax benefits related to stock option exercises are recorded in the financial statements.

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

On March 30, 2017, the FASB issued ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities. This ASU is intended to enhance the accounting for the amortization of premiums for purchased callable debt securities and will require premiums to be amortized to the earliest call date. For public companies, the ASU is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods. QNB does not anticipate this new standard will have a material impact on its consolidated financial statements as it already uses the earliest call date to amortize premiums on callable debt securities.

## 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 $33,000 and $26,000 for the three months ended June 30, 2017 and 2016, respectively. Stock-based compensation expense was $51,000 and $42,000 for the six months ended June 30, 2017 and 2016, respectively. As of June 30, 2017, there was approximately $129,000 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 2005 Plan authorized the issuance of 200,000 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 five years after the date the option is awarded. The granted options vest after a three-year period. As of June 30, 2017, there were 184,200 options granted, 65,150 options forfeited, 79,375 options exercised, and 39,675 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 48,500 options granted and outstanding under this Plan as of June 30, 2017. There were no options forfeited or exercised as of June 30, 2017. 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, | 2017 | 2016 |
|---|---|---|
| Risk free interest rate | 1.48 % | 1.14 % |
| Dividend yield | 3.19 % | 3.78 % |
| Volatility | 17.89 % | 22.62 % |
| Expected life (years) | 4.20 | 4.20 |

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 2017 and 2016 was $3.88 and $3.79, respectively.

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Stock option activity during the six months ended June 30, 2017 and 2016 is as follows:

| | Number of options | Weighted average exercise price | Weighted average remaining contractual term (in years) | Aggregate intrinsic value |
|---|---|---|---|---|
| Outstanding at December 31, 2016 | 73,950 | $ 27.14 | | |
| Granted | 25,000 | 37.60 | | |
| Exercised | (10,675) | 22.24 | | |
| Forfeited | (100) | 21.35 | | |
| Outstanding at June 30, 2017 | 88,175 | $ 30.71 | 3.09 | $ 849 |
| Exercisable at June 30, 2017 | 21,825 | $ 24.33 | 1.15 | $ 349 |

| | 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 |

4. EARNINGS PER SHARE & SHARE REPURCHASE PLAN

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Numerator for basic and diluted earnings per share - net income | $2,386 | $2,098 | $5,246 | $4,363 |
| Denominator for basic earnings per share - weighted average shares outstanding | 3,425,356 | 3,383,109 | 3,420,239 | 3,376,445 |
| Effect of dilutive securities - employee stock options | 17,852 | 8,766 | 16,027 | 8,389 |
| Denominator for diluted earnings per share - adjusted weighted average shares outstanding | 3,443,208 | 3,391,875 | 3,436,266 | 3,384,834 |
| Earnings per share - basic | $0.70 | $0.62 | $1.53 | $1.29 |
| Earnings per share - diluted | 0.69 | 0.62 | 1.53 | 1.29 |

There were 25,000 stock options that were anti-dilutive for the three and six-month periods ended June 30, 2017. There were 41,350 stock options that were anti-dilutive for the three and six-month periods ended June 30, 2016. These stock options were not included in the above calculation.

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 three or six months ended June 30, 2017 and 2016. As of June 30, 2017, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000.

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5. COMPREHENSIVE INCOME (LOSS)

The following shows the components of accumulated other comprehensive loss at June 30, 2017 and December 31, 2016:

| | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Unrealized net holding losses on available-for-sale securities | $(3,596) | $ (5,446 ) |
| Unrealized losses on available-for-sale securities for which a portion of an other-than-temporary impairment loss has been recognized in earnings | (30 ) | (247 ) |
| Accumulated other comprehensive loss | (3,626) | (5,693 ) |
| Tax effect | 1,233 | 1,936 |
| Accumulated other comprehensive loss, net of tax | $(2,393) | $ (3,757 ) |

The following tables present amounts reclassified out of accumulated other comprehensive income (loss) for the three and six months ended June 30, 2017 and 2016:

| Three months ended June 30, | Amount reclassified from accumulated other comprehensive income | | |
|---|---|---|---|
| Details about accumulated other comprehensive income | 2017 | 2016 | Affected line item in statement of income |
| Unrealized net holding gains on available-for-sale securities | $ 115 | $ 137 | Net gain on sale of investment securities |
| Other-than-temporary impairment losses on | — | (122 ) | Net other-than-temporary |

| | | | |
|---|---|---|---|
| investment securities | | | impairment losses on investment securities |
| | 115 | 15 | |
| Tax effect | (40 ) | (5 ) | Provision for income taxes |
| Total reclass out of accumulated other comprehensive income, net of tax | $ 75 | $ 10 | Net of tax |

| Six months ended June 30, | Amount reclassified from accumulated other comprehensive income | | |
|---|---|---|---|
| Details about accumulated other comprehensive income | 2017 | 2016 | Affected line item in statement of income |
| Unrealized net holding gains on available-for-sale securities | $ 864 | $ 526 | 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 |
| | 864 | 334 | |
| Tax effect | (294 ) | (114 ) | Provision for income taxes |
| Total reclass out of accumulated other comprehensive income, net of tax | $ 570 | $ 220 | Net of tax |

## 6. INVESTMENT SECURITIES

QNB engaged in trading activities for its own account, comprised of municipal securities that were held principally for resale in the near term recorded at fair value with changes in fair value recorded in non-interest income.  During the second quarter 2017, QNB Bank redeemed the trading securities portfolio, as lack of market volatility and the interest rate environment resulted in declining performance of the portfolio.  The net realized gains recorded for the six months ended June 30, 2017 were $27,000.  The  net realized and unrealized losses  recorded at December 31, 2016 were $40,000 and fair value was $3,596,000. Unrealized gains on trading activity related to trading securities held at December 31, 2016 totaled  $69,000. Interest and dividends are included in interest income.

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The amortized cost and estimated fair values of investment securities available-for-sale at June 30, 2017 and December 31, 2016 were as follows:

| June 30, 2017 | Fair value | Gross unrealized holding gains | Gross unrealized holding losses | Amortized cost |
|---|---|---|---|---|
| U.S. Government agency | $72,938 | $ 11 | $ (1,541 ) | $74,468 |
| State and municipal | 78,687 | 940 | (133 ) | 77,880 |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | |
| Mortgage-backed | 141,358 | 379 | (1,681 ) | 142,660 |
| Collateralized mortgage obligations (CMOs) | 73,765 | 62 | (1,469 ) | 75,172 |
| Pooled trust preferred | 212 | - | (30 ) | 242 |
| Corporate debt | 8,074 | 31 | (19 ) | 8,062 |
| Equity | 7,530 | 151 | (327 ) | 7,706 |
| Total investment securities available-for-sale | $382,564 | $ 1,574 | $ (5,200 ) | $386,190 |

| December 31, 2016 | Fair value | Gross unrealized holding gains | Gross unrealized holding losses | Amortized cost |
|---|---|---|---|---|
| U.S. Government agency | $76,650 | $ 36 | $ (2,118 ) | $78,732 |
| State and municipal | 72,295 | 614 | (398 ) | 72,079 |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | |
| Mortgage-backed | 145,301 | 561 | (2,241 ) | 146,981 |
| Collateralized mortgage obligations (CMOs) | 77,415 | 109 | (1,846 ) | 79,152 |
| Pooled trust preferred | 2,281 | 263 | (891 ) | 2,909 |
| Corporate debt | 8,030 | 16 | (57 ) | 8,071 |
| Equity | 8,503 | 587 | (328 ) | 8,244 |
| Total investment securities available-for-sale | $390,475 | $ 2,186 | $ (7,879 ) | $396,168 |

The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at June 30, 2017 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, 2017 | Fair value | Amortized cost |
|---|---|---|
| Due in one year or less | $7,111 | $7,069 |
| Due after one year through five years | 205,142 | 206,788 |
| Due after five years through ten years | 140,510 | 142,352 |
| Due after ten years | 22,271 | 22,275 |
| Equity securities | 7,530 | 7,706 |
| Total investment securities available-for-sale | $382,564 | $386,190 |

Proceeds from sales of investment securities available-for-sale were approximately $10,624,000 and $4,198,000 for the three months ended June 30, 2017 and 2016, respectively. Proceeds from sales of investment securities available-for-sale were approximately $24,620,000 and $28,814,000 for the six months ended June 30, 2017 and 2016 respectively.

At June 30, 2017 and December 31, 2016, investment securities available-for-sale totaling approximately $171,738,000 and $166,628,000, respectively, were pledged as collateral for repurchase agreements and deposits of public funds.

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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, 2017 | | | | Three months ended June 30, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | Gross realized gains | Gross realized losses | Other-than-temporary impairment losses | Net gains (losses) | Gross realized gains | Gross realized losses | Other-than-temporary impairment losses | Net gains (losses) |
| Equity securities | $131 | $ — | $ — | $ 131 | $36 | $ — | $ (122) | $ (86) |
| Debt securities | 431 | (447) | — | (16) | 101 | — | — | 101 |
| Total | $562 | $ (447) | $ — | $ 115 | $137 | $ — | $ (122) | $ 15 |

| | Six months ended June 30, 2017 | | | | Six months ended June 30, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | 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 | $856 | $ — | $ — | $856 | $417 | $ — | $ (192) | $225 |
| Debt securities | 509 | (501) | — | 8 | 182 | (73) | — | 109 |
| Total | $1,365 | $ (501) | $ — | $864 | $599 | $ (73) | $ (192) | $334 |

The tax expense applicable to the net realized gains for the quarters and six-month periods ended June 30, 2017 and 2016 were $40,000 and $5,000 for the quarter and $294,000 and $114,000 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 second quarter of 2017 or 2016. The 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, | 2017 | 2016 |
|---|---|---|
| Balance, beginning of period | $1,153 | $1,153 |
| Reductions: sale, pooled trust preferred | (1,152) | — |
| Additions: | | |
| Initial credit impairments | — | — |
| Subsequent credit impairments | — | — |
| Balance, end of period | $1 | $1,153 |

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The following table indicates the length of time individual securities have been in a continuous unrealized loss position at June 30, 2017 and December 31, 2016:

| June 30, 2017 | No. of securities | Less than 12 months Fair value | Unrealized losses | 12 months or longer Fair value | Unrealized losses | Total Fair value | Unrealized losses |
|---|---|---|---|---|---|---|---|
| U.S. Government agency | 52 | $69,935 | $ (1,541 ) | $— | $ — | $69,935 | $ (1,541 ) |
| State and municipal | 25 | 10,312 | (113 ) | 518 | (20 ) | 10,830 | (133 ) |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | | | | |
| Mortgage-backed | 90 | 126,077 | (1,681 ) | — | — | 126,077 | (1,681 ) |
| Collateralized mortgage obligations (CMOs) | 65 | 53,910 | (1,013 ) | 14,000 | (456 ) | 67,910 | (1,469 ) |
| Pooled trust preferred | 1 | — | — | 212 | (30 ) | 212 | (30 ) |
| Corporate debt | 3 | 3,016 | (19 ) | — | — | 3,016 | (19 ) |
| Equity | 13 | 2,962 | (276 ) | 498 | (51 ) | 3,460 | (327 ) |
| Total | 249 | $266,212 | $ (4,643 ) | $15,228 | $ (557 ) | $281,440 | $ (5,200 ) |

| December 31, 2016 | No. of securities | Less than 12 months Fair value | Unrealized losses | 12 months or longer Fair value | Unrealized losses | Total Fair value | Unrealized losses |
|---|---|---|---|---|---|---|---|
| U.S. Government agency | 55 | $72,626 | $ (2,118 ) | $— | $ — | $72,626 | $ (2,118 ) |
| State and municipal | 70 | 29,280 | (398 ) | — | — | 29,280 | (398 ) |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | | | | |
| Mortgage-backed | 88 | 123,087 | (2,241 ) | — | — | 123,087 | (2,241 ) |
| Collateralized mortgage obligations (CMOs) | 68 | 56,853 | (1,269 ) | 15,426 | (577 ) | 72,279 | (1,846 ) |
| Pooled trust preferred | 5 | — | — | 1,952 | (891 ) | 1,952 | (891 ) |
| Corporate debt | 4 | 4,002 | (57 ) | — | — | 4,002 | (57 ) |
| Equity | 16 | 2,985 | (268 ) | 888 | (60 ) | 3,873 | (328 ) |
| Total | 306 | $288,833 | $ (6,351 ) | $18,266 | $ (1,528 ) | $307,099 | $ (7,879 ) |

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, 2017 in U.S. Government agency 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.

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 one trust preferred security, PreTSL IV. As of June 30, 2017, PreTSL IV is no longer considered impaired: all capitalized interest has been repaid, no cashflows are being diverted to any senior tranche, and the bond has excess subordination, which represents cushion to absorb future defaults or deferrals.

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The following table provides additional information related to the pooled trust preferred security (PreTSL) as of June 30, 2017:

| Deal | Class | Book value | Fair value | Unrealized gains (losses) | Realized OTTI credit loss (YTD 2017) | 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* | $242 | $212 | $ (30) | $ — | $ (1) | B1/BB | 5 | — | 18.0 % | 141.6 % |

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

In June 2017, QNB Bank sold five non-performing pooled trust preferred securities, with a $2,235,000 carrying value, recording a loss on sale of $15,000, included in non-interest income in the consolidated statement of income.  Several years ago, QNB had recorded $1,152,000 in OTTI for four of these five these bonds, and subsequently applied any cashflow received to the balance of these non-performing, nonaccrual assets. Improvement in market prices for these securities during the second quarter 2017 reduced realized losses, and the reduction of approximately $19,000,000 in risk-based assets required for these bonds drove the decision to redeem these debt securities.

On a quarterly basis we evaluate our debt securities for other-than-temporary impairment (OTTI), which involves the use of a third-party valuation firm to assist management with the valuation. When evaluating these investments a credit-related portion and a non-credit related portion of 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 quarter and six months ended June 30, 2017 and 2016, no other-than-temporary impairment charges representing credit impairment were recognized on our pooled trust preferred collateralized debt obligations.

PreTSL IV is rated lower than AA and 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). In addition to discounted cash-flows, QNB considers trends in the financial performance ratios of the bond's underlying issuers, as well as the bond's structure (QNB holds the senior-most obligation of the trust for PreTSL IV), determining there is little likelihood of default. 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. Lack of liquidity in the market for trust preferred collateralized debt obligations contributed to the temporary impairment of this security. Although classified as available-for-sale, the Company has the intent to hold PreTSL IV and does not believe it will be required to sell it before recovery occurs. QNB could be subject to additional write-downs in the future if additional deferrals and defaults occur.

## 7. 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.

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

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

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

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

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized 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.

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Major classes of loans are as follows:

| | June 30 2017 | December 31, 2016 |
|---|---|---|
| Commercial: | | |
| Commercial and industrial | $140,218 | $110,233 |
| Construction | 44,823 | 39,268 |
| Secured by commercial real estate | 276,738 | 255,188 |
| Secured by residential real estate | 68,704 | 68,731 |
| State and political subdivisions | 35,259 | 35,260 |
| Retail: | | |
| 1-4 family residential mortgages | 51,138 | 47,124 |
| Home equity loans and lines | 71,791 | 71,525 |
| Consumer | 6,394 | 5,670 |
| Total loans | 695,065 | 632,999 |
| Net unearned costs | 148 | 80 |
| Loans receivable | $695,213 | $633,079 |

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, 2017 and December 31, 2016, overdrafts were approximately $100,000 and $171,000, 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, 2017, 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.

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.

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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. In October 2016, the Company sold its interest in these third-party originated lease financing receivables.

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

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.

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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, 2017 and December 31, 2016:

| June 30, 2017 | Pass | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial: | | | | | |
| Commercial and industrial | $132,360 | $3,153 | $ 4,705 | $ — | $140,218 |
| Construction | 44,819 | — | 4 | — | 44,823 |
| Secured by commercial real estate | 261,754 | 4,630 | 10,354 | — | 276,738 |
| Secured by residential real estate | 65,984 | 227 | 2,493 | — | 68,704 |
| State and political subdivisions | 35,259 | — | — | — | 35,259 |
| Total | $540,176 | $8,010 | $ 17,556 | $ — | $565,742 |

| December 31, 2016 | Pass | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial: | | | | | |
| Commercial and industrial | $102,396 | $686 | $ 7,151 | $ — | $110,233 |
| Construction | 39,259 | — | 9 | — | 39,268 |
| Secured by commercial real estate | 238,290 | 5,185 | 11,713 | — | 255,188 |
| Secured by residential real estate | 65,169 | 231 | 3,331 | — | 68,731 |
| State and political subdivisions | 35,260 | — | — | — | 35,260 |
| Total | $480,374 | $6,102 | $ 22,204 | $ — | $508,680 |

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, 2017 and December 31, 2016:

| June 30, 2017 | Performing | Non-performing | Total |
|---|---|---|---|
| Retail: | | | |
| 1-4 family residential mortgages | $ 50,264 | $ 874 | $51,138 |
| Home equity loans and lines | 71,679 | 112 | 71,791 |
| Consumer | 6,305 | 89 | 6,394 |

| | | | |
|---|---|---|---|
| Total | $ 128,248 | $ 1,075 | $ 129,323 |

| December 31, 2016 | Performing | Non-performing | Total |
|---|---|---|---|
| Retail: | | | |
| 1-4 family residential mortgages | $ 46,858 | $ 266 | $ 47,124 |
| Home equity loans and lines | 71,436 | 89 | 71,525 |
| Consumer | 5,577 | 93 | 5,670 |
| Total | $ 123,871 | $ 448 | $ 124,319 |

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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, 2017 and December 31, 2016:

| June 30, 2017 | 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 | $ 73 | — | — | $ 73 | $ 140,145 | $ 140,218 |
| Construction | — | — | — | — | 44,823 | 44,823 |
| Secured by commercial real estate | 59 | — | $ 775 | 834 | 275,904 | 276,738 |
| Secured by residential real estate | 218 | $ 204 | 155 | 577 | 68,127 | 68,704 |
| State and political subdivisions | — | — | — | — | 35,259 | 35,259 |
| Retail: | | | | | | |
| 1-4 family residential mortgages | — | — | 481 | 481 | 50,657 | 51,138 |
| Home equity loans and lines | — | 31 | 50 | 81 | 71,710 | 71,791 |
| Consumer | 23 | 7 | 10 | 40 | 6,354 | 6,394 |
| Total | $ 373 | $ 242 | $ 1,471 | $ 2,086 | $ 692,979 | $ 695,065 |

| December 31, 2016 | 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 | $ 463 | — | — | $ 463 | $ 109,770 | $ 110,233 |
| Construction | 214 | — | — | 214 | 39,054 | 39,268 |
| Secured by commercial real estate | 64 | $ 395 | $ 1,596 | 2,055 | 253,133 | 255,188 |
| Secured by residential real estate | — | — | 285 | 285 | 68,446 | 68,731 |
| State and political subdivisions | — | — | — | — | 35,260 | 35,260 |
| Retail: | | | | | | |
| 1-4 family residential mortgages | 1,459 | 323 | — | 1,782 | 45,342 | 47,124 |
| Home equity loans and lines | 107 | 15 | — | 122 | 71,403 | 71,525 |
| Consumer | 14 | 2 | — | 16 | 5,654 | 5,670 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | $2,321 | $735 | $1,881 | $4,937 | $628,062 | $632,999 |

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, 2017 and December 31, 2016:

| June 30, 2017 | 90 days or more past due (still accruing) | Non-accrual |
|---|---|---|
| Commercial: | | |
| Commercial and industrial | $ — | $ 4,467 |
| Construction | — | — |
| Secured by commercial real estate | — | 2,140 |
| Secured by residential real estate | — | 1,771 |
| State and political subdivisions | — | — |
| Retail: | | |
| 1-4 family residential mortgages | — | 874 |
| Home equity loans and lines | — | 112 |
| Consumer | — | 89 |
| Total | $ — | $ 9,453 |

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| December 31, 2016 | 90 days or more past due (still accruing) | Non-accrual |
|---|---|---|
| Commercial: | | |
| Commercial and industrial | $ — | $ 4,798 |
| Construction | — | — |
| Secured by commercial real estate | — | 3,007 |
| Secured by residential real estate | — | 1,866 |
| State and political subdivisions | — | — |
| Retail: | | |
| 1-4 family residential mortgages | — | 266 |
| Home equity loans and lines | — | 89 |
| Consumer | — | 93 |
| Total | $ — | $ 10,119 |

Activity in the allowance for loan losses for the three months ended June 30, 2017 and 2016 are as follows:

| Three months ended June 30, 2017 | Balance, beginning of period | Provision for (credit to) loan losses | Charge-offs | Recoveries | Balance, end of period |
|---|---|---|---|---|---|
| Commercial: | | | | | |
| Commercial and industrial | $ 1,978 | $ 191 | — | $ 8 | $ 2,177 |
| Construction | 463 | 53 | — | — | 516 |
| Secured by commercial real estate | 2,577 | 61 | — | 2 | 2,640 |
| Secured by residential real estate | 1,344 | (156) | — | 12 | 1,200 |
| State and political subdivisions | 124 | (1) | — | — | 123 |
| Retail: | | | | | |
| 1-4 family residential mortgages | 415 | 24 | — | — | 439 |
| Home equity loans and lines | 342 | (25) | — | 2 | 319 |
| Consumer | 77 | 9 | $ (18) | 10 | 78 |
| Unallocated | 399 | 144 | N/A | N/A | 543 |
| Total | $ 7,719 | $ 300 | $ (18) | $ 34 | $ 8,035 |

| Three 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 | $ 1,334 | $ 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 |
| Total | $ 7,556 | $ — | $ (79) | $ 73 | $ 7,550 |

Activity in the allowance for loan losses for the six months ended June 30, 2017 and 2016 are as follows:

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| Six months ended June 30, 2017 | Balance, beginning of period | Provision for (credit to) loan losses | Charge-offs | Recoveries | Balance, end of period |
|---|---|---|---|---|---|
| Commercial: | | | | | |
| Commercial and industrial | $ 1,459 | $ 698 | — | $ 20 | $ 2,177 |
| Construction | 449 | 67 | — | — | 516 |
| Secured by commercial real estate | 2,646 | (10) | — | 4 | 2,640 |
| Secured by residential real estate | 1,760 | (592) | $ (3) | 35 | 1,200 |
| State and political subdivisions | 123 | — | — | — | 123 |
| Retail: | | | | | |
| 1-4 family residential mortgages | 366 | 73 | — | — | 439 |
| Home equity loans and lines | 353 | (39) | — | 5 | 319 |
| Consumer | 76 | 22 | (39) | 19 | 78 |
| Unallocated | 162 | 381 | N/A | N/A | 543 |
| Total | $ 7,394 | $ 600 | $ (42) | $ 83 | $ 8,035 |

| 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 |
| Total | $ 7,554 | $ 125 | $ (245 ) | $ 116 | $ 7,550 |

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

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necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

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

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

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

Performing TDRs (not reported as non-accrual or past due 90 days or more and still accruing) totaled $1,393,000 and $1,819,000 as of June 30, 2017 and December 31, 2016, respectively. Non-performing TDRs totaled $3,339,000 and $3,555,000 as of June 30, 2017 and December 31, 2016, 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, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Unpaid | Related | Unpaid | Related |

| | principal balance | allowance | principal balance | allowance |
|---|---|---|---|---|
| TDRs with no specific allowance recorded | $4,110 | — | $3,992 | — |
| TDRs with an allowance recorded | 622 | $ 311 | 1,382 | $ 761 |
| Total | $4,732 | $ 311 | $5,374 | $ 761 |

There were no newly identified TDRs during the six months ended June 30, 2017. As of June 30, 2017, and December 31, 2016, QNB had commitments of $20,000 and $30,000, respectively, to lend additional funds to customers with loans whose terms have been modified in troubled debt restructurings. There were net charge-offs of $3,000 and $0 during the six months ended June 30, 2017 and 2016, respectively, resulting from loans previously modified as TDRs.

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The following tables present loans, by loan class, modified as TDRs during the three and six months ended June 30, 2017 and 2016. The pre-modification and post-modification outstanding recorded investments disclosed in the tables below, represent carrying amounts immediately prior to the modification and as of the period end indicated.

| Three months ended June 30, | 2017 | | | 2016 | | |
|---|---|---|---|---|---|---|
| | 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 |

| Six months ended June 30, | 2017 | | | 2016 | | |
|---|---|---|---|---|---|---|
| | 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 |
| Total | — | $ — | $ — | 10 | $ 1,598 | $ 1,581 |

There was one loan with an outstanding balance of $21,000 that was modified as a TDR within 12 months prior to June 30, 2017 for which there was a payment default (60 days or more past due) during the six months ended June 30, 2017. There were no loans modified as TDRs within 12 months prior to June 30, 2016 for which there was a payment default during the six months ended June 30, 2016.

The Company has three consumer mortgage loans secured by residential real estate for which foreclosure proceedings are in process at June 30, 2017. The recorded investment is $531,000.

The following tables present the balance in the allowance for loan losses at June 30, 2017 and December 31, 2016 disaggregated based on 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 based on the Company's impairment methodology:

| | Allowance for Loan Losses | | | Loans Receivable | | |
|---|---|---|---|---|---|---|
| June 30, 2017 | Balance | Balance related to loans individually evaluated for impairment | Balance related to loans collectively evaluated for impairment | Balance | Balance individually evaluated for impairment | Balance collectively evaluated for impairment |
| Commercial: | | | | | | |
| Commercial and industrial | $2,177 | $ 964 | $ 1,213 | $140,218 | $ 4,712 | $ 135,506 |
| Construction | 516 | — | 516 | 44,823 | 4 | 44,819 |
| Secured by commercial real estate | 2,640 | 42 | 2,598 | 276,738 | 5,401 | 271,337 |
| Secured by residential real estate | 1,200 | 127 | 1,073 | 68,704 | 2,200 | 66,504 |
| State and political subdivisions | 123 | — | 123 | 35,259 | — | 35,259 |
| Retail: | | | | | | |
| 1-4 family residential mortgages | 439 | — | 439 | 51,138 | 1,213 | 49,925 |
| Home equity loans and lines | 319 | — | 319 | 71,791 | 134 | 71,657 |
| Consumer | 78 | — | 78 | 6,394 | 89 | 6,305 |
| Unallocated | 543 | N/A | N/A | N/A | N/A | N/A |
| Total | $8,035 | $ 1,133 | $ 6,359 | $695,065 | $ 13,753 | $ 681,312 |

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| | Allowance for Loan Losses | | | Loans Receivable | | |
|---|---|---|---|---|---|---|
| December 31, 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 | $1,459 | $ 696 | $ 763 | $110,233 | $ 5,134 | $ 105,099 |
| Construction | 449 | — | 449 | 39,268 | 224 | 39,044 |
| Secured by commercial real estate | 2,646 | — | 2,646 | 255,188 | 6,383 | 248,805 |
| Secured by residential real estate | 1,760 | 494 | 1,266 | 68,731 | 2,313 | 66,418 |
| State and political subdivisions | 123 | — | 123 | 35,260 | — | 35,260 |
| Retail: | | | | | | |
| 1-4 family residential mortgages | 366 | 8 | 358 | 47,124 | 748 | 46,376 |
| Home equity loans and lines | 353 | — | 353 | 71,525 | 111 | 71,414 |
| Consumer | 76 | — | 76 | 5,670 | 93 | 5,577 |
| Unallocated | 162 | N/A | N/A | N/A | N/A | N/A |
| Total | $7,394 | $ 1,198 | $ 6,034 | $632,999 | $ 15,006 | $ 617,993 |

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The following tables summarize additional information in regards to impaired loans by loan portfolio class as of June 30, 2017 and December 31, 2016:

| | June 30, 2017 | | | December 31, 2016 | | |
|---|---|---|---|---|---|---|
| | Recorded investment (after charge-offs) | Unpaid principal balance | Related allowance | Recorded investment (after charge-offs) | Unpaid principal balance | Related allowance |
| With no specific allowance recorded: | | | | | | |
| Commercial: | | | | | | |
| Commercial and industrial | $2,235 | $2,584 | $ — | $2,482 | $2,862 | $ — |
| Construction | 4 | 4 | — | 224 | 234 | — |
| Secured by commercial real estate | 5,299 | 5,832 | — | 6,383 | 6,367 | — |
| Secured by residential real estate | 1,607 | 2,037 | — | 1,046 | 1,438 | — |
| State and political subdivisions | — | — | — | — | — | — |
| Retail: | | | | | | |
| 1-4 family residential mortgages | 1,213 | 1,256 | — | 570 | 589 | — |
| Home equity loans and lines | 134 | 176 | — | 111 | 174 | — |
| Consumer | 89 | 92 | — | 93 | 95 | — |
| Total | $10,581 | $11,981 | $ — | $10,909 | $11,759 | $ — |
| | | | | | | |
| With an allowance recorded: | | | | | | |
| Commercial: | | | | | | |
| Commercial and industrial | $2,477 | $2,686 | $ 964 | $2,652 | $2,812 | $ 696 |
| Construction | — | — | — | — | — | — |
| Secured by commercial real estate | 102 | 105 | 42 | — | — | — |
| Secured by residential real estate | 593 | 724 | 127 | 1,267 | 1,435 | 494 |
| State and political subdivisions | — | — | — | — | — | — |
| Retail: | | | | | | |
| 1-4 family residential mortgages | — | — | — | 178 | 193 | 8 |
| Home equity loans and lines | — | — | — | — | — | — |
| Consumer | — | — | — | — | — | — |
| Total | $3,172 | $3,515 | $ 1,133 | $4,097 | $4,440 | $ 1,198 |
| | | | | | | |
| Total: | | | | | | |
| Commercial: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial and industrial | $4,712 | $5,270 | $ 964 | $5,134 | $5,674 | $ 696 |
| Construction | 4 | 4 | — | 224 | 234 | — |
| Secured by commercial real estate | 5,401 | 5,937 | 42 | 6,383 | 6,367 | — |
| Secured by residential real estate | 2,200 | 2,761 | 127 | 2,313 | 2,873 | 494 |
| State and political subdivisions | — | — | — | — | — | — |
| Retail: | | | | | | |
| 1-4 family residential mortgages | 1,213 | 1,256 | — | 748 | 782 | 8 |
| Home equity loans and lines | 134 | 176 | — | 111 | 174 | — |
| Consumer | 89 | 92 | — | 93 | 95 | — |
| Total | $13,753 | $15,496 | $ 1,133 | $15,006 | $16,199 | $ 1,198 |

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

| Six Months Ended June 30, | 2017 Average recorded investment | Interest income recognized | 2016 Average recorded investment | Interest income recognized |
|---|---|---|---|---|
| Commercial: | | | | |
| Commercial and industrial | $4,879 | $ 8 | $4,370 | $ 35 |
| Construction | 86 | 2 | 429 | 10 |
| Secured by commercial real estate | 5,838 | 78 | 6,426 | 67 |
| Secured by residential real estate | 2,252 | 13 | 2,013 | 7 |
| State and political subdivisions | — | — | — | — |
| Indirect lease financing | — | — | 112 | — |
| Retail: | | | | |
| 1-4 family residential mortgages | 955 | 7 | 576 | 5 |
| Home equity loans and lines | 102 | 1 | 139 | 1 |
| Consumer | 91 | — | — | — |
| Total | $14,203 | $ 109 | $14,065 | $ 125 |

## 8. FAIR VALUE MEASUREMENTS AND DISCLOSURES

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

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

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

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

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

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(Unaudited)

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, 2017:

| June 30, 2017 | Quoted prices in active markets for identical assets (Level 1) | Significant other observable input (Level 2) | Significant unobservable inputs (Level 3) | Balance at end of period |
|---|---|---|---|---|
| Recurring fair value measurements | | | | |
| Securities available-for-sale | | | | |
| U.S. Government agency securities | — | $ 72,938 | — | $ 72,938 |
| State and municipal securities | — | 78,687 | — | 78,687 |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | |
| Mortgage-backed securities | — | 141,358 | — | 141,358 |
| Collateralized mortgage obligations (CMOs) | — | 73,765 | — | 73,765 |
| Pooled trust preferred securities | — | — | $ 212 | 212 |
| Corporate debt securities | — | 8,074 | — | 8,074 |
| Equity securities | $ 7,530 | — | — | 7,530 |
| Total securities available-for-sale | $ 7,530 | $ 374,822 | $ 212 | $ 382,564 |
| Total recurring fair value measurements | $ 7,530 | $ 374,822 | $ 212 | $ 382,564 |
| | | | | |
| Nonrecurring fair value measurements | | | | |
| Impaired loans | $ — | $ — | $ 2,039 | $ 2,039 |
| Mortgage servicing rights | — | — | 36 | 36 |
| Total nonrecurring fair value measurements | $ — | $ — | $ 2,075 | $ 2,075 |

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three or six months ended June 30, 2017. 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 three- and six-month periods ended June 30, 2017.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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, 2016:

| December 31, 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 | $ — | $ 3,596 | $ — | $ 3,596 |
| | | | | |
| Securities available-for-sale | | | | |
| U.S. Government agency securities | — | $ 76,650 | — | $ 76,650 |
| State and municipal securities | — | 72,295 | — | 72,295 |
| U.S. Government agencies and sponsored enterprises (GSEs): | | | | |
| Mortgage-backed securities | — | 145,301 | — | 145,301 |
| Collateralized mortgage obligations (CMOs) | — | 77,415 | — | 77,415 |
| Pooled trust preferred securities | — | — | $ 2,281 | 2,281 |
| Corporate debt securities | — | 8,030 | — | 8,030 |
| Equity securities | $ 8,503 | — | — | 8,503 |
| Total securities available-for-sale | $ 8,503 | $ 379,691 | $ 2,281 | $ 390,475 |
| Total recurring fair value measurements | $ 8,503 | $ 383,287 | $ 2,281 | $ 394,071 |
| | | | | |
| Nonrecurring fair value measurements | | | | |
| Impaired loans | $ — | $ — | $ 2,899 | $ 2,899 |
| Mortgage servicing rights | — | — | 58 | 58 |
| Total nonrecurring fair value measurements | $ — | $ — | $ 2,957 | $ 2,957 |

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, 2017 | Fair value | Valuation techniques | | Unobservable input | | Value or range of values |
|---|---|---|---|---|---|---|
| Impaired loans | $526 | Appraisal of collateral | (1) | Appraisal adjustments | (2) | -15% to -80% |
| | | | | Liquidation expenses | (3) | -10% |
| Impaired loans | 14 | Used commercial vehicle and equipment guides | | Guide value discounts | (4) | -25% |
| Impaired loans | $1,499 | Financial statement values for UCC collateral | | Financial statement value discounts | (5) | -25% to -50% |
| Mortgage servicing rights | 36 | Discounted cash flow | | Remaining term | | 2 to 27 yrs |
| | | | | Discount rate | | 14% to 16% |

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Quantitative information about Level 3 fair value measurements

| December 31, 2016 | Fair value | Valuation techniques | | Unobservable input | | Value or range of values |
|---|---|---|---|---|---|---|
| Impaired loans | $938 | Appraisal of collateral | (1) | Appraisal adjustments | (2) | -10% to -80% |
| | | | | Liquidation expenses | (3) | -10% |
| Impaired loans | 76 | Used commercial vehicle and equipment guides | | Guide value discounts | (4) | 0% to -25% |
| Impaired loans | 1,880 | Financial statement values for UCC collateral | | Financial statement value discounts | (5) | -20% to -50% |
| Impaired loans | 5 | Agreement of sale | (6) | | | |
| Mortgage servicing rights | 58 | Discounted cash flow | | Remaining term | | 2 to 27 yrs |
| | | | | Discount rate | | 14% to 16% |

(1) Fair value is primarily determined through appraisals of the underlying collateral by independent parties, which generally includes various level 3 inputs which are not always identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and 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 or sale price.
(4) If lendable value (lower than wholesale) is utilized then no additional discounts are taken. If lendable value is not provided, additional discounts are applied.
(5) Values obtained from financial statements for UCC collateral (fixed assets, accounts receivable, and inventory) are discounted to estimated realizable liquidation value.
(6) Fair value is determined by the net amount due.

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, 2017 and 2016:

Fair value measurements using significant unobservable inputs

| | (Level 3) | |
|---|---|---|
| | 2017 | 2016 |
| Balance, January 1, | $2,281 | $2,653 |
| Payments received | (55) | (197) |
| Sale of securities | (2,026) | — |
| Total gains or losses (realized/unrealized) | | |
| Included in earnings | (15) | — |
| Included in other comprehensive income | 27 | (56) |
| Transfers in and/or out of Level 3 | — | — |
| Balance, June 30, | $212 | $2,400 |

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(Unaudited)

The Level 3 securities consist of one collateralized debt obligation security ("PreTSL"), which is backed by trust preferred securities issued by banks. 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, 2017;
- 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
- Trust preferred securities 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 utilized a third party to value this security using a discounted cash flow analysis. Based on management's review of the five underlying issuers, there are no expected credit losses or prepayments; cashflows used were contractual based on the Bloomberg YA screen. The assumed cash flows have been discounted using an estimated market discount rate based on the 30-year swap rate. The 30-year swap rate is used as the reference rate, since it is indicative of market expectation for short term rates in the future. This is consistent with the 30-year nature of PreTSL securities, which are priced using the 3-month LIBOR as a reference rate. The discount rate of 6.18% includes the risk-free rate, a credit component and a spread for illiquidity. For a further discussion of PreTSL valuation see Note 6, 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, 2017 and December 31, 2016:

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

Investment securities - trading (carried at fair value), available for sale (carried at fair value) and held-to-maturity (carried at amortized cost): The fair value of securities are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. Level 2 debt securities are valued by a third-party pricing service commonly used in the banking industry. Level 2 fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution date, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

Restricted investment in bank stocks (carried at cost): The fair value of stock in Atlantic 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.

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.

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

Impaired Loans (generally carried at fair value): Impaired loans are loans, in which the Company has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

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

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.

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 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.

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(Unaudited)

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, 2017 | Carrying amount | Fair value | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Financial assets | | | | | |
| Cash and cash equivalents | $15,248 | $15,248 | $15,248 | — | — |
| Investment securities: Available-for-sale | 382,564 | 382,564 | 7,530 | $374,822 | $ 212 |
| Restricted investment in bank stocks | 1,974 | 1,974 | — | 1,974 | — |
| Loans held-for-sale | 530 | 539 | — | 539 | — |
| Net loans | 687,178 | 694,371 | — | — | 694,371 |
| Mortgage servicing rights | 485 | 571 | — | — | 571 |
| Accrued interest receivable | 2,506 | 2,506 | — | 2,506 | — |
| | | | | | |
| Financial liabilities | | | | | |
| Deposits with no stated maturities | $729,465 | $729,465 | $729,465 | — | $ — |
| Deposits with stated maturities | 221,849 | 221,628 | — | $221,628 | — |
| Short-term borrowings | 66,907 | 66,907 | 66,907 | — | — |
| Accrued interest payable | 298 | 298 | — | 298 | — |
| | | | | | |
| Off-balance sheet instruments | | | | | |
| Commitments to extend credit | $— | $— | $— | $— | $ — |
| Standby letters of credit | — | — | — | — | — |

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| | | | Fair value measurements | | |
|---|---|---|---|---|---|
| December 31, 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 | $10,721 | $10,721 | $10,721 | — | — |
| Investment securities: | | | | | |
| Trading | 3,596 | 3,596 | — | $3,596 | — |
| Available-for-sale | 390,475 | 390,475 | 8,503 | 379,691 | $2,281 |
| Restricted investment in bank stocks | 1,017 | 1,017 | — | 1,017 | — |
| Loans held-for-sale | 789 | 789 | — | 789 | — |
| Net loans | 625,685 | 626,052 | — | — | 626,052 |
| Mortgage servicing rights | 498 | 579 | — | — | 579 |
| Accrued interest receivable | 3,128 | 3,128 | — | 3,128 | — |
| | | | | | |
| Financial liabilities | | | | | |
| Deposits with no stated maturities | $687,773 | $687,773 | $687,773 | — | $ — |
| Deposits with stated maturities | 225,582 | 225,403 | — | $225,403 | — |
| Short-term borrowings | 52,660 | 52,660 | 52,660 | — | — |
| Accrued interest payable | 335 | 335 | — | 335 | — |
| | | | | | |
| Off-balance sheet instruments | | | | | |
| Commitments to extend credit | $— | $— | $— | $— | $ — |
| Standby letters of credit | — | — | — | — | — |

9. 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 consolidated 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, 2017 | December 31, 2016 |
|---|---|---|
| Commitments to extend credit and unused lines of credit | $295,823 | $277,216 |
| Standby letters of credit | 14,386 | 16,490 |
| Total financial instrument commitments | $310,209 | $293,706 |

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. The majority of these standby letters of credit expire within one year with the longest term being five 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, 2017 and December 31, 2016 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.

## 10. 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, 2017, 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 below.

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

| | Capital levels | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | Adequately capitalized | | Well capitalized | |
| As of June 30, 2017 | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total risk-based capital (to risk-weighted assets): | | | | | | |
| Consolidated | $109,129 | 12.76% | $68,444 | 8.00% | $85,555 | 10.00% |
| Bank | 100,244 | 12.04 | 66,628 | 8.00 | 83,285 | 10.00 |
| | | | | | | |
| Tier I capital (to risk-weighted assets): | | | | | | |
| Consolidated | 101,021 | 11.81 | 51,333 | 6.00 | 51,333 | 6.00 |
| Bank | 92,136 | 11.06 | 49,971 | 6.00 | 66,628 | 8.00 |
| | | | | | | |
| Common equity tier 1 capital (to risk-weighted assets): | | | | | | |
| Consolidated | 101,021 | 11.81 | 38,500 | 4.50 | N/A | N/A |
| Bank | 92,136 | 11.06 | 37,478 | 4.50 | 54,135 | 6.50 |
| | | | | | | |
| Tier I capital (to average assets): | | | | | | |
| Consolidated | 101,021 | 9.17 | 44,078 | 4.00 | N/A | N/A |
| Bank | 92,136 | 8.43 | 43,712 | 4.00 | 54,640 | 5.00 |

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| | Capital levels | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | Adequately capitalized | | Well capitalized | |
| As of December 31, 2016 | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total risk-based capital (to risk-weighted assets): | | | | | | |
| Consolidated | $104,820 | 12.75% | $65,777 | 8.00% | $82,221 | 10.00% |
| Bank | 96,478 | 12.10 | 63,792 | 8.00 | 79,740 | 10.00 |
| Tier I capital (to risk-weighted assets): | | | | | | |
| Consolidated | 97,320 | 11.84 | 49,333 | 6.00 | 49,333 | 6.00 |
| Bank | 89,025 | 11.16 | 47,844 | 6.00 | 63,792 | 8.00 |
| Common equity tier 1 capital (to risk-weighted assets): | | | | | | |
| Consolidated | 97,320 | 11.84 | 36,999 | 4.50 | N/A | N/A |
| Bank | 89,025 | 11.16 | 35,883 | 4.50 | 51,831 | 6.50 |
| Tier I capital (to average assets): | | | | | | |
| Consolidated | 97,320 | 9.16 | 42,479 | 4.00 | N/A | N/A |
| Bank | 89,025 | 8.45 | 42,144 | 4.00 | 52,680 | 5.00 |

QNB CORP. AND SUBSIDIARY

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 2016 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 CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

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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 uses the current statutory tax rate of 34% to value its deferred tax assets and liabilities. Proposed comprehensive tax reform, announced April 26, 2017, included a reduction in the U.S. corporate income tax rate to 15%. If corporate tax rates were reduced, management expects the Company would be required to record an initial charge against earnings to lower the carrying amount of its net deferred tax asset, and then, going forward, would record lower tax provisions. The proposal is at the beginning stages of negotiations and will need to be addressed by both houses of Congress. It is too early in the process to determine if any of the proposals are actionable. Accordingly, management cannot assess the effect a change in the corporate tax rate would have on Company's operating results or financial position.

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. There were no other-than-temporary impairment charges recorded during the first six months of 2017.

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 based on the timing of future estimated cash flows of the security. There were no credit-related other-than-temporary impairment charges in the second quarters and first six months ended June 30, 2017 or 2016.

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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 or present value of future estimated cash flows. The general reserves are based on the composition and risk characteristics of the loan portfolio, including the nature of the loan portfolio, credit concentration trends, delinquency and loss experience, as well as other qualitative factors such as current economic trends.

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized 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 collection. 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

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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 on matters that may, at least in part, be beyond QNB’s control, it is at least reasonably possible that management’s judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

RESULTS OF OPERATIONS - OVERVIEW

QNB reported net income for the second quarter of 2017 of $2,386,000, or $0.69 per share on a diluted basis, compared to net income of $2,098,000, or $0.62 per share on a diluted basis, for the same period in 2016. For the six-month period ended June 30, 2017, QNB reported net income of $5,246,000, or $1.53 per share on a diluted basis, compared to net income of $4,363,000, or $1.29 per share on a diluted basis, for the same period in 2016.

Net income expressed as an annualized rate of return on average assets and average shareholders’ equity was 0.87% and 9.52%, respectively, for the quarter ended June 30, 2017 compared with 0.84% and 9.01%, respectively, for the same period in 2016. For the six months ended June 30, 2017, return on average assets and average shareholders’ equity was 0.97% and 10.62%, respectively, compared with 0.87% and 9.44% for the same period in 2016.

Total assets as of June 30, 2017 were $1,120,523,000, compared with $1,063,141,000 at December 31, 2016. Loans receivable at June 30, 2017 were $695,213,000, compared with $633,079,000 at December 31, 2016, an increase of $62,134,000, or 9.8%, with commercial lending as the largest contributor to the growth. Total deposits of $951,314,000 at June 30, 2017 increased $37,959,000, or 4.2%, compared with total deposits of $913,355,000 at December 31, 2016.

Results for the three and six months ended June 30, 2017 include the following significant components:

- Net interest income increased $839,000, or 12.0%, to $7,858,000 and $1,598,000, or 11.3%, to $15,738,000 for the three and six months ended June 30, 2017, respectively.
- Net interest margin on a tax-equivalent basis increased two basis points for the quarter and five basis points year-to-date, to 3.10% and 3.16%, respectively.
- QNB recorded $300,000 in provision for loan losses for the quarter and $600,000 for the six months ended June 30, 2017, compared with $125,000 for the first six months of 2016. There was no provision recorded for the second quarter of 2016.
- Non-interest income increased $241,000, or 17.5%, to $1,615,000 for the second quarter and $655,000, or 22.2%, to $3,605,000 for year-to-date 2017, compared with the same periods in 2016.
- Non-interest expense increased $349,000, or 6.2%, to $5,942,000 for the second quarter and $418,000, or 3.8%, to $11,530,000 for year-to-date 2017, compared to the same periods in 2016.

- Total non-performing loans were $10,846,000, or 1.56% of loans receivable at June 30, 2017, compared with $11,938,000, or 1.89% of loans receivable at December 31, 2016. Loans on non-accrual status were $9,453,000 at June 30, 2017 compared with $10,119,000 at December 31, 2016. Net recoveries for the six months ended June 30, 2017 were $41,000, or -0.01% annualized of average total loans, compared with net charge-offs of $129,000, or 0.04% annualized of average total loans for the same period in 2016.

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. Management 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.

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, 2017 and 2016.

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Total interest income | $9,192 | $8,184 | $18,328 | $16,464 |
| Total interest expense | 1,334 | 1,165 | 2,590 | 2,324 |
| Net interest income | 7,858 | 7,019 | 15,738 | 14,140 |
| Tax-equivalent adjustment | 390 | 412 | 777 | 848 |
| Net interest income (fully taxable-equivalent) | $8,248 | $7,431 | $16,515 | $14,988 |

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, 2017 | | | June 30, 2016 | | |
| | Average Balance | Average Rate | Interest | Average Balance | Average Rate | Interest |
| Assets | | | | | | |
| Trading securities | $1,985 | 4.78 % | $24 | $3,899 | 4.67 % | $46 |
| Investment securities (AFS & HTM): | | | | | | |
| U.S. Government agencies | 73,007 | 1.78 | 325 | 53,551 | 1.84 | 247 |
| State and municipal | 75,620 | 3.88 | 733 | 73,191 | 4.05 | 741 |
| Mortgage-backed and CMOs | 221,045 | 2.04 | 1,130 | 192,598 | 1.99 | 957 |
| Pooled trust preferred securities | 2,846 | 2.27 | 16 | 3,216 | 0.22 | 2 |
| Corporate debt securities | 8,064 | 1.98 | 40 | 8,186 | 1.97 | 40 |
| Equities | 6,923 | 3.18 | 55 | 7,491 | 3.28 | 61 |
| Total investment securities | 387,505 | 2.37 | 2,299 | 338,233 | 2.42 | 2,048 |
| Loans: | | | | | | |
| Commercial real estate | 387,959 | 4.41 | 4,270 | 326,670 | 4.44 | 3,607 |
| Residential real estate | 49,196 | 3.84 | 472 | 44,600 | 3.93 | 438 |
| Home equity loans | 65,822 | 3.78 | 621 | 62,457 | 3.74 | 580 |
| Commercial and industrial | 124,363 | 4.63 | 1,437 | 112,393 | 4.24 | 1,185 |
| Indirect lease financing | - | - | - | 9,927 | 8.76 | 218 |
| Consumer loans | 6,494 | 5.38 | 87 | 4,367 | 5.21 | 57 |
| Tax-exempt loans | 34,927 | 3.97 | 346 | 40,347 | 3.74 | 375 |
| Total loans, net of unearned income* | 668,761 | 4.34 | 7,233 | 600,761 | 4.32 | 6,460 |
| Other earning assets | 9,018 | 1.18 | 26 | 28,900 | 0.59 | 42 |
| Total earning assets | 1,067,269 | 3.60 | 9,582 | 971,793 | 3.56 | 8,596 |
| Cash and due from banks | 13,213 | | | 14,197 | | |
| Allowance for loan losses | (7,766 ) | | | (7,627 ) | | |
| Other assets | 29,228 | | | 28,673 | | |
| Total assets | $1,101,944 | | | $1,007,036 | | |
| | | | | | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing demand | $171,584 | 0.21 % | 88 | $153,457 | 0.23 % | 87 |
| Municipals | 92,188 | 0.61 | 140 | 86,770 | 0.35 | 76 |
| Money market | 92,866 | 0.33 | 76 | 69,558 | 0.27 | 47 |
| Savings | 253,524 | 0.44 | 278 | 230,086 | 0.40 | 229 |
| Time | 128,394 | 1.16 | 372 | 133,832 | 1.11 | 371 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Time of $100,000 or more | 94,741 | 1.39 | 328 | 94,052 | 1.36 | 319 |
| Total interest-bearing deposits | 833,297 | 0.62 | 1,282 | 767,755 | 0.59 | 1,129 |
| Short-term borrowings | 44,365 | 0.46 | 52 | 38,208 | 0.38 | 36 |
| Total interest-bearing liabilities | 877,662 | 0.61 | 1,334 | 805,963 | 0.58 | 1,165 |
| Non-interest-bearing deposits | 118,895 | | | 103,624 | | |
| Other liabilities | 4,846 | | | 3,761 | | |
| Shareholders' equity | 100,541 | | | 93,688 | | |
| Total liabilities and shareholders' equity | $1,101,944 | | | $1,007,036 | | |
| Net interest rate spread | | 2.99 % | | | 2.98 % | |
| Margin/net interest income | | 3.10 % | $8,248 | | 3.08 % | $7,431 |

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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| | Six Months Ended<br>June 30, 2017<br>Average Balance | Average Rate | Interest | June 30, 2016<br>Average Balance | Average Rate | Interest |
|---|---|---|---|---|---|---|
| Assets | | | | | | |
| Trading securities | $2,393 | 5.69 % | $68 | $3,883 | 5.48 % | $106 |
| Investment securities (AFS & HTM): | | | | | | |
| U.S. Government agencies | 74,540 | 1.76 | 657 | 55,290 | 1.84 | 508 |
| State and municipal | 73,823 | 3.89 | 1,438 | 74,705 | 4.08 | 1,523 |
| Mortgage-backed and CMOs | 222,497 | 2.05 | 2,278 | 196,511 | 2.00 | 1,963 |
| Pooled trust preferred securities | 2,876 | 1.26 | 18 | 3,250 | 0.21 | 3 |
| Corporate debt securities | 8,067 | 1.94 | 78 | 8,634 | 1.78 | 77 |
| Equities | 6,881 | 3.27 | 112 | 7,507 | 3.48 | 130 |
| Total investment securities | 388,684 | 2.36 | 4,581 | 345,897 | 2.43 | 4,204 |
| Loans: | | | | | | |
| Commercial real estate | 381,609 | 4.57 | 8,650 | 325,929 | 4.45 | 7,209 |
| Residential real estate | 48,370 | 3.85 | 930 | 43,862 | 3.89 | 852 |
| Home equity loans | 66,104 | 3.82 | 1,251 | 62,262 | 3.77 | 1,166 |
| Commercial and industrial | 118,717 | 4.65 | 2,736 | 113,858 | 4.21 | 2,386 |
| Indirect lease financing | - | - | - | 10,168 | 9.02 | 458 |
| Consumer loans | 6,377 | 5.25 | 166 | 4,376 | 5.27 | 115 |
| Tax-exempt loans | 35,117 | 3.95 | 689 | 40,330 | 3.77 | 757 |
| Total loans, net of unearned income* | 656,294 | 4.43 | 14,422 | 600,785 | 4.33 | 12,943 |
| Other earning assets | 7,540 | 0.92 | 34 | 19,687 | 0.60 | 59 |
| Total earning assets | 1,054,911 | 3.65 | 19,105 | 970,252 | 3.59 | 17,312 |
| Cash and due from banks | 12,658 | | | 12,818 | | |
| Allowance for loan losses | (7,605 ) | | | (7,618 ) | | |
| Other assets | 29,032 | | | 28,661 | | |
| Total assets | $1,088,996 | | | $1,004,113 | | |
| | | | | | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing demand | $166,783 | 0.20 % | 168 | $149,242 | 0.21 % | 157 |
| Municipals | 89,764 | 0.53 | 234 | 90,878 | 0.35 | 158 |
| Money market | 85,469 | 0.30 | 128 | 69,844 | 0.27 | 94 |
| Savings | 247,317 | 0.44 | 537 | 227,579 | 0.40 | 455 |
| Time | 129,540 | 1.15 | 740 | 134,251 | 1.11 | 744 |
| Time of $100,000 or more | 95,129 | 1.38 | 651 | 93,728 | 1.37 | 637 |
| Total interest-bearing deposits | 814,002 | 0.61 | 2,458 | 765,522 | 0.59 | 2,245 |
| Short-term borrowings | 52,418 | 0.51 | 132 | 40,638 | 0.39 | 79 |
| Total interest-bearing liabilities | 866,420 | 0.60 | 2,590 | 806,160 | 0.58 | 2,324 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Non-interest-bearing deposits | 118,381 | | | 101,287 | | | |
| Other liabilities | 4,605 | | | 3,696 | | | |
| Shareholders' equity | 99,590 | | | 92,970 | | | |
| Total liabilities and shareholders' equity | $1,088,996 | | | $1,004,113 | | | |
| Net interest rate spread | | 3.05 | % | | 3.01 | % | |
| Margin/net interest income | | 3.16 | % $16,515 | | 3.11 | % | $14,988 |

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, 2017 compared to June 30, 2016 | | | Six months ended June 30, 2017 compared to June 30, 2016 | | |
|---|---|---|---|---|---|---|
| | Total | Due to change in: | | Total | Due to change in: | |
| | Change | Volume | Rate | Change | Volume | Rate |
| Interest income: | | | | | | |
| Trading securities | $(22) | $(23) | $1 | $(38) | $(40) | $2 |
| Investment securities (AFS & HTM): | | | | | | |
| U.S. Government agencies | 78 | 90 | (12) | 149 | 177 | (28) |
| State and municipal | (8) | 24 | (32) | (85) | (18) | (67) |
| Mortgage-backed and CMOs | 173 | 142 | 31 | 315 | 259 | 56 |
| Pooled trust preferred securities | 14 | (1) | 15 | 15 | — | 15 |
| Corporate debt securities | - | — | - | 1 | (6) | 7 |
| Equities | (6) | (4) | (2) | (18) | (11) | (7) |
| Total Investment securities (AFS & HTM) | 251 | 251 | - | 377 | 401 | (24) |
| Loans: | | | | | | |
| Commercial real estate | 663 | 689 | (26) | 1,441 | 1,208 | 233 |
| Residential real estate | 34 | 45 | (11) | 78 | 88 | (10) |
| Home equity loans | 41 | 33 | 8 | 85 | 68 | 17 |
| Commercial and industrial | 252 | 130 | 122 | 350 | 94 | 256 |
| Indirect lease financing | (218) | (218) | - | (458) | (458) | - |
| Consumer loans | 30 | 27 | 3 | 51 | 52 | (1) |
| Tax-exempt loans | (29) | (49) | 20 | (68) | (99) | 31 |
| Total Loans | 773 | 657 | 116 | 1,479 | 953 | 526 |
| Other earning assets | (16) | (29) | 13 | (25) | (37) | 12 |
| Total interest income | 986 | 856 | 130 | 1,793 | 1,277 | 516 |
| Interest expense: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing demand | 1 | 11 | (10) | 11 | 18 | (7) |
| Municipals | 64 | 4 | 60 | 76 | (3) | 79 |
| Money market | 29 | 15 | 14 | 34 | 20 | 14 |
| Savings | 49 | 24 | 25 | 82 | 38 | 44 |
| Time | 1 | (15) | 16 | (4) | (28) | 24 |
| Time of $100,000 or more | 9 | 4 | 5 | 14 | 8 | 6 |
| Total interest-bearing deposits | 153 | 43 | 110 | 213 | 53 | 160 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Short-term borrowings | 16 | 6 | 10 | 53 | 22 | 31 |
| Total interest expense | 169 | 49 | 120 | 266 | 75 | 191 |
| Net interest income | $817 | $807 | $10 | $1,527 | $1,202 | $325 |

Net Interest Income and Net Interest Margin – Quarterly Comparison

Average earning assets for the second quarter of 2017 were $1,067,269,000, an increase of $95,476,000, or 9.8%, from the second quarter of 2016, with average loans increasing $68,000,000, or 11.3%, and average investment securities increasing $47,358,000, or 13.8%, over the same period. 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 were 62.7% for the second quarter of 2017, compared with 61.8% for the second quarter of 2016. On the funding side, average deposits increased $80,813,000, or 9.3%, to $952,192,000 for the second quarter of 2017 with growth in all categories except for time deposits. Customers continue to reinvest funds into non-time deposits, as the yield in time deposits remains low and customers prefer to keep their funds liquid to capitalize on rising rates. Average borrowed funds for the second quarter of 2017 increased $6,157,000, to

$44,365,000, which consisted of average commercial repurchase agreements of $40,216,000 and average overnight borrowings of $4,149,000. For the same period in 2016, borrowings consisted solely of commercial repurchase agreements.

The net interest margin for the second quarter of 2017 was 3.10% compared with 3.08% for same period in 2016. While competition for quality loans in our local market continues to exert pressure on the net interest margin, three increases in the prime lending rate since June 2016 have provided increased interest income on variable rate loans, and little competitive pricing pressure on deposits.

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 $986,000, or 11.5%, to $9,582,000 for the second quarter of 2017; total interest expense increased 14.5% to $1,334,000. Growth in earning assets contributed to the increase in interest income, as well as the additional interest income referenced above. All categories of interest-bearing deposits except interest-bearing demand deposits experienced higher rates in the second quarter of 2017 compared to second quarter of 2016, due to rate increases for municipal deposits indexed to Fed Funds, and rate increases to the eSavings and Rewards checking products in late 2016 and the second quarter of 2017.

The yield on earning assets on a tax-equivalent basis increased four basis points from 3.56% for the second quarter of 2016, to 3.60% for the second quarter of 2017. The cost of interest-bearing liabilities was 0.61% for the quarter ended June 30, 2017, compared with 0.58% for the same period in 2016.

Interest income on investment securities (trading, available-for-sale and held-to-maturity) increased $229,000 when comparing the quarters ended June 30, 2017 and 2016. The average yield on the investment portfolio was 2.39% for the second quarter of 2017 compared with 2.45% for the second quarter of 2016. Investment opportunities in the current rate environment provide a yield comparable to the overall portfolio yield.

Income on U.S. Government agency securities increased $78,000, as the $19,456,000, or 36.3%, increase in average balances contributed to an increase in interest income of $90,000. This was offset by a $12,000 decrease in interest income due to a six basis point decrease in the yield from 1.84% for the second quarter of 2016 to 1.78% for the same period in 2017.

Average tax-exempt municipal securities increased $2,429,000, contributing $24,000 to interest income, which was offset by a 17 basis point reduction in average yield, which resulted in a decrease of interest income of $32,000. 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 purchases municipal bonds with 10-15 year maturities 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 2017. The current yield on replacement bonds is well below the yield of the bonds being called or maturing.

Interest income on mortgage-backed securities and CMOs increased $173,000 with a five basis point increase in average yield, plus the $28,447,000 increase in average balances contributing to the increase. This portfolio generally provides higher yields relative to agency bonds and provides monthly cash flow which can be used for liquidity purposes or can be reinvested when interest rates eventually increase.

Income on loans increased $773,000 to $7,233,000 when comparing the second quarters of 2017 and 2016, with the strong growth in average balances contributing an increase in interest income of $657,000. The yield on average loans for the second quarter of 2017 was 4.34%, two basis points higher than the 4.32% in second quarter of 2016. Despite increases in the Fed funds rate in December 2016, March 2017, and June 2017, competitive pressures result in new loans being originated at relatively low rates. Mitigating competitive pricing, variable rate loans have repriced higher as the prime rate increase went into effect.

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. Average balances increased $61,289,000, or 18.8%, to $387,959,000 for the quarter ended June 30, 2017 compared with the same quarter in 2016, contributing $689,000 in increased interest income. This increase was offset in part by a $26,000 decrease in interest income, as the yield on commercial real estate loans decreased three basis points from 4.44% in 2016 to 4.41% in 2017.

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Income on commercial and industrial loans increased $252,000. Average balances increased $11,970,000, or 10.7%, to $124,363,000 for the second quarter of 2017 resulting in a $130,000 increase in income. The average yield on these loans increased 39 basis points to 4.63% resulting in an increase in income of $122,000. Many of the loans in this category are indexed to the prime interest rate, which increased by one quarter of one percent three times since June 2016.

Tax-exempt loan income was $346,000 for the second quarter of 2017, a decrease of $29,000 from the same period in 2016. As with municipal marketable securities, many municipalities have refinanced existing loans. While QNB has been successful in winning some of these bids, average balances have decreased $5,420,000, or 13.4%, to $34,927,000 for the second quarter of 2017, resulting in a decrease of $49,000 in income. The yield on municipal loans improved 23 basis points, to 3.97% for the second quarter of 2017, compared with the same period in 2016, resulting in an additional $20,000 in interest income.

In October 2016, QNB sold its interest in third-party originated indirect lease financing contracts. This portfolio provided $218,000 in interest income during the second quarter of 2016.

QNB desires to become the “local consumer lender of choice” and to affect this QNB refocused 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 $4,596,000, or 10.3%, to $49,196,000 for the second quarter of 2017 compared to the same period in 2016. Over this same timeframe, the average yield on the portfolio decreased nine basis points to 3.84% for the second quarter of 2017. The net result was an increase in interest income of $34,000. Average home equity loans increased $3,365,000, or 5.4%, to $65,822,000 while the average yield increased four basis points to 3.78% resulting in an increase in interest income of $41,000. Average consumer loans increased $2,127,000, or 48.7%, to $6,494,000, led primarily by student loan average balances, which increased $1,897,000 from second quarter 2016 to second quarter 2017. When comparing these two periods, the yield on the portfolio increased seventeen basis points to 5.38%, resulting in a $30,000 increase in interest income.

Earning assets are funded by deposits and borrowed funds. Interest expense increased $169,000, when comparing the second quarter of 2017 to the same period in 2016. 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 $15,271,000, or 14.7%, to $118,895,000 for the second quarter of 2017. QNB has been successful in increasing business checking accounts as average balances in these accounts have increased by $13,211,000, or 15.9%, to $96,369,000 when comparing the quarters. Average interest-bearing demand accounts increased $18,127,000, or 11.8%, to $171,584,000 for the second quarter of 2017. Interest expense on interest-bearing demand accounts increased $1,000 to $88,000 for the same period, as the average rate paid decreased two basis points to 0.21% for the second quarter of 2017. Included in this category is QNB-Rewards checking, a higher-rate checking account product that pays 1.10% on balances up to $25,000 and 0.30% 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 2017, the average balance in this product was $51,815,000 and the related interest expense was $70,000 for an average yield of 0.54%. In comparison, the average balance of the QNB-Rewards accounts for the first quarter of 2016 was $45,528,000 with a related interest expense of $71,000 and an average rate paid of 0.63%. 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 $107,929,000 for the second quarter of 2016 to $119,769,000 for the second quarter of 2017. The average rate paid on these balances was 0.06% for both periods.

Interest expense on municipal interest-bearing demand accounts increased $64,000 to $140,000 for the second quarter of 2017. The average balance of municipal interest-bearing demand accounts increased $5,418,000, or 6.2%, to $92,188,000, with the average interest rate paid on these accounts increasing 26 basis points to 0.61% for the second quarter of 2017. Many of these accounts are indexed to the Federal funds rate with rate floors between 0.25% and 0.50%, therefore the increases in the Federal funds rate affected the yield of these deposits. Municipal 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.

Average money market accounts increased $23,308,000, or 33.5%, to $92,866,000 for the second quarter of 2017 compared with the same period in 2016. Interest expense on money market accounts increased $29,000 to $76,000, while the average interest rate paid on money market accounts increased six basis points to 0.33% for the second quarter of 2017 compared with the same period in 2016. Most of balances in this category are in a product that pays a tiered rate based on account balances.

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Interest expense on savings accounts increased $49,000 when comparing the second quarter of 2017 to the second quarter of 2016, and the average rate increased four basis points to 0.44%. When comparing these same periods, average savings accounts increased $23,438,000, or 10.2%, to $253,524,000 for the second quarter of 2017 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 2017 at $184,660,000. This product has grown successfully since its introduction in the third quarter of 2009. The average yield paid on these accounts was 0.55% for the second quarter of 2017 and 0.50% for the same period in 2016. 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 $6,765,000, or 10.9%, when comparing the second quarter of 2017 average to the same period in 2016.

Total interest expense on time deposits totaled $700,000 and $690,000 for the second quarters of 2017 and 2016, respectively. Average total time deposits decreased by $4,749,000 to $223,135,000 for the second quarter of 2017. As with 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, however, the maturity and repricing characteristics of time deposits tend to be shorter. The average rate paid on time deposits increased four basis points from 1.22% to 1.26% when comparing the second quarter of 2017 to the same period in 2016.

Approximately $87,000,000, or 39%, of time deposits at June 30, 2017 will mature over the next 12 months. The average rate paid on these time deposits is approximately 0.69%. 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 may 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 and overnight FHLB borrowings. Interest expense on short-term borrowings increased $16,000 for the second quarter of 2017 to $52,000 when compared to the same period in 2016. When comparing these same periods, average balances increased from $38,208,000 to $44,365,000, due to an increase in average FHLB borrowings of $4,149,000, while the average rate paid increased eight basis points to 0.46% for the second quarter of 2017.

Six Month Comparison

For the six-month period ending June 30, 2017 average earning assets increased $84,659,000, or 8.7%, to $1,054,911,000, with average loans increasing 9.2% and average investment securities increasing 11.8%. Average total deposits increased $65,574,000, or 7.6%, to $932,383,000 for the six-month period ended June 30, 2017 compared to the same period in 2016. The net interest margin on a tax-equivalent basis was 3.16% for the six-month period ended June 30, 2017, a five basis point increase from the same period in 2016.

Total interest income on a tax-equivalent basis increased $1,793,000, or 10.4%, from $17,312,000 to $19,105,000, when comparing the six-month periods ended June 30, 2016 and June 30, 2017 due to 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 $1,277,000 as a result of volume increases, and $516,000 as a result of better 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 3.59% to 3.65% for the six-month periods with the yield on loans up 10 basis points to 4.43%. QNB continues to experience pressure on yields due to historically low levels of interest rates over the past several years and competitive pressures on loan pricing. The yield on investments, including trading securities, decreased eight basis points from 2.46% to 2.38% when comparing the six-month periods.

Total interest expense increased $266,000 for the six-month period ended June 30, 2017 compared with the same period in 2016, attributable to the increase in deposits into higher-earning tiered money markets and interest-bearing DDA, as well as rate increases in the eSavings, Rewards checking, and municipal deposits, which are correlated to changes in the Fed Funds target rate. The average rate paid on interest bearing deposits increased two basis point to 0.61% for the six-month period ended June 30, 2017 versus the first half of 2016. QNB Bank funded short-term cash needs with increased Federal Home Loan Bank borrowings in the first half of 2017 compared with the same period in 2016, and the borrowing rate increased 12 basis points, which also contributed to the increase in interest expense. The yield on interest-bearing liabilities rose two basis points to 0.60% for the first half of 2017.

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 several 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 $300,000 and $600,000 in provision for loan losses in the second quarter and first six months of 2017, respectively, compared with no provisions in the second quarter and $125,000 year-to-date in 2016. QNB's allowance for loan losses of $8,035,000 represents 1.16% of loans receivable at June 30, 2017 compared with an allowance for loan losses of $7,394,000, or 1.17% of loans receivable, at December 31, 2016, and $7,550,000, or 1.25% of loans receivable at June 30, 2016. Management believes the allowance for loan losses at June 30, 2017 is adequate as of that date based on its analysis of known and inherent losses in the portfolio.

Net recoveries were $16,000 and $41,000, respectively, for the three and six months ended June 30, 2017, compared with net loan charge-offs of $6,000 and $129,000, respectively, for the same periods in 2016.

Non-performing assets of $10,846,000 at June 30, 2017 compares favorably with $14,219,000 as of December 31, 2016 and $12,583,000 as of June 30, 2016. Prior to June 2017, this category comprised non-performing loans and trust preferred securities. In June 2017, QNB Bank sold five non-performing pooled trust preferred securities, with a $2,235,000 carrying value. The remaining trust preferred security, which had a carrying balance of $212,000 at June 30, 2017, was returned to accruing status. Non-accrual pooled trust preferred securities are carried at fair value of $2,281,000, and $2,400,000 at December 31, 2016 and June 30, 2016, respectively.

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 $10,846,000, or 1.56% of loans receivable at June 30, 2017 compared with $11,938,000, or 1.89% of loans receivable at December 31, 2016, and $10,183,000, or 1.68% of loans receivable at June 30, 2016. 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, 2017, $7,655,000, or approximately 81% of the loans classified as non-accrual, are current or past due less than 30 days. Loans classified as substandard or doubtful within the Company's risk rating system totaled $17,556,000, a reduction of $4,648,000 from the $22,204,000 reported at December 31, 2016 and a $5,920,000 decline from the $23,476,000 reported at June 30, 2016.

QNB had no loans past due 90 days or more and still accruing interest at June 30, 2017 or December 31, 2016 compared with $65,000 at June 30, 2016. Total loans 30 days or more past due, which includes non-accrual loans by actual number of days delinquent, represented 0.30% of loans receivable at June 30, 2017 compared with 0.78% at December 31, 2016 and 0.65% at June 30, 2016.

Troubled debt restructured loans, not classified as non-accrual loans or loans past due 90 days or more and accruing, were $1,393,000 at June 30, 2017, compared with $1,819,000 at December 31, 2016, and $1,433,000 at June 30, 2016. There were no newly identified troubled debt restructures in the three or six months ended June 30, 2017. QNB had no other real estate owned or repossessed assets as of June 30, 2017, December 31, 2016, or June 30, 2016.

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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 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.

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

| | June 30, 2017 | December 31, 2016 | June 30, 2016 |
|---|---|---|---|
| Non-accrual loans | $9,453 | $10,119 | $8,685 |
| Loans past due 90 days or more and still accruing interest | — | — | 65 |
| Troubled debt restructured loans (not already included above) | 1,393 | 1,819 | 1,433 |
| Total non-performing loans | 10,846 | 11,938 | 10,183 |
| Non-accrual investment securities | — | 2,281 | 2,400 |
| Total non-performing assets | $10,846 | $14,219 | $12,583 |
| | | | |
| Total loans (excluding loans held-for-sale): | | | |
| Average total loans (YTD) | $656,026 | $604,757 | $600,601 |
| Total loans | 695,213 | 633,079 | 604,478 |
| | | | |
| Allowance for loan losses | 8,035 | 7,394 | 7,550 |
| | | | |
| Allowance for loan losses to: | | | |
| Non-performing loans | 74.09 % | 61.94 % | 74.14 % |
| Total loans (excluding held-for-sale) | 1.16 % | 1.17 % | 1.25 % |
| Average total loans | 1.22 % | 1.22 % | 1.26 % |
| | | | |
| Non-performing loans / total loans (excluding held-for-sale) | 1.56 % | 1.89 % | 1.68 % |
| Non-performing assets / total assets | 0.97 % | 1.34 % | 1.22 % |

An analysis of net loan (recoveries) charge-offs for the three and six months ended June 30, 2017 compared to 2016 is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Net (recoveries) charge-offs | $(16 ) | $6 | $(41 ) | $129 |
| | | | | |
| Net annualized (recoveries) charge-offs to: | | | | |
| Total loans | (0.01%) | 0.00% | (0.01%) | 0.04% |
| Average total loans excluding held-for-sale | (0.01%) | 0.00% | (0.01%) | 0.04% |
| Allowance for loan losses | (0.81%) | 0.29% | (1.03%) | 3.45% |

At June 30, 2017 and December 31, 2016, the recorded investment in loans for which impairment has been identified totaled $13,753,000 and $15,006,000 of which $10,581,000 and $10,909,000, respectively, required no specific allowance for loan loss. The recorded investment in impaired loans requiring an allowance for loan losses was $3,172,000 and $4,097,000 at June 30, 2017 and December 31, 2016, respectively, and the related allowance for loan losses associated with these loans was $1,133,000 and

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$1,198,000, respectively. Most of the loans that have been identified as impaired are collateral-dependent. See Note 7 to the Notes to Consolidated Financial Statements for additional detail of impaired loans.

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 | |
|---|---|---|---|---|---|---|---|---|
| | 2017 | 2016 | Amount | Percent | 2017 | 2016 | Amount | Percent |
| Net gain on investment securities | $115 | $15 | $100 | 666.7 % | $864 | $334 | $530 | 158.7 % |
| Net gain on trading activity | 10 | 52 | (42 ) | -80.8 % | 27 | 86 | (59 ) | -68.6 % |
| Fees for services to customers | 421 | 397 | 24 | 6.0 % | 813 | 780 | 33 | 4.2 % |
| ATM and debit card | 449 | 422 | 27 | 6.4 % | 866 | 810 | 56 | 6.9 % |
| Retail brokerage and advisory | 104 | 126 | (22 ) | -17.5 % | 207 | 296 | (89 ) | -30.1 % |
| Bank-owned life insurance | 120 | 73 | 47 | 64.4 % | 191 | 144 | 47 | 32.6 % |
| Merchant | 92 | 83 | 9 | 10.8 % | 172 | 156 | 16 | 10.3 % |
| Net gain on sale of loans | 201 | 71 | 130 | 183.1 % | 251 | 120 | 131 | 109.2 % |
| Other | 103 | 135 | (32 ) | -23.7 % | 214 | 224 | (10 ) | -4.5 % |
| Total | $1,615 | $1,374 | $241 | 17.5 % | $3,605 | $2,950 | $655 | 22.2 % |

Quarter to Quarter Comparison

Total non-interest income for the second quarter of 2017 was $1,615,000, an increase of $241,000, compared to $1,374,000 for the second quarter of 2016. Excluding net gains on investment securities, trading activities and sale of loans for both periods, total non-interest income was $1,289,000 and $1,236,000 for the second quarters of 2017 and 2016, respectively.

Net gains on investment securities increased $100,000 from $15,000 in the second quarter of 2016 to $115,000 in the second quarter of 2017. Gain on investments are primarily derived from sale of equities, offset in part by loss on sale of $15,000 due to the sale of five trust preferred securities during the quarter. Market conditions in the equities market for the quarter ended June 30, 2017 versus the same period in 2016 resulted in better opportunities for sales.

QNB originates residential mortgage loans for sale in the secondary market. Net gain on sale of mortgage loans originated for resale was $102,000, an increase of $31,000 when comparing the two periods. The net gain on residential mortgage sales is directly related to the volume of mortgages sold and the timing of the sales relative to the interest rate environment. Proceeds from the sale of residential mortgages were $2,652,000 and $1,999,000 for the second quarters of 2017 and 2016, respectively. QNB Bank also realized a $99,000 gain on sale of a non-performing loan during the quarter.

ATM and debit card income and merchant income increased $27,000 and $9,000, respectively, to $449,000 and $92,000, respectively, for the second quarter of 2017, compared to the same period in 2016, due to increases in card-based transactions and expansion of retail and business account households. Fees for services to customers increased $24,000 to $421,000, primarily due to increased overdrafts. The increase in bank-owned life insurance income, to $120,000 for the quarter, includes a life insurance benefit of $51,000.

These increases in non-interest income were offset in part by a $42,000 decrease in net gain on trading activity. During the quarter, QNB Bank redeemed the trading portfolio, as lack of market volatility and the interest rate environment resulted in declining performance. Retail brokerage and advisory income declined $22,000, or 17.5%. While assets under management have grown to $116,000,000 at June 30, 2017, recent asset growth has been in products with more trailing income than up-front income. Other non-interest income decreased $32,000, or 23.7%, due to sales tax refunds received in 2016.

Six-Month Comparison

Total non-interest income for the six-month periods ended June 30, 2017 and 2016 was $3,605,000 and $2,950,000, respectively, an increase of $655,000, or 22.2%. Excluding net gains on investment securities, trading activities and loans for both periods total non-interest income was $2,463,000 and $2,410,000, an increase of $53,000.

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Net investment securities gains increased $530,000 to $864,000 for the six months ended June 30, 2017 compared to $334,000 for the comparable six months in 2016. 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 2017. Gains on sales of securities were $526,000 in the 2016 period.

ATM and debit card income, merchant income and fees for services to customers increased for the first six months of 2017 compared to 2016, for reasons detailed in the quarterly comparison.

Excluding the $99,000 gain on note sale during 2017, net gains on the sale of loans increased $32,000 to $152,000, when comparing the six months ended June 30, 2017 to the same period in 2016. Proceeds from the sale of residential mortgages were $4,675,000 and $3,556,000 for the six-month periods ended June 30, 2017 and 2016, respectively.

Retail brokerage and advisory income was $207,000 for the first half of 2017 compared with $296,000 for the first half of 2016, a decrease of $89,000, or 30.1%. Trading revenue decreased $59,000 in the first half of 2017 compared to the same period 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 | |
|---|---|---|---|---|---|---|---|---|
| | 2017 | 2016 | Amount | Percent | 2017 | 2016 | Amount | Percent |
| Salaries and employee benefits | $3,237 | $2,988 | $249 | 8.3 % | $6,323 | $6,042 | $281 | 4.7 % |
| Net occupancy | 425 | 426 | (1) | -0.2 % | 876 | 867 | 9 | 1.0 % |
| Furniture and equipment | 456 | 440 | 16 | 3.6 % | 885 | 865 | 20 | 2.3 % |
| Marketing | 307 | 265 | 42 | 15.8 % | 536 | 461 | 75 | 16.3 % |
| Third-party services | 407 | 403 | 4 | 1.0 % | 801 | 806 | (5) | -0.6 % |
| Telephone, postage and supplies | 199 | 174 | 25 | 14.4 % | 399 | 360 | 39 | 10.8 % |
| State taxes | 155 | 141 | 14 | 9.9 % | 348 | 321 | 27 | 8.4 % |
| FDIC insurance premiums | 134 | 157 | (23) | -14.6 % | 275 | 327 | (52) | -15.9 % |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Other | 622 | 599 | 23 | 3.8 | % | 1,087 | 1,063 | 24 | 2.3 | % |
| Total | $5,942 | $5,593 | $349 | 6.2 | % | $11,530 | $11,112 | $418 | 3.8 | % |

Quarter to Quarter Comparison

Total non-interest expense was $5,942,000 for the second quarter of 2017, an increase of $349,000, or 6.2%, compared to the second quarter of 2016.

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 increased $249,000, or 8.3%, to $3,237,000 when comparing the two quarters. Salary expense and related payroll taxes increased $274,000, or 10.7%, to $2,822,000 during the second quarter of 2017 compared to the same period in 2016, due to merit increases and additional staff. Benefits expense decreased $25,000, due primarily to decreased medical insurance claims when comparing the two periods.

Net occupancy and furniture and equipment expense increased $15,000, or 1.7%, to $881,000 for the second quarter of 2017, with maintenance and rent expense increases of $32,000 and $20,000, respectively, partially offset by a $23,000 decrease in building repairs and maintenance and $25,000 decrease in depreciation and amortization expense. Marketing expense increased $42,000, or 15.8%, to $307,000 for the quarter ended June 30, 2017. The increase is due to additional sponsorships and donations for the second quarter of 2017 compared to the same period in 2016.

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 increased slightly when comparing the two periods. Telephone and postage and supplies expenses increased $25,000, or

14.4%, due to increased data line capacity, and costs related to debit chip card conversion and the increase in new deposits and loans. State taxes are based on the Bank's equity, and the $14,000 increase is due to increased net worth of the Bank as well as a higher rate in effect for 2017. FDIC insurance premiums decreased $23,000, or 14.6%, due to the change in the FDIC insurance premium calculation, implemented starting in late 2016. The increase in other expenses is attributable to higher third-party processing and check card expense, offset in part by a reduction in foreclosure expense.

Six-Month Comparison

Total non-interest expense was $11,530,000 for the six-month period ended June 30, 2017, an increase of $418,000, or 3.8%, compared to the first half of 2016.

Salaries and benefits expense increased $281,000 to $6,323,000 for the six months ended June 30, 2017 compared to the same period in 2016. Salary and related payroll tax expense increased $380,000, or 7.4% during the period, to $5,524,000 while benefits expense decreased $99,000, to $799,000, related to decreased medical premium and post-retirement life insurance expense.

Net occupancy and furniture and equipment expense increased $29,000 to $1,761,000, for the same reasons described in the quarter comparison.

Marketing expense increased $75,000, or 16.3%, to $536,000 for the six months ended June 30, 2017 attributable to increased donations and advertising campaigns and sales promotions.

Telephone, postage and supplies expenses increased in the first six months of 2017 compared to 2016, due to the reasons described in the quarter comparison. Third party services expense decreased slightly to $801,000 for the six months ended June 30, 2017 when compared to the same period in 2016.

State taxes and other non-interest expense increased $27,000 and $24,000, respectively, while FDIC insurance premiums decreased $52,000 for the first half of 2017 for reasons described in the quarter comparison.

INCOME TAXES

QNB utilizes an asset and liability approach for financial accounting and reporting of income taxes. As of June 30, 2017, QNB’s net deferred tax asset was $4,639,000. The primary components comprise deferred tax assets of $2,732,000 relating to the allowance for loan losses, $1,233,000 related to unrealized losses on available for sale securities, $489,000 related to non-accrual interest income, $218,000 related to deferred fees and rent, $125,000 related to accrued bonus and payroll taxes, and $41,000 generated by OTTI charges on equity securities. As of December 31, 2016, QNB’s net deferred tax asset was $5,473,000. The sale of the trust preferred bonds with prior OTTI charges during the second quarter 2017 resulted in a $392,000 reduction in the deferred tax asset. The remaining balance difference is the result of a $702,000 decline, due to decreased unrealized losses on available for sale securities at June 30, 2017, compared with December 31, 2016, which was offset in part by a $218,000 increase related to additional loan provisions recorded in 2017.

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 $845,000 for the quarter and $1,967,000 for the six months ended June 30, 2017, compared with $702,000 and $1,490,000 for the same periods in 2016. The effective tax rate for the second quarter and year-to-date 2017 was 26.2% and 27.3%, respectively, compared with 25.1% and 25.5% for the same periods in 2016. This increase in effective tax rate in 2017 is due to the decreased proportion of tax-free income to total income, primarily municipal securities and municipal loan interest income.

FINANCIAL CONDITION ANALYSIS

Financial service organizations are challenged to demonstrate they can generate sustainable and consistent earnings growth in a dynamic operating environment. Rate competition for quality loans is anticipated to continue through 2017. It is also anticipated that

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the rate competition for attracting and retaining deposits may increase in 2017 and into 2018 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, 2017 were $1,120,523,000 compared with $1,063,141,000 at December 31, 2016. Cash and cash equivalents increased $4,527,000 from $10,721,000 at December 31, 2016 to $15,248,000 at June 30, 2017, due primarily to growth in deposit balances and paydowns of amortizing mortgage-backed securities during the quarter.

During the second quarter 2017, QNB Bank redeemed the trading securities portfolio, as lack of market volatility and the interest rate environment resulted in declining performance of the portfolio, since its inception in 2014. The fair value of the trading portfolio was $3,596,000 at December 31, 2016.

In June 2017, QNB Bank sold five non-performing pooled trust preferred securities, with a $2,235,000 carrying value, recording a loss on sale of $15,000. Several years ago, QNB had recorded OTTI for four of these five bonds, and subsequently written them down by applying any cashflow received to reducing the balance of these non-performing assets. Recent improvement in market prices for these securities reduced realized losses, and the reduction of approximately $19,000,000 in risk-based assets related to these bonds drove the decision to sell them. These securities are CDOs in the form of pooled trust preferred securities and are comprised mainly of securities issued by banks or bank holding companies, and to a lesser degree, insurance companies. QNB owned the mezzanine tranches of these securities. These securities are structured so that the senior and mezzanine tranches are protected from defaults by over-collateralization and cash flow default protection provided by subordinated tranches. The trust preferred security the Bank continues to hold, PreTSL IV, with a carrying balance of $212,000 at June 30, 2017, was returned to accrual status during the second quarter 2017. QNB’s ownership in PreTSL IV represents the senior-most obligation of the trust. There was no credit-related other-than-temporary impairment charge during the quarter or six months ended June 30, 2017 or 2016. It is possible that future valuations could require recording additional other-than-temporary impairment charges through earnings. For additional detail on these securities see Note 6 Investment Securities and Note 8 Fair Value Measurements and Disclosures.

Aside from the redemptions detailed above, the composition of the investment portfolio is essentially unchanged since December 31, 2016. 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 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.

Loans receivable grew $62,134,000, or 9.8%, with commercial loans increasing $57,130,000, or 11.2%, to $565,890,000 at June 30, 2017, compared with $508,760,000 at year-end 2016. Retail loan balances grew $5,004,000, or 4.0%, to $129,323,000, when comparing June 30, 2017 to December 31, 2016. QNB has experienced growth in part due to market disruption created by bank mergers in its footprint throughout 2016 and 2017.

Deposit growth was led by savings balances, which increased $16,780,000, or 7.0%, to $255,027,000 from December 31, 2016 to June 30, 2017. Interest-bearing demand balances, excluding municipal deposits, grew $15,313,000, or 9.4%, to $178,300,000. Municipal deposit balances increased $1,197,000 to $93,964,000. Municipal deposits can be volatile depending on the timing of deposits and withdrawals, and the cash flow needs of the school districts or municipalities. 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. Money market balances grew $7,043,000, or 9.4%, to $81,805,000 and non-interest bearing demand balances increased $1,359,000 to $120,369,000 at June 30, 2017, due primarily to increased business deposits. Time deposits decreased $3,733,000 from December 31, 2016 to June 30, 2017. It is anticipated that total deposits will increase in the third quarter 2017, as tax money received from the local school districts peaks during September, then flows out for the subsequent twelve months as the schools use the funds for operations.

Short-term borrowings increased 27.1%, from $52,660,000 at December 31, 2016 to $66,907,000 at June 30, 2017. Commercial sweep accounts decreased $5,130,000, as these funds may be volatile based on businesses' receipt and disbursement of funds. Overnight borrowings from FHLB increased $19,377,000 to $26,699,000.

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 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, 2017, the Bank had a maximum borrowing capacity with the FHLB of approximately $249,544,000, net overnight borrowings and a letter of credit at June 30, 2017. The maximum borrowing depends upon qualifying collateral assets and QNB's asset quality and capital adequacy. In addition, the Bank maintains unsecured Federal funds lines with three correspondent banks totaling $46,000,000. At June 30, 2017, there were no outstanding borrowings under these lines. During the first and second quarters of 2017, 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.

Liquid sources of funds, including cash, trading and available-for-sale investment securities and loans held-for-sale decreased $7,239,000 since December 31, 2016, totaling $398,342,000 at June 30, 2017. Cashflow from payments, calls and sales of securities have been used since year-end 2016 to fund loans. Management expects these liquid sources will be adequate to meet normal fluctuations in loan demand or deposit withdrawals. The investment portfolio is expected to continue to provide sufficient liquidity, even in a rising rate environment, as municipal bonds are called and cash flow on mortgage-backed and CMO securities continues to be steady. As interest rates rise, the cash flow available from the investment portfolio may decrease.

Approximately $171,738,000 and $166,628,000 of available-for-sale securities at June 30, 2017 and December 31, 2016, respectively, were pledged as collateral for repurchase agreements and deposits of public funds. The level of pledged securities depends upon the level of municipal deposits and repurchase agreement balances.

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, 2017 was $98,750,000, or 8.81% of total assets, compared with shareholders' equity of $93,567,000, or 8.80% of total assets, at December 31, 2016. Shareholders’ equity at June 30, 2017 and December 31, 2016 included a negative adjustment of $2,393,000 and $3,757,000, respectively, related to unrealized holding losses, net of taxes, on investment securities available-for-sale. Without these adjustments, shareholders' equity to total assets would have been 9.01% and 9.12% at June 30, 2017 and December 31, 2016, respectively.

Average shareholders' equity and average total assets were $99,590,000 and $1,088,996,000 for the first six months of 2017, an increase of 5.4% and 5.6%, respectively, from the averages for the year ended December 31, 2016. The ratio of average total equity to average total assets was 9.15% for six months ended June 30, 2017 compared to 9.16% for all 2016.

Retained earnings at June 30, 2017 were impacted by six months of net income totaling $5,246,000 partially offset by dividends declared and paid of $2,122,000 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 $512,000 and $477,000 to capital during the six months ended June 30, 2017 and 2016, respectively.

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, 2017, 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.

The following table sets forth consolidated information for QNB Corp.

| Capital Analysis | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Regulatory Capital | | |
| Shareholders' equity | $98,750 | $93,567 |
| Net unrealized securities losses, net of tax | 2,393 | 3,757 |
| Net unrealized losses on available-for-sale equity securities, | (116 ) | — |

| | | |
|---|---|---|
| net of tax | | |
| Disallowed intangible assets | (6 ) | (4 ) |
| Common equity tier I capital | 101,021 | 97,320 |
| | | |
| Tier I capital | 101,021 | 97,320 |
| Allowable portion: Allowance for loan losses and reserve for unfunded commitments | 8,108 | 7,453 |
| Unrealized gains on equity securities, net of tax | — | 47 |
| Total regulatory capital | $109,129 | $104,820 |
| Risk-weighted assets | $855,546 | $822,210 |
| Quarterly average assets for leverage capital purposes | $1,101,938 | $1,061,976 |

| Capital Ratios | June 30, 2017 | December 31, 2016 |
|---|---|---|
| Common equity tier I capital / risk-weighted assets | 11.81 % | 11.84 % |
| Tier I capital / risk-weighted assets | 11.81 % | 11.84 % |
| Total regulatory capital / risk-weighted assets | 12.76 % | 12.75 % |
| Tier I capital / average assets (leverage ratio) | 9.17 % | 9.16 % |

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There was little change in capital ratios between December 31, 2016 and June 30, 2017. The Company remains well-capitalized by all applicable regulatory requirements as of June 30, 2017.

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 considers 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.

A balance sheet is considered liability sensitive when its liabilities (deposits and borrowings) reprice faster or 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, 2017 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, 2017 and 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) | 2017 | 2016 |
| +300 | -8.81% | -2.60% |
| +200 | -5.77% | -1.48% |
| +100 | -2.69% | -0.62% |
| -100 | -5.78% | *N/A |

* Certain short-term interest rates 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, 2017 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, 2017

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, 2016.

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

QNB did not repurchase any shares of its common stock during the quarter ended June 30, 2017. The following provides certain information relating to QNB's stock repurchase plan.

| 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, 2017 through April 30, 2017 | — | — | — | 42,117 |
| May 1, 2017 through May 31, 2017 | — | — | — | 42,117 |
| June 1, 2017 through June 30, 2017 | — | — | — | 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 3.1 | 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 3.2 | 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 31.1 | Section 302 Certification of Chief Executive Officer |
| Exhibit 31.2 | Section 302 Certification of Chief Financial Officer |
| Exhibit 32.1 | Section 906 Certification of Chief Executive Officer |
| Exhibit 32.2 | Section 906 Certification of Chief Financial Officer |

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

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

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

SIGNATURES

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

| | | |
|---|---|---|
| | | QNB Corp. |
| Date: | August 8, 2017 | By: /s/ David W. Freeman<br>David W. Freeman<br>Chief Executive Officer |
| Date: | August 8, 2017 | By: /s/ Janice McCracken Erkes<br>Janice McCracken Erkes<br>Chief Financial Officer |
| Date: | August 8, 2017 | By: /s/ Phillip N. Geiger<br>Phillip N. Geiger<br>Chief Accounting Officer, QNB Bank |