

QNB CORP  
Form 10-K  
March 16, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
for the fiscal year ended December 31, 2017  
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<br>(State or Other Jurisdiction of Incorporation or Organization)                  | 23-2318082<br>(I.R.S. Employer Identification No.) |
| 15 North Third Street, P.O. Box 9005 Quakertown, PA<br>(Address of Principal Executive Offices) | 18951-9005<br>(Zip Code)                           |

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---------------------|---|
| None                | N/A                                       |

Securities registered pursuant to Section 12(g) of the Act:

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Title of each class  
Common Stock, \$0.625 par value

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," "smaller reporting company", and "emerging growth company" in Rule 12b-2 of the Exchange Act.

|                         |   |
|-------------------------|---|
| Large accelerated filer | Accelerated filer   |
| Non-accelerated filer   | (Do not check if a small reporting company) 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 new or 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

As of March 2, 2018, 3,453,366 shares of common stock of the registrant were outstanding. As of June 30, 2017, the aggregate market value of the common stock of the registrant held by non-affiliates was approximately \$126,849,958 based upon the average bid and asked prices of the common stock as reported on the OTC BB.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of registrant's Proxy Statement for the annual meeting of its shareholders to be held May 22, 2018 are incorporated by reference in Part III of this report.



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## PART I

### FORWARD-LOOKING STATEMENTS

In addition to historical information, this document contains forward-looking statements. Forward-looking statements are typically identified by words or phrases such as “believe,” “expect,” “anticipate,” “intend,” “estimate,” “project” and variations 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 a safe harbor in regard to the inclusion of forward-looking statements in this document and documents incorporated by reference.

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

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

### ITEM 1. BUSINESS

#### Overview

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

Prior to December 28, 2007, the Bank was a national banking association organized in 1877 as The Quakertown National Bank, was chartered under the National Banking Act and was subject to Federal and state laws applicable to national banks. Effective December 28, 2007, the Bank became a Pennsylvania chartered commercial bank and changed its name to QNB Bank. The Bank, whose principal office is located in Quakertown, Bucks County, Pennsylvania, operated eleven full-service community banking offices in Bucks, Montgomery and Lehigh counties in southeastern Pennsylvania as of December 31, 2017.

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

At December 31, 2017, QNB had total assets of \$1,152,337,000, total loans of \$733,283,000, total deposits of \$993,948,000 and total shareholders' equity of \$98,570,000. For the year ended December 31, 2017, QNB reported net income of \$8,289,000 compared to net income for the year ended December 31, 2016 of \$8,924,000 and December 31, 2015 of \$8,233,000.

At February 22, 2018, the Bank had 172 full-time employees and 9 part-time employees. The Bank's employees have a customer-oriented philosophy emphasizing personal service and flexible solutions which together make achieving our customers' goals possible. They maintain close contact with both the residents and local business people in the communities in which they serve, responding to changes in market conditions and customer requests in a timely manner.

### Competition and Market Area

The banking business is highly competitive, and the profitability of QNB depends principally upon the Bank's ability to compete in its market area. QNB faces intense competition within its market, both in making loans and attracting deposits. Bucks, Lehigh, and Montgomery counties have a high concentration of financial institutions, including large national and regional banks, community banks, savings institutions and credit unions. Some of QNB's competitors offer products and services that QNB currently does not offer, such as traditional trust services and full-service insurance.

In addition, as a result of consolidation in the banking industry, some of QNB's competitors may enjoy advantages such as greater financial resources, a wider geographic presence, more favorable pricing alternatives and lower origination and operating costs. However, QNB has been able to compete effectively with other financial institutions by emphasizing the establishment of long-term relationships and customer loyalty. A strong focus on small-business solutions, providing fast local decision-making on loans, exceptional personal customer service and technology solutions, including internet- and mobile-banking, electronic bill pay and remote deposit capture, also enable QNB to compete successfully.

Competition for loans and deposits comes principally from commercial banks, savings institutions, credit unions and non-bank financial service providers. Factors in successfully competing for deposits include providing excellent customer service, convenient locations and hours of operation, attractive rates, low fees, and alternative delivery systems. One such delivery system is remote deposit capture for those commercial customers that are not conveniently located near one of our branches, or mobile banking for retail customers. Successful loan origination tends to depend not only on interest rate and terms of the loan but also on being responsive and flexible to the customers' needs. While many competitors within the Bank's primary market have substantially higher legal lending limits, QNB often has the ability, through loan participations, to meet the larger lending needs of its customers.

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

### Monetary Policy and Economic Conditions

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

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



## Supervision and Regulation

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

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

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

#### Bank Holding Company Regulation

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

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

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

#### Regulatory Restrictions on Dividends

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

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

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

It is also the policy of the Federal Reserve that a bank holding company generally only pay dividends on common stock out of net income available to common shareholders over the past year and only if the prospective rate of

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

In July 2013, the Federal bank regulatory agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. The final rules generally implemented higher minimum capital requirements, added a new common equity Tier 1 capital requirement, and established criteria that instruments must meet to be considered common equity Tier 1 capital, additional Tier 1 capital or Tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity Tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a Tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered "well capitalized"). Under the new rules, in order to avoid limitations on capital

distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity Tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements were effective on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016.

Under these policies and subject to the restrictions applicable to the Bank, to remain “well capitalized,” the Bank had approximately \$14,444,000 available for payment of dividends to the Company at December 31, 2017.

#### Capital Adequacy

Bank holding companies are required to comply with the Federal Reserve’s risk-based capital guidelines. The required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of total capital must be Tier 1 capital. Tier 1 capital consists principally of common shareholders’ equity, plus retained earnings, less certain intangible assets. The remainder of total capital may consist of the allowance for loan losses, which is considered Tier 2 capital. At December 31, 2017, QNB’s Tier 1 capital and total capital (Tier 1 and Tier 2 combined) and common equity Tier 1 equity ratios were 11.62% and 12.52%, and 11.62%, respectively.

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

In addition to the risk-based capital guidelines, the Federal Reserve requires a bank holding company to maintain a minimum leverage ratio. This requires a minimum level of Tier 1 capital (as determined under the risk-based capital rules) to average total consolidated assets of 4% for those bank holding companies that have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. The Federal Reserve expects all other bank holding companies to maintain a ratio of at least 1% to 2% above the stated minimum. At December 31, 2017, QNB’s leverage ratio was 8.88%.

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

- Total risk-based capital ratio of 10% or more.
- Tier 1 risk-based capital ratio of 8% or more.
- Common equity tier 1 risk-based capital ratio of 6.5% or more.
- Leverage ratio of 5% or more, and
- Not subject to any order or written directive to meet and maintain a specific capital level

At December 31, 2017, the Bank qualified as well capitalized under these regulatory standards. See Note 19 of the Notes to Consolidated Financial Statements included at Item 8 of this Report for additional information.

#### Bank Regulation

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

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

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

#### FDIC Insurance Assessments

The Bank's deposits are insured to the applicable limits as determined by the FDIC, which is currently \$250,000 per depositor.

The FDIC utilizes a risk-based premium system that provides for quarterly assessments (billed in arrears) based on an insured institution's ranking in one of four risk categories based on their examination ratings and capital ratios. Well-capitalized institutions with the CAMELS ratings of 1 or 2 are grouped in Risk Category I.

Beginning with the second quarter of 2011, as mandated by the Dodd-Frank Act, the assessment base that the FDIC uses to calculate assessment premiums is a bank's average assets minus average tangible equity. The FDIC is required under the Dodd-Frank Act to establish assessment rates that will allow the Deposit Insurance Fund ("DIF") to achieve a reserve ratio of 1.35% of Insurance Fund insured deposits by September 2020. In addition, the FDIC has established a "designated reserve ratio" of 2.0%, a target ratio that, until it is achieved, will not likely result in the FDIC reducing assessment rates. In attempting to achieve the mandated 1.35% ratio, the FDIC is required to implement assessment formulas that charge banks over \$10 billion in consolidated assets ("large institutions") more than banks below \$10 billion ("small institutions").

The FDIC Reserve Ratio is the total of the DIF divided by the total estimated insured deposits of the industry. The reserve ratio reached 1.15% effective June 30, 2016, which prompted assessment changes. The assessment changes and corresponding legislative rulings are:

¶ In February 7, 2011, the FDIC adopted a rule that included the provision that, effective the quarter after the Reserve Ratio reaches 1.15%, the assessment rate schedule for the industry is reduced.

¶ In March 15, 2016, the FDIC adopted a rule in accordance with provisions of the Dodd-Frank Act that requires large institutions to bear the burden of raising the Reserve Ratio from 1.15% to 1.35%. Since the Reserve Ratio has reached 1.15%, the FDIC will collect assessment surcharges from large institutions. Once the reserve ratio reaches 1.38%, small institutions will receive credits to offset their contribution to raising the Reserve Ratio to 1.35% (see below).

¶ In April 26, 2016, the FDIC adopted a rule amending small institution pricing for deposit insurance which is also effective the quarter after the Reserve Ratio reaches 1.15%.

Effective July 1, 2016, changes took place to the pricing system for established (insured 5 or more years) small institutions, that appeared starting with the December 30, 2016 invoice. The new pricing system results in:

¶ New Assessment Rate Schedule - Effective July 1, 2016, the initial base assessment rates for all insured institutions were reduced from 5 to 35 basis points to 3 to 30 basis points. Total base assessment rates after possible adjustments were reduced from 2.5 to 45 basis points to 1.5 to 40 basis points.

**Large Institution Surcharges & future Small Institution Credits** - Large institution surcharges will be collected for up to eight quarters, therefore, the regular quarterly assessments paid by small banks during that period will also contribute to raising the Reserve Ratio from 1.15% to 1.35 %. The FDIC will provide future credit offsets to assessments of small institutions for the portion of their assessments that contributed to the Reserve Ratio growth. Eligible institutions will receive a portion of the aggregate credit amount as determined by the FDIC. The credits will be applied for each quarter the Reserve Ratio is above 1.38% and will not exceed the institution's quarterly assessment due amount. Institutions will not be allowed to buy or sell credits. Credits will transfer only in a legal merger or consolidation of two insured institutions.

**Small Institution Pricing Changes** - The new pricing system uses the Financial Ratios Method to determine assessment rates for all small established institutions. CAMELS composite ratings are used to set minimum and maximum assessment rates for an institution. The new pricing system also revises the Financial Ratios Method so that it is based on a statistical model estimating the probability of failure over three years and updates the financial measures used in the Financial Ratios Method so the measures are consistent with the statistical model.

For the years ended December 31, 2017, 2016 and 2015, the Bank recorded \$525,000, \$520,000 and \$579,000, respectively, in FDIC deposit insurance premium expense.

All insured institutions of the FDIC are required to pay assessments to fund interest payments on Financing Corporation (FICO) bonds. The Financing Corporation was created by Congress to issue bonds to finance the resolution of failed thrift institutions. Prior to 1997, only thrift institutions were subject to assessments to raise funds to pay the FICO bonds; however, beginning in 2000, commercial banks and thrifts are subject to the same assessment for FICO bonds. The FDIC has the authority to set the Financing Corporation assessment rate every quarter. The expense for 2017, 2016 and 2015 recorded by QNB was \$52,000 \$48,000 and \$52,000, respectively. These assessments will continue until the Financing Corporation bonds mature through 2019.

#### Federal Home Loan Bank System

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (“FHLB”), which is one of 11 regional Federal Home Loan Banks. Each Federal Home Loan Bank serves as a reserve or central bank for members within its assigned region. It is funded primarily from funds deposited by member institutions and proceeds from the sale of consolidated obligations of the Federal Home Loan Bank System. It makes loans to members (i.e. advances) in accordance with policies and procedures established by the board of directors of the Federal Home Loan Bank. At December 31, 2017, the Bank had \$13,911,000 of overnight FHLB advances outstanding.

The Bank is required to purchase and maintain stock in the FHLB as a condition of membership in an amount equal to 0.10% of its assets. In addition, each member is required to purchase and maintain activity-based stock of 4% of outstanding advances from the FHLB. At December 31, 2017, the Bank had \$1,489,000 in stock of the FHLB.

#### Community Reinvestment Act

Under the Community Reinvestment Act, (“CRA”) as amended the FDIC is required to assess all financial institutions that it regulates to determine whether these institutions are meeting the credit needs of the communities that they serve. The CRA focuses specifically on low and moderate income neighborhoods.

An institution’s record is considered during the evaluation of any application made by such institutions for, among other things:

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

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

#### USA Patriot Act

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

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

#### Sarbanes-Oxley Act of 2002



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

• **Corporate Responsibility for Financial Reports** - requires Chief Executive Officers ("CEOs") and Chief Financial Officers ("CFOs") to certify certain matters relating to a company's financial records and accounting and internal controls.

• **Management Assessment of Internal Controls** - requires auditors to certify the company's underlying controls and processes that are used to compile the financial results for companies that are accelerated filers.

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Real-time Issuer Disclosures - requires that companies provide real-time disclosures of any events that may affect the company's stock price or financial performance, generally within a 48-hour period.

Criminal Penalties for Altering Documents - provides severe penalties for "whoever knowingly alters, destroys, mutilates" any record or document with intent to impede an investigation. Penalties include monetary fines and prison time.

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

QNB's Code of Business Conduct and Ethics can be found on the Bank's website at [www.qnbbank.com](http://www.qnbbank.com).

#### Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")

The Dodd-Frank Act was enacted on July 21, 2010. This law made significant changes to the bank regulatory structure and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies.

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

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

As mandated by the Dodd-Frank Act, in December 2013, the Office of the Comptroller of the Currency ("OCC"), Federal Reserve, FDIC, and Securities and Exchange Commission ("SEC") issued a final rule implementing certain prohibitions and restrictions on the ability of a banking entity and non-bank financial company supervised by the FRB to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund (the so-called "Volcker Rule"). The final rules also require regulated entities to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include making regular reports about those activities to regulators. Although the final rules provide some compliance and reporting exceptions based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size, including the Company. The final rules were effective April 1, 2014, with an extended effective date of July 2015. Under the final rules implementing the Volcker Rule, financial institutions are prohibited from owning certain covered funds. The Company has reviewed its securities holdings and does not believe that any qualify as impermissible holdings. If future regulatory interpretation requires us to divest of any such investments, it could cause us to recognize unexpected losses on the dispositions.

Many of the provisions of the Dodd-Frank Act do not apply to the Bank, as it does not engage in many of the specific activities sought to be regulated by the Dodd-Frank Act. Many of the provisions, however, such as the increased capital requirements that began in 2015 and the changes to FDIC insurance premiums already implemented, affected all banking entities. In addition, the financial crisis of 2008 and the enactment of the Dodd-Frank Act in response to

that crisis has resulted in an era of increased regulatory oversight over all financial entities. The ultimate changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

#### Possible Future Legislation

Congress is often considering some financial industry legislation, and the Federal banking agencies routinely propose new regulations. The Company cannot predict the future effect any new legislation, or new rules adopted by Federal or state banking agencies, will have on the business of the Company and its subsidiaries. Given that the financial industry remains under scrutiny, the Company expects that there will be legislative and regulatory actions that may materially affect the banking industry in the foreseeable future.

## Additional Information

QNB's principal executive offices are located at 320 West Broad Street, Quakertown, Pennsylvania. Its telephone number is (215) 538-5600. This annual report, including the exhibits and schedules filed as part of the annual report on Form 10-K, may be inspected at the public reference facility maintained by the SEC at its public reference room at 100 F Street, NE, Washington, DC 20549 and copies of all, or any part thereof, may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room, and you can request copies of the documents upon payment of a duplicating fee by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including QNB, that file electronically with the SEC which can be accessed at [www.sec.gov](http://www.sec.gov).

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

## ITEM 1A. RISK FACTORS

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

1) Unfavorable economic and financial market conditions may adversely affect our financial condition and results of operations.

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

• We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs and limit our ability to pursue business opportunities.

- Our ability to assess the creditworthiness of customers and to estimate the losses inherent in our credit exposure is made more complex by these difficult market and economic conditions.

• We also may be required to pay higher FDIC premiums if further financial institution failures reduce the deposit insurance fund and its ratio of reserves to insured deposits to a level where higher premiums would be necessary.

• Our ability to borrow from other financial institutions or the FHLB could be adversely affected by disruptions in the capital markets or other events.

- We may experience increases in foreclosures, delinquencies and customer bankruptcies.

2) Our net interest income, net income and results of operations are sensitive to fluctuations in interest rates.

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

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

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

Generally speaking, a yield curve with a higher degree of slope provides more opportunity to increase the spread between earning asset yields and funding costs. It should be emphasized that while the yield curve is a critical benchmark in setting prices for various monetary assets and liabilities in banks, its influence is not exerted in a vacuum. Credit risk, market risk, competitive issues, and other factors must all be considered in the pricing of financial instruments. A steep or highly-sloped yield curve may be a precursor of higher interest rates or elevated inflation in the future, while a flat yield curve may be characteristic of a Federal Reserve policy designed to calm an overheated economy by tightening credit availability via increases in short-term rates. If other rates along the maturity spectrum do not rise correspondingly, the yield curve can be expected to flatten. This scenario may reflect an economic outlook that has little or no expectation of higher future interest rates or higher rates of inflation. For banks, the presence of a flat yield curve for a prolonged or sustained period could measurably lower expectations for expanding the net interest margin.

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

3) We are subject to credit risk in connection with our lending activities, and our financial condition and results of operations may be negatively affected by economic conditions and other factors that could adversely affect our customers.

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

4) We face significant competition from other banks and financial institutions in our market area, many of which are larger in terms of asset size and market capitalization.

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

At December 31, 2017, our lending limit per borrower was approximately \$15,156,000. Accordingly, the size of loans that we may offer to potential borrowers (without participation by other lenders) is less than the size of loans that many of our competitors with larger capitalization are able to offer. Our legal lending limit also impacts the efficiency of our lending operation because it tends to lower our average loan size, which means we have to generate a higher number of transactions to achieve the same portfolio volume. We may engage in loan participations with other banks for loans in excess of our legal lending limit. However, there can be no assurance that such participations will be available or on terms which are favorable to us and our customers.

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5) Our results of operations may be adversely affected by other-than-temporary impairment charges relating to our investment portfolio.

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

QNB Bank sold five non-performing pooled trust preferred securities, with \$2,235,000 carrying value, recording a loss on sale of \$15,000, included in non-interest income in the consolidated statement of income. As of December 31, 2017, QNB held one trust preferred security, PreTSL IV, with \$215,000 carrying value and an amortized cost of \$241,000. In 2017, PreTSL IV was reclassified from impaired to a performing asset. This security is comprised of securities issued by banks and QNB owns the senior-most obligation of the trust. Although classified as available-for-sale, the Company has the intent to hold this security and does not believe it will be required to sell before recovery occurs.

On a quarterly basis, we evaluate our debt securities for other-than-temporary impairment ("OTTI"), which involves the use of a third-party valuation firm to assist management with the valuation. When evaluating these investments, a credit related portion and a non-credit related portion of OTTI are determined. The pooled trust preferred collateralized debt obligation held by QNB are rated lower than AA and are measured for OTTI within the scope of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 325 (formerly known as EITF 99-20-1). QNB performs a discounted cash flow analysis on all of its impaired debt securities to determine if the amortized cost basis of an impaired security will be recovered. In determining whether a credit loss exists, QNB uses its best estimate of the present value of cash flows expected to be collected from the debt security and discounts them at the effective yield implicit in the security at the date of acquisition or the prospective yield for those securities with prior OTTI charges. The discounted cash flow analysis is considered to be the primary evidence when determining whether credit related other-than-temporary impairment exists. The credit related portion is recognized in earnings and represents the expected shortfall in future cash flows. The non-credit related portion is recognized in other comprehensive income and represents the difference between the book value and the fair value of the security less any current quarter credit related impairment. During 2017, 2016, and 2015, there were no charges representing the recognition of credit impairments on our investment in pooled trust preferred collateralized debt obligations.

The Company's investment in marketable equity securities primarily consists of investments in large cap stock companies. These equity securities are analyzed for impairment on an ongoing basis. As a result of prolonged declines in some equity securities' fair values, \$80,000 of other-than-temporary impairment charges were taken in 2017, \$192,000 in charges were taken in 2016 and \$55,000 in charges were taken in 2015. QNB had 11 equity securities with unrealized losses of approximately \$349,000 at December 31, 2017. The severity and duration of the impairment is consistent with current stock market developments. 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.

At December 31, 2017, the Bank had \$1,489,000 in capital stock of the FHLB. These equity securities are restricted in that they can only be sold back to the respective institutions or another member institution at par. Therefore, they are less liquid than other tradable equity securities, their fair value is equal to amortized cost, and no impairment write-downs have been recorded on these securities.



6) Our assets at December 31, 2017 included a deferred tax asset and we may not be able to realize the full benefit of that asset.

As of December 31, 2017, QNB had a net deferred tax asset of \$3,319,000. Our ability to realize these tax benefits ultimately depends on the existence of sufficient taxable income of the appropriate character (ordinary income or capital gains) within the applicable carryback and carryforward periods provided under the tax law. Estimating whether the deferred tax asset will be realized requires us to exercise significant judgment and is inherently uncertain because it requires the prediction of future occurrences. The deferred tax asset may be reduced in the future if estimates of future income, our tax planning strategies, or tax rate changes resulting from Federal tax reform do not support the amount of the deferred tax asset. If it is determined in the future that a valuation allowance of the deferred tax asset is necessary, we may incur a charge to earnings resulting and a reduction to regulatory capital for the amount included in any such allowance.

7) The effects of the Tax Cuts and Jobs Act of 2017 on our business have not yet been fully analyzed and could have an adverse effect on our net income.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Reform Act") was enacted into law. The 2017 Tax Reform Act makes significant changes to U.S. corporate income tax laws including a decrease in the corporate income tax rate from 35% to 21% effective January 1, 2018. As a result of the 2017 Tax Reform Act, the Company recorded additional tax expense of

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\$2.05 million in the fourth quarter of 2017 due to a remeasurement of the Company's deferred tax assets and liabilities. Reasonable estimates were made based on the Company's analysis of the 2017 Tax Reform Act. We have completed our accounting for the tax effects related to the re-measurement of the Company's deferred tax assets and liabilities as a result of the enactment of the Act. Additional information that may affect the Company's deferred tax assets and liabilities in the future would include further clarification and guidance on how the IRS will implement tax reform, further clarification and guidance on how state taxing authorities will implement tax reform and the related effect on the Company's state income tax returns, completion of the Company's 2017 tax return filings, and the potential for additional guidance from the SEC or the FASB related to the 2017 Tax Reform Act. The Company cannot determine at this time the full effects of the 2017 Tax Reform Act on its business and future financial results.

8) A disruption in components of our business infrastructure resulting from financial or technological difficulties of our third-party vendors on which we rely could adversely affect our business.

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

9) Our failure to properly or timely utilize effective technologies to deliver our products and services, or a systems failure or breach of network security with respect to our information systems could adversely affect our business.

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

In addition, we rely heavily on our information systems to conduct business. Maintaining and protecting those systems is difficult and expensive, as is dealing with any failure, interruption or breach in security of these systems, whether due to acts or omissions by us or by a third party and whether intentional or not. Any such failure, interruption or breach could result in failures or disruptions in our customer relationship management or our information systems. The policies, procedures and technical safeguards we have in place to prevent or limit the effect of any failure, interruption or security breach of our information systems may be insufficient to prevent or remedy the effects of any such event. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, cause us to incur additional expenses, result in losses, or subject us to regulatory sanctions or additional regulatory scrutiny, any of which could adversely affect our business, financial condition or operating results.

10) Changes in accounting standards applicable to us could materially impact how we report our financial condition and results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time the FASB changes the financial accounting and reporting standards that govern the preparation of our financial statements.

These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in our restating prior period financial statements. Management believes the current financial statements are prepared in

accordance with U.S. generally accepted accounting principles.

11) The Company is required to adopt the FASB's accounting standard which requires measurement of certain financial assets (including loans) using the current expected credit losses ("CECL") beginning in calendar year 2020.

Current GAAP requires an incurred loss methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. The FASB's amendment replaces the current incurred loss methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonableness and supportable information to inform credit loss estimates. The Company is in the process of evaluating the impact of the adoption of this guidance on the Company's financial statements; however, it is anticipated that the allowance will increase upon the adoption of CECL and that the increased allowance level will have the effect of decreasing shareholders' equity and the Company's and Bank's regulatory capital ratios.

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12) We are subject to numerous government regulations and to examination and supervision by bank regulatory agencies, which could have an adverse impact on our business and operations.

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

In response to the financial crisis that commenced in 2008, Congress has taken actions that are intended to strengthen confidence and encourage liquidity in financial institutions, and the FDIC has taken actions to increase insurance coverage on deposit accounts. The Dodd-Frank Act provides for the creation of a consumer protection division at the Federal Reserve that will have broad authority to issue regulations governing the services and products we provide consumers. This additional regulation could increase our compliance costs and otherwise adversely impact our operations. That legislation also contains provisions that resulted in higher regulatory capital requirements and, over time, could result in higher loan loss provisions for the Bank and may increase interest expense due to the ability to pay interest on all demand deposits.

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

13) We are required to pay FDIC insurance premiums, which could be increased in the future.

In order to maintain a strong funding position and restore reserve ratios of the DIF, the FDIC has increased assessment rates of insured institutions, particularly those over \$10 billion. The Company is generally unable to control the amount of premiums that the Bank is required to pay for FDIC insurance. If there are additional bank failures, or the cost of resolving prior failures exceeds expectations, the Bank may be required to pay higher FDIC premiums. Any future increases or required prepayments of FDIC insurance premiums may adversely impact the Company's earnings and financial condition.

14) Our disclosure controls and procedures and our internal control over financial reporting may not achieve their intended objectives.

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

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

detected.

15) We may not be able to attract and retain highly qualified personnel to execute our business strategy.

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

16) Acts of terrorism and other external events could impact our ability to conduct business.

Financial institutions have been, and continue to be, targets of terrorist threats aimed at compromising operating and communication systems. Such events could cause significant damage, impact the stability of our facilities and result in additional expenses, impair the ability of our borrowers to repay their loans, and result in the loss of revenue. While we have established and regularly test disaster recovery procedures, the occurrence of any such event could have a material adverse effect on our business, operations and financial condition.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The principal office of both QNB Bank and QNB Corp. is located at 15 North Third Street, Quakertown, Pennsylvania. QNB Bank conducts business from its principal office and ten other retail offices located in Bucks, Lehigh, and Montgomery Counties in Pennsylvania. QNB Bank owns its principal office, three retail locations, its operations facility and a computer facility. QNB Bank leases its remaining seven retail properties. The leases on the properties generally contain renewal options. In management’s opinion, these properties are in good condition and are currently adequate for QNB’s purposes.

The following table details QNB Bank’s properties:

Location

|  |        |
|--|--------|
| •Quakertown, PA - Downtown Office - 15 North Third Street                  | Owned  |
| •Quakertown, PA - Towne Bank Center - 320-322 West Broad Street            | Owned  |
| •Quakertown, PA - Computer Center - 121 West Broad Street                  | Owned  |
| •Quakertown, PA - Country Square Office - 240 South West End Boulevard     | Leased |
| •Quakertown, PA - Quakertown Commons Branch - 901 South West End Boulevard | Leased |
| •Dublin, PA - Dublin Branch - 161 North Main Street                        | Leased |
| •Pennsburg, PA - Pennsburg Square Branch - 410-420 Pottstown Avenue        | Leased |
| •Coopersburg, PA - Coopersburg Branch - 51 South Third Street              | Owned  |
| •Perkasie, PA - Perkasie Branch - 607 Chestnut Street                      | Owned  |
| •Souderton, PA - Souderton Branch - 750 Route 113                          | Leased |
| •Wescosville, PA - Wescosville Branch - 950 Mill Creek Road                | Leased |
| •Colmar, PA - Colmar Branch - 127 Bethlehem Pike                           | Owned  |
| •Warminster, PA – Warminster Business Office – 1410 West Street Road       | Leased |

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. MINE SAFETY DISCLOSURES

None.

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

## Stock Information

QNB common stock is quoted on the over-the-counter bulletin board ("OTCBB"). QNB had approximately 834 shareholders of record as of March 2, 2018.

The following table sets forth the high and low bid and ask stock prices for QNB common stock on a quarterly basis during 2017 and 2016. These prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

|                | High    |         | Low     |         | Cash dividend per share |
|----------------|---------|---------|---------|---------|-------------------------|
|                | Bid     | Ask     | Bid     | Ask     |                         |
| <b>2017</b>    |         |         |         |         |                         |
| First Quarter  | \$38.25 | \$38.42 | \$36.01 | \$36.25 | \$ 0.31                 |
| Second Quarter | 42.00   | 42.25   | 38.15   | 38.42   | 0.31                    |
| Third Quarter  | 40.75   | 42.40   | 40.20   | 40.30   | 0.31                    |
| Fourth Quarter | 44.35   | 44.85   | 40.55   | 40.70   | 0.31                    |
| <b>2016</b>    |         |         |         |         |                         |
| First Quarter  | \$31.25 | \$32.24 | \$29.25 | \$29.50 | \$ 0.30                 |
| Second Quarter | 32.00   | 33.50   | 29.90   | 30.40   | 0.30                    |
| Third Quarter  | 35.00   | 39.00   | 32.15   | 33.25   | 0.30                    |
| Fourth Quarter | 36.60   | 37.00   | 29.27   | 33.95   | 0.30                    |

QNB has traditionally paid quarterly cash dividends on the last Friday of each quarter. The Company expects to continue the practice of paying quarterly cash dividends to its shareholders; however, future dividends are dependent upon future earnings, financial condition, appropriate legal restrictions, and other factors relevant at the time the board of directors considers declaring a dividend. Certain laws restrict the amount of dividends that may be paid to shareholders in any given year. See "Shareholders' Equity - Capital Adequacy" included in Item 7 of this Form 10-K filing and Note 19 of the Notes to Consolidated Financial Statements included in Item 8 of this Form 10-K filing, for additional information that discusses and quantifies this regulatory restriction.

The following table provides information on repurchases by QNB of its common stock in each month of the quarter ended December 31, 2017.

| Period | Total Number of  | Average Price  | Total Number of  | Maximum     |
|--------|------------------|----------------|------------------|-------------|
|        | Shares Purchased | Paid per Share | Shares           | Number of   |
|        |                  |                | Purchased as     | Shares that |
|        |                  |                | Part of Publicly | may yet be  |



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|  |   |   | Announced | Purchased      |
|--|---|---|-----------|----------------|
|  |   |   | Plan      | Under the Plan |
| October 1, 2017 through October 31, 2017   | — | — | —         | 42,117         |
| November 1, 2017 through November 30, 2017 | — | — | —         | 42,117         |
| December 1, 2017 through December 31, 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 as of the filing of this Form 10-K.

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

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

## Stock Performance Graph

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

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

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

| Index                        | Period Ending |          |          |          |          |          |
|------------------------------|---------------|----------|----------|----------|----------|----------|
|                              | 12/31/12      | 12/31/13 | 12/31/14 | 12/31/15 | 12/31/16 | 12/31/17 |
| QNB Corp.                    | 100.00        | 112.73   | 132.40   | 152.08   | 179.22   | 229.29   |
| NASDAQ Composite Index       | 100.00        | 140.12   | 160.78   | 171.97   | 187.22   | 242.71   |
| SNL Bank \$500M-\$1B Index   | 100.00        | 129.67   | 142.26   | 160.57   | 216.81   | 264.51   |
| SNL Mid-Atlantic Bank Index  | 100.00        | 134.79   | 146.85   | 152.36   | 193.66   | 237.34   |
| SNL Bank Pink > \$500M Index | 100.00        | 121.54   | 142.47   | 158.06   | 184.29   | 230.18   |

Source : SNL Financial LC, Charlottesville, VA

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

| Year ended December 31,                              | 2017      | 2016      | 2015      | 2014      | 2013      |
|--|-----------|-----------|-----------|-----------|-----------|
| <b>Income and expense</b>                            |           |           |           |           |           |
| Interest income                                      | \$38,102  | \$33,237  | \$31,875  | \$30,670  | \$30,584  |
| Interest expense                                     | 5,680     | 4,733     | 4,506     | 4,544     | 5,033     |
| Net interest income                                  | 32,422    | 28,504    | 27,369    | 26,126    | 25,551    |
| Provision for loan losses                            | 1,400     | 30        | 200       | 400       | 400       |
| Non-interest income                                  | 6,887     | 5,667     | 6,032     | 7,542     | 5,813     |
| Non-interest expense                                 | 23,720    | 22,163    | 22,398    | 21,626    | 20,226    |
| Income before income taxes                           | 14,189    | 11,978    | 10,803    | 11,642    | 10,738    |
| Provision for income taxes                           | 5,900     | 3,054     | 2,570     | 2,644     | 2,346     |
| Net income   | \$8,289   | \$8,924   | \$8,233   | \$8,998   | \$8,392   |
| <b>Share and Per Share Data</b>                      |           |           |           |           |           |
| Net income - basic                                   | \$2.42    | \$2.64    | \$2.47    | \$2.73    | \$2.58    |
| Net income - diluted                                 | 2.41      | 2.63      | 2.46      | 2.72      | 2.57      |
| Book value   | 28.59     | 27.43     | 26.92     | 26.04     | 23.12     |
| Cash dividends                                       | 1.24      | 1.20      | 1.16      | 1.12      | 1.08      |
| Average common shares outstanding - basic            | 3,428,970 | 3,386,766 | 3,337,505 | 3,291,939 | 3,248,397 |
| Average common shares outstanding - diluted          | 3,445,811 | 3,395,839 | 3,350,539 | 3,302,574 | 3,260,075 |
| <b>Balance Sheet at Year-end</b>                     |           |           |           |           |           |
| <b>Investment securities</b>                         |           |           |           |           |           |
| Trading  | —         | \$3,596   | \$4,189   | \$4,207   | —         |
| Available-for-sale                                   | \$379,545 | 390,475   | 361,915   | 375,219   | \$388,670 |
| Held-to-maturity                                     | —         | —         | 147       | 146       | 146       |
| Restricted investment in bank stocks                 | 1,501     | 1,017     | 508       | 647       | 1,764     |
| Loans held-for-sale                                  | —         | 789       | 987       | 380       | —         |
| Loans receivable                                     | 733,283   | 633,079   | 615,270   | 555,282   | 501,716   |
| Allowance for loan losses                            | (7,841 )  | (7,394 )  | (7,554 )  | (8,001 )  | (8,925 )  |
| Other earning assets                                 | 5,538     | 1,824     | 7,832     | 7,143     | 3,569     |
| Total assets   | 1,152,337 | 1,063,141 | 1,020,936 | 977,135   | 932,883   |
| Deposits   | 993,948   | 913,355   | 889,786   | 851,592   | 814,532   |
| Borrowed funds                                       | 55,756    | 52,660    | 37,163    | 35,189    | 40,156    |
| Shareholders' equity                                 | 98,570    | 93,567    | 90,443    | 86,354    | 75,625    |
| <b>Selected Financial Ratios</b>                     |           |           |           |           |           |
| Net interest margin                                  | 3.14      | % 3.03    | % 3.05    | % 3.07    | % 3.09    |
| Net income as a percentage of:                       |           |           |           |           |           |
| Average total assets                                 | 0.74      | 0.87      | 0.83      | 0.95      | 0.91      |
| Average shareholders' equity                         | 8.17      | 9.45      | 9.29      | 10.89     | 10.95     |
| Average shareholders' equity to average total assets | 9.09      | 9.16      | 8.97      | 8.72      | 8.30      |
| Dividend payout ratio                                | 51.31     | 45.56     | 47.03     | 40.99     | 41.81     |



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

Results of Operations – Overview

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

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

Net income for the year ended December 31, 2017 was \$8,289,000, or \$2.41 per share on a diluted basis. This compares to 2016 net income of \$8,924,000, or \$2.63 per share on a diluted basis and 2015 net income of \$8,233,000, or \$2.46 per share on a diluted basis. Two important measures of profitability in the banking industry are an institution’s return on average assets and return on average shareholders’ equity. Return on average assets was 0.74%, 0.87% and 0.83% in 2017, 2016, and 2015, respectively, and return on average shareholders’ equity was 8.17%, 9.45% and 9.29%, respectively, during those same periods.

2017 versus 2016

The results for 2017 include the following significant components:

• Net interest income increased \$3,918,000, or 13.8%, to \$32,422,000 for 2017.

• The net interest margin on a tax-equivalent basis increased 11 basis points to 3.14% for 2017 from 3.03% for 2016.

• Provision for loan losses totaled \$1,400,000 for 2017, compared with \$30,000 for 2016.

• Non-interest income for 2017 was \$6,887,000, an increase of \$1,220,000, or 21.5%, compared with 2016. Non-interest expense for 2017 was \$23,720,000, an increase of \$1,557,000, or 7.0%, compared with 2016.

• Provision for income taxes included a \$2,054,000 charge related to deferred tax asset revaluation due to tax reform lowering the federal corporate income tax rate to 21%.

• Loans receivable grew \$100,204,000, or 15.8%, from December 31, 2016. Deposits increased \$80,593,000, or 8.8%, from December 31, 2016.

• 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 \$9,242,000, or 1.26% of total loans at December 31, 2017, compared with \$11,938,000, or 1.89% of total loans at December 31, 2016. Loans on non-accrual status were \$7,921,000 at December 31, 2017 compared with \$10,119,000 at December 31, 2016. Net charge-offs for 2017 were \$953,000, or 0.14% of average total loans, as compared with \$190,000, or 0.03% of average total loans for 2016. 2016 versus 2015

The results for 2016 include the following significant components:

• Net interest income increased \$1,135,000, or 4.1%, to \$28,504,000 for 2016.

• The net interest margin on a tax-equivalent basis decreased two basis points to 3.03% for 2016 from 3.05% for 2015.

• Provision for loan losses totaled \$30,000 for 2016, compared with \$200,000 for 2015.

• Non-interest income for 2016 was \$5,667,000, a decrease of \$365,000, or 6.1%, compared with 2015. Non-interest expense for 2016 was \$22,163,000, a decrease of \$235,000, or 1.0%, compared with 2015.

• Loans receivable grew \$17,809,000, or 2.9%, from December 31, 2015. Deposits increased \$23,569,000, or 2.6%, from December 31, 2015.

• 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 \$11,938,000, or 1.89% of total loans at December 31, 2016, compared with \$10,719,000, or 1.74% of total loans at December 31, 2015. Loans on non-accrual status were \$10,119,000 at December 31, 2016 compared with \$9,420,000 at December 31, 2015. Net charge-offs for 2016 were \$190,000, or 0.03% of average total loans, as compared with \$647,000, or 0.11% of average total loans for 2015.

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

### Net Interest Income

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the years ended December 31, 2017, 2016, and 2015.

| Year ended December 31,                    | 2017     | 2016     | 2015     |
|--|----------|----------|----------|
| Total interest income                      | \$38,102 | \$33,237 | \$31,875 |
| Total interest expense                     | \$5,680  | 4,733    | 4,506    |
| Net interest income                        | 32,422   | 28,504   | 27,369   |
| Tax-equivalent adjustment                  | 1,582    | 1,641    | 1,785    |
| Net interest income (tax-equivalent basis) | \$34,004 | \$30,145 | \$29,154 |

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 and interest bearing balances at the Federal Reserve Bank (Fed). Sources used to fund these assets include deposits and borrowed funds. Net interest income is affected by changes in interest rates, the volume and mix of earning assets and interest-bearing liabilities, and the amount of earning assets funded by non-interest bearing deposits.

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

The net interest rate spread is the difference between average rates received on earning assets and average rates paid on interest-bearing liabilities, while the net interest margin, which includes interest-free sources of funds, is net interest income expressed as a percentage of average interest-earning assets. The Asset/Liability and Investment Management Committee works to manage and maximize the net interest margin for the Company.

### 2017 versus 2016

On a tax-equivalent basis, net interest income for 2017 increased \$3,859,000, or 12.8%, to \$34,004,000. The net interest margin, which increased to 3.14% was favorably impacted by a \$59,846,000 increase in average commercial real estate loans and a 12 basis point increase in the related yield and a \$17,451,000 increase in average commercial and industrial loans and a 38 basis point increase in the related yield. The average rate earned on earning assets increased 17 basis points from 3.50% for 2016 to 3.67% for 2017 with the yield on loans increasing 13 basis points while the yield on investment securities declined slightly to 2.39%. In comparison, the interest rate paid on total average interest-bearing liabilities increased seven basis points from 0.57% for 2016 to 0.64% for 2017 with the average rate paid on interest-bearing deposits increasing from 0.58% to 0.65% for the same time periods, respectively, and a \$55,717,000 increase in average interest-bearing deposits.



Market disruption caused by local bank consolidation positively impacted both loan and deposit growth which was partially offset by the competitive local interest rate market for quality loans and deposits. Net interest spread increased ten basis points to 3.03% for 2017 compared to 2.93% for 2016. Average earning assets increased by \$86,590,000, or 8.7%, to \$1,082,436,000 for 2017, with average loans increasing \$77,442,000, or 12.8%, to \$682,482,000, while average investment securities increased \$32,379,000, or 9.0%, to \$391,689,000. With the growth in earning assets occurring primarily in the loan portfolio, the mix of earning assets changed, which also contributed to relative stability of the net interest margin, as investment securities generally earn a lower yield than loans. The growth in earning assets was funded by a \$69,957,000, or 7.8%, increase in average total deposits to \$962,498,000, and the increase in average short-term borrowing, primarily sweep accounts structured as repurchase agreements with our commercial customers, of \$8,472,000, or 21.1%.

On December 22, 2017, the Tax Cuts and Jobs Act (the “2017 Tax Reform Act”) was signed into law, reducing the federal corporate income tax rate from 34% to 21% effective January 1, 2018. This reduction in the tax rate will impact the tax-equivalent yield on certain interest-earning assets. Had the 2017 Tax Reform Act been in effect in 2017, the impact would have resulted in a reduction to the interest margin of approximately seven basis points.

#### 2016 versus 2015

On a tax-equivalent basis, net interest income for 2016 increased \$991,000, or 3.4%, to \$30,145,000. The net interest margin, which declined to 3.03% was negatively impacted by declining yields on earning assets resulting from the prolonged low interest rate

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environment. The average rate earned on earning assets declined three basis points from 3.53% for 2015 to 3.50% for 2016 with the yield on loans declining by five basis points while the yield on investment securities remained steady at 2.42%. In comparison, the interest rate paid on total average interest-bearing liabilities increased by one basis point from 0.56% for 2015 to 0.57% for 2016 with the average rate paid on interest-bearing deposits increasing from 0.57% to 0.58% for the same time periods, respectively.

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

|   | 2017               |                 |          | 2016               |                 |          | 2015               |                 |          |
|---|--------------------|-----------------|----------|--------------------|-----------------|----------|--------------------|-----------------|----------|
|   | Average<br>balance | Average<br>rate | Interest | Average<br>balance | Average<br>rate | Interest | Average<br>balance | Average<br>rate | Interest |
| <b>Assets</b>                                     |                    |                 |          |                    |                 |          |                    |                 |          |
| Trading securities                                | \$1,187            | 5.73 %          | \$68     | \$3,896            | 5.37 %          | \$209    | \$4,054            | 6.09 %          | \$247    |
| <b>Investment securities<br/>(AFS &amp; HTM):</b> |                    |                 |          |                    |                 |          |                    |                 |          |
| <b>U.S. Government</b>                            |                    |                 |          |                    |                 |          |                    |                 |          |
| agencies  | 74,143             | 1.78            | 1,319    | 61,376             | 1.83            | 1,126    | 52,572             | 1.62            | 850      |
| State and municipal                               | 75,906             | 3.91            | 2,966    | 73,121             | 4.04            | 2,954    | 73,482             | 4.14            | 3,043    |
| <b>Mortgage-backed<br/>and CMOs</b>               |                    |                 |          |                    |                 |          |                    |                 |          |
| Pooled trust                                      | 223,715            | 2.05            | 4,583    | 202,279            | 1.98            | 4,005    | 207,549            | 1.97            | 4,098    |
| preferred   | 1,548              | 1.45            | 22       | 3,141              | 0.23            | 7        | 3,484              | 0.33            | 11       |
| Corporate debt                                    | 8,062              | 2.01            | 162      | 8,051              | 1.79            | 144      | 6,542              | 1.24            | 81       |
| Equities  | 7,128              | 3.49            | 249      | 7,446              | 3.13            | 233      | 7,290              | 3.35            | 244      |
| Total investment securities                       | 390,502            | 2.38            | 9,301    | 355,414            | 2.38            | 8,469    | 350,919            | 2.37            | 8,327    |
| <b>Loans:</b>                                     |                    |                 |          |                    |                 |          |                    |                 |          |
| Commercial real estate                            | 393,504            | 4.55            | 17,909   | 333,658            | 4.43            | 14,767   | 296,272            | 4.51            | 13,364   |
| Residential real estate                           | 51,242             | 3.89            | 1,996    | 45,233             | 3.89            | 1,759    | 39,575             | 4.09            | 1,618    |
| Home equity loans                                 | 66,578             | 3.86            | 2,567    | 63,439             | 3.68            | 2,337    | 59,079             | 3.59            | 2,120    |
| Commercial and industrial                         | 128,841            | 4.64            | 5,984    | 111,390            | 4.26            | 4,749    | 122,294            | 4.14            | 5,061    |
| Indirect lease financing                          | —                  | 0.00            | —        | 7,969              | 8.80            | 702      | 9,136              | 8.95            | 818      |
| Consumer loans                                    | 6,575              | 5.39            | 355      | 4,713              | 5.20            | 245      | 4,034              | 5.37            | 216      |
| Tax-exempt loans                                  | 35,742             | 3.95            | 1,410    | 38,638             | 3.80            | 1,468    | 43,949             | 4.00            | 1,758    |
| Total loans, net of unearned income*              | 682,482            | 4.43            | 30,221   | 605,040            | 4.30            | 26,027   | 574,339            | 4.35            | 24,955   |
| Other earning assets                              | 8,265              | 1.13            | 94       | 31,496             | 0.55            | 173      | 25,269             | 0.52            | 131      |
| Total earning assets                              | 1,082,436          | 3.67            | 39,684   | 995,846            | 3.50            | 34,878   | 954,581            | 3.53            | 33,660   |
| Cash and due from banks                           | 13,366             |                 |          | 14,243             |                 |          | 12,063             |                 |          |
| Allowance for loan losses                         | (7,858 )           |                 |          | (7,583 )           |                 |          | (7,860 )           |                 |          |
| Other assets                                      | 29,219             |                 |          | 28,692             |                 |          | 29,110             |                 |          |

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|  |             |        |          |             |        |          |           |        |          |
|--|-------------|--------|----------|-------------|--------|----------|-----------|--------|----------|
| Total assets                               | \$1,117,163 |        |          | \$1,031,198 |        |          | \$987,894 |        |          |
| Liabilities and Shareholders' Equity       |             |        |          |             |        |          |           |        |          |
| Interest-bearing deposits:                 |             |        |          |             |        |          |           |        |          |
| Interest-bearing                           |             |        |          |             |        |          |           |        |          |
| demand                                     | \$169,940   | 0.21 % | \$353    | \$153,598   | 0.21 % | \$315    | \$134,342 | 0.21 % | \$289    |
| Municipals                                 | 110,052     | 0.71   | 784      | 102,060     | 0.34   | 351      | 115,975   | 0.34   | 389      |
| Money market                               | 84,203      | 0.30   | 249      | 71,256      | 0.27   | 192      | 65,413    | 0.24   | 158      |
| Savings                                    | 249,894     | 0.46   | 1,156    | 229,779     | 0.40   | 923      | 217,561   | 0.37   | 806      |
| Time                                       | 128,603     | 1.18   | 1,512    | 133,407     | 1.12   | 1,497    | 141,869   | 1.09   | 1,548    |
| Time of \$100,000 or more                  | 97,987      | 1.40   | 1,373    | 94,862      | 1.37   | 1,301    | 92,495    | 1.30   | 1,199    |
| Total interest-bearing deposits            | 840,679     | 0.65   | 5,427    | 784,962     | 0.58   | 4,579    | 767,655   | 0.57   | 4,389    |
| Short-term borrowings                      | 48,672      | 0.52   | 253      | 40,200      | 0.38   | 154      | 31,911    | 0.37   | 117      |
| Total interest-bearing liabilities         | 889,351     | 0.64   | 5,680    | 825,162     | 0.57   | 4,733    | 799,566   | 0.56   | 4,506    |
| Non-interest-bearing deposits              | 121,819     |        |          | 107,579     |        |          | 96,146    |        |          |
| Other liabilities                          | 4,497       |        |          | 3,985       |        |          | 3,540     |        |          |
| Shareholders' equity                       | 101,496     |        |          | 94,472      |        |          | 88,642    |        |          |
| Total liabilities and shareholders' equity | \$1,117,163 |        |          | \$1,031,198 |        |          | \$987,894 |        |          |
| Net interest rate spread                   |             | 3.03 % |          |             | 2.93 % |          |           | 2.97 % |          |
| Margin/net interest income                 |             | 3.14 % | \$34,004 |             | 3.03 % | \$30,145 |           | 3.05 % | \$29,154 |

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

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

\* Includes loans held-for-sale

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

|   | 2017 vs. 2016 |        |              | 2016 vs. 2015 |          |              |
|---|---------------|--------|--------------|---------------|----------|--------------|
|   | Due to change |        | Total Change | Due to change |          | Total Change |
|   | in: Volume    | Rate   |              | in: Volume    | Rate     |              |
| <b>Interest income:</b>                       |               |        |              |               |          |              |
| Trading securities                            | \$(145 )      | \$4    | \$(141 )     | \$(10 )       | \$(28 )  | \$(38 )      |
| <b>Investment securities (AFS &amp; HTM):</b> |               |        |              |               |          |              |
| U.S. Government agencies                      | 234           | (41 )  | 193          | 142           | 134      | 276          |
| State and municipal                           | 113           | (101 ) | 12           | (15 )         | (74 )    | (89 )        |
| Mortgage-backed and CMOs                      | 425           | 153    | 578          | (105 )        | 12       | (93 )        |
| Pooled trust preferred                        | (4 )          | 19     | 15           | (1 )          | (3 )     | (4 )         |
| Corporate debt                                | —             | 18     | 18           | 19            | 44       | 63           |
| Equities                                      | (10 )         | 26     | 16           | 5             | (16 )    | (11 )        |
| Total investment securities (AFS & HTM)       | 758           | 74     | 832          | 45            | 97       | 142          |
| <b>Loans:</b>                                 |               |        |              |               |          |              |
| Commercial real estate                        | 2,650         | 492    | 3,142        | 1,686         | (283 )   | 1,403        |
| Residential real estate                       | 233           | 4      | 237          | 232           | (91 )    | 141          |
| Home equity loans                             | 115           | 115    | 230          | 157           | 60       | 217          |
| Commercial and industrial                     | 744           | 491    | 1,235        | (451 )        | 139      | (312 )       |
| Indirect lease financing                      | (702 )        | —      | (702 )       | (104 )        | (12 )    | (116 )       |
| Consumer loans                                | 98            | 12     | 110          | 37            | (8 )     | 29           |
| Tax-exempt loans                              | (111 )        | 53     | (58 )        | (212 )        | (78 )    | (290 )       |
| Total loans                                   | 3,027         | 1,167  | 4,194        | 1,345         | (273 )   | 1,072        |
| Other earning assets                          | (127 )        | 48     | (79 )        | 31            | 11       | 42           |
| Total interest income                         | 3,513         | 1,293  | 4,806        | 1,411         | (193 )   | 1,218        |
| <b>Interest expense:</b>                      |               |        |              |               |          |              |
| Interest-bearing demand                       | 34            | 4      | 38           | 41            | (15 )    | 26           |
| Municipals                                    | 27            | 406    | 433          | (47 )         | 9        | (38 )        |
| Money market                                  | 35            | 22     | 57           | 15            | 19       | 34           |
| Savings                                       | 81            | 152    | 233          | 45            | 72       | 117          |
| Time  | (53 )         | 68     | 15           | (93 )         | 42       | (51 )        |
| Time of \$100,000 or more                     | 42            | 30     | 72           | 31            | 71       | 102          |
| Total interest-bearing deposits               | 166           | 682    | 848          | (8 )          | 198      | 190          |
| Short-term borrowings                         | 33            | 66     | 99           | 31            | 6        | 37           |
| Total interest expense                        | 199           | 748    | 947          | 23            | 204      | 227          |
| Net interest income                           | \$3,314       | \$545  | \$3,859      | \$1,388       | \$(397 ) | \$991        |

(1) Loan fees have been included in the change in interest income totals presented. Non-accrual loans and investment securities have been included in average balances.

(2) Changes due to both volume and rates have been allocated in proportion to the relationship of the dollar amount change in each.

(3) Interest income on loans and securities is presented on a tax-equivalent basis.

The Rate-Volume Analysis 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 \$4,806,000 to \$39,684,000 for 2017, while total interest expense increased \$947,000 to \$5,680,000. Volume growth in earning assets contributed an additional \$3,513,000 of interest income and interest rate increases contributed to additional interest income of \$1,293,000. Rate-related interest expense increased \$748,000, while volume-related interest expense increased \$199,000.

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## Investments

## 2017 versus 2016

Interest income on trading, available-for-sale, and held-to-maturity investment securities increased \$691,000 when comparing the two years. The increase in average balances contributed to \$613,000 of the increase, while better rates contributed the remaining \$78,000 increase. The average yield on the investment portfolio declined slightly to 2.39% for 2017 compared to 2.42% for 2016. The increase in the investment portfolio is due to investment opportunities at a yield comparable to the overall portfolio yield in late 2016 compared with previous periods, as well as continuing increase in deposits.

Income on U.S. Government agency securities increased \$193,000, due to an increase in average balances totaling \$12,767,000, which was offset by a decline in the yield on the portfolio of five basis points from 1.83% for 2016 to 1.78% for 2017. Most of the bonds in the agency portfolio have call features ranging from three months to three years, many of which were not exercised during 2017 as a result of the rising rates during the year.

Interest income on tax-exempt municipal securities increased \$12,000. Average balances, which increased \$2,785,000, contributed \$113,000 to interest income. This was partially offset by a 13-basis point decline in yield from 4.04% in 2016 to 3.91% in 2017 contributing to a \$101,000 reduction in interest income. QNB had purchased many municipal securities when rates were significantly higher. Many of these bonds have either reached maturity or their call dates and are being replaced with municipal bonds with lower yields. Typically, QNB purchased municipal bonds with 10 to 15 year maturities with call dates between 2 and 5 years. Under the 2017 Tax Reform Act, private activity bonds will maintain their tax-exempt status. Had the 2017 Tax Reform Act been in effect in 2017, the impact would have resulted in a reduction to the yield on municipal bonds of approximately 65 basis points. Future demand for tax-exempt municipal securities is uncertain, as the tax-equivalent yield is less favorable compared to other securities with similar risk-based capital asset-weighting characteristics. This portfolio is expected to continue to decline as there are \$25,154,000 in municipal bonds with a 2017 tax-equivalent yield of 4.66% that are expected to be called or mature in 2018. The current yield on replacement bonds is well below this threshold.

All the mortgage-backed and collateralized mortgage obligations (“CMO”) securities owned by QNB are issued by U.S. Government agencies and sponsored enterprises (“GSE”) and carry the implicit backing of the U.S. Government, but they are not direct obligations of the U.S. Government. Interest income on mortgage-backed securities and CMOs increased \$578,000 primarily due to an increase of \$21,436,000, or 10.6%, in average balances. The yield on the mortgage-backed and CMO portfolio improved by seven basis points from 1.98% for 2016 to 2.05% for 2017. 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 as interest rates increase.

## 2016 versus 2015

Interest income on trading, available-for-sale, and held-to-maturity investment securities increased \$104,000 when comparing the two years. The increase in average balances contributed to \$35,000 of the increase, while better rates contributed the remaining \$69,000 increase. The average yield on the investment portfolio was 2.42% for both 2015 and 2016. The increase in the investment portfolio is due to investment opportunities at a yield comparable to the overall portfolio yield in late 2016 compared with previous periods, as well as continuing increase in deposits.

Income on U.S. Government agency securities increased \$276,000, due to an increase in average balances totaling \$8,804,000. The yield on the portfolio increased by 21 basis points from 1.62% for 2015 to 1.83% for 2016, as investments in this sector had better yields than previously available.

Interest income on tax-exempt municipal securities decreased \$89,000. Average balances, which declined \$361,000, contributed \$15,000 to the decrease in interest income and the ten-basis point decline in yield from 4.14% in 2015 to 4.04% in 2016 contributed the remaining \$74,000 reduction in interest income.

Interest income on mortgage-backed securities and CMOs decreased \$93,000 primarily due to a decrease of \$5,270,000, or 2.5%, in average balances. The yield on the mortgage-backed and CMO portfolio improved by one basis point from 1.97% for 2015 to 1.98% for 2016.

## Loans

### 2017 versus 2016

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 or investment properties. The category also includes construction

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and land development loans. Income on commercial real estate loans increased \$3,142,000. The increase in average balances of \$59,846,000, or 17.9%, contributed an increase in interest income of \$2,650,000. The 12-basis point increase in yield, from 4.43% in 2016 to 4.55% in 2017 resulted in an increase of interest income of \$492,000.

Income on commercial and industrial loans, the second largest category, increased \$1,235,000 with the positive impact from an increase in yield and average balances. Average commercial and industrial loans increased \$17,451,000, or 15.7%, to \$128,841,000 for 2017, resulting in a \$744,000 increase in interest income. Average yield on these loans increased 38 basis points to 4.64% providing an additional \$491,000 in interest income. 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 December 2016.

Tax-exempt loan income decreased \$58,000 from 2016. When comparing the same periods, average balances decreased \$2,896,000 to \$35,742,000, which contributed a \$111,000 decrease in interest income. This decrease was partially offset by an increase in the average yield on the tax-exempt loan portfolio from 3.80% for 2016 to 3.95% for 2017, resulting in additional interest income of \$53,000. Had the 2017 Tax Reform Act been in effect in 2017, the impact would have resulted in a reduction to the yield on municipal bonds of approximately 65 basis points.

Indirect lease financing receivables represent loans to small businesses that are collateralized by equipment. In October 2016, the Company sold its interest in these third-party originated finance contracts. Due to this sale, there was a decrease in interest income of \$702,000 in 2017.

QNB strives to become the “local consumer lender of choice”, and to affect this goal, QNB has refocused its retail lending efforts by strengthening the management of the area, adding new product offerings and by increasing marketing and promotion. The positive impact of this renewed focus has been year-over-year growth in balances in all three categories of retail lending: residential mortgage, home equity and consumer loans. Overall, interest income for retail lending increased \$577,000 in 2017 compared with 2016, driven by the increase in average balances.

Income on home equity loans increased by \$230,000 when comparing 2017 and 2016. During 2017 and 2016, QNB offered attractive rates on both variable rate and fixed rate home equity loans, which contributed to an increase in average balances totaling \$3,139,000, or 4.9%, to \$66,578,000 when comparing 2017 and 2016. The yield on the home equity portfolio increased 18 basis points to 3.86% when comparing the two years. The demand for home equity loans has improved along with the recovery in home values. We expect that the demand for home equity loans will continue.

Given the low yields on alternative investment securities, QNB retained certain hybrid adjustable rate mortgages to borrowers with high credit scores and low loan-to-value ratios. As a result, average residential mortgage loans secured by first lien 1-4 family residential mortgages increased by \$6,009,000, or 13.3%, to \$51,242,000 for 2017. The average yield on the residential real estate portfolio remained level at 3.89% for 2017 and 2016. Overall, interest income for this segment grew \$237,000 in 2017.

Interest income on consumer loans increased \$110,000. As with all other categories of retail loans, consumer loans at QNB experienced growth in average balances in 2017, led by student loan average balances, which increased \$1,663,000, or 90%. Growth in volume contributed \$98,000 to the increase in income, and the 19-basis point increase in the average yield from 5.20% in 2016 to 5.39% in 2017 contributed to an increase in interest income of \$12,000.

#### 2016 versus 2015

Income on commercial real estate loans increased \$1,403,000. The increase in average balances of \$37,386,000, or 12.6%, contributed an increase in interest income of \$1,686,000. This was offset in part by an eight-basis point decline in yield, from 4.51% in 2015 to 4.43% in 2016, which resulted in a decrease of interest income of \$283,000.



Income on commercial and industrial loans decreased \$312,000 with the positive impact from an increase in yield offset by a decrease in average balances. Average commercial and industrial loans decreased \$10,904,000, or 8.9%, to \$111,390,000 for 2016, resulting in a \$451,000 decrease in interest income. Average yield on these loans increased 12 basis points to 4.26%, providing an additional \$139,000 in interest income.

Tax-exempt loan income decreased \$290,000 from 2015. When comparing the same periods, average balances decreased \$5,311,000 to \$38,638,000, which contributed a \$212,000 decrease in interest income. The average yield on the tax-exempt loan portfolio has declined from 4.00% for 2015 to 3.80% for 2016, resulting in decreased interest income of \$78,000.

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. In October 2016, the Company sold its interest in these third-party originated finance contracts, recording a loss on sale of \$223,000, which was essentially offset by a \$220,000 reversal of the

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allowance for loan losses associated with this portfolio. The third party who had originated the leases and acted as primary servicer of the portfolio had recently sold his company and QNB did not have staff with the expertise needed to continue to service this portfolio, nor the ability to effectively repossess and resell equipment in case of borrower default. Therefore, based on management's recommendation, QNB's Board of Directors approved the sale of this portfolio in its entirety.

Interest income for retail lending increased \$387,000 in 2016 compared with 2015, driven by the increase in average balances. Income on home equity loans increased by \$217,000 when comparing 2016 and 2015. Average balances increased \$4,360,000, or 7.4%, to \$63,439,000 when comparing 2016 and 2015. The yield on the home equity portfolio increased nine basis points to 3.68% when comparing the two years.

Average residential mortgage loans secured by first lien 1-4 family residential mortgages increased by \$5,658,000, or 14.3%, to \$45,233,000 for 2016. The average yield on the residential real estate portfolio decreased by 20 basis points to 3.89% for 2016. Overall, interest income for this segment grew \$141,000 in 2016.

Interest income on consumer loans increased \$29,000. Growth in average balances in 2016 in this segment increased \$679,000. This growth in volume contributed \$37,000 to the increase in income, while a decline in yield from 5.37% in 2015 to 5.20% offset the volume increase by \$8,000.

#### Deposits and Borrowings

##### 2017 versus 2016

Earning assets are funded primarily by deposits, which increased on average by \$69,957,000, or 7.8%, to \$962,498,000, when comparing 2017 and 2016. Total interest expense for 2017 was \$5,680,000 compared with \$4,733,000 for 2016, an increase of \$947,000. Interest expense on total deposits increased \$848,000 and interest expense on borrowed funds increased \$99,000 when comparing the two years. The rate paid on both interest-bearing deposits and interest-bearing liabilities increased seven basis points; the rate paid on borrowings increased 14 basis points, when comparing the two periods. Deposit and borrowing costs are expected to increase as short-term interest rates begin to rise and the competition for deposits increases.

Consistent with the past several years, the growth in deposits during 2017 was centered in accounts with greater liquidity, including non-interest and interest-bearing demand, money market accounts, and savings deposits. Average non-interest-bearing demand accounts increased \$14,240,000, or 13.2%, to \$121,819,000 for 2017. QNB has been successful in increasing business checking accounts as average balances in these accounts increased by \$11,707,000, or 13.5%, when comparing the two years. Average interest-bearing demand accounts increased \$16,342,000, or 10.6%, to \$169,940,000 for 2017 compared with 2016, with interest expense on interest-bearing demand accounts increasing \$38,000 to \$353,000 for 2017. The average rate paid remained unchanged at 0.21% for 2016 and 2017. Included in this category is QNB-Rewards checking, a tiered-rate checking account product. 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. If these qualifications are not met, the rate paid for 2016 and 2017 was 0.15%. For 2017, the average balance in this product was \$50,907,000 and the related interest expense was \$281,000 for an average cost of funds of 0.55%. In comparison, the average balance of the QNB-Rewards accounts for 2016 was \$44,918,000, yielding 0.56%. The rates paid on the QNB-Rewards product, assuming qualifications are met, is still attractive relative to competitors' offerings as well as other QNB products. This product also generates fee income through the use of the check card. The average balance of other interest-bearing demand accounts included in this category increased from \$108,680,000 for 2016 to \$119,033,000 for 2017. The average rate paid on these balances was 0.06% for both years.

Average money market accounts increased \$12,947,000, or 18.2%, to \$84,203,000 for 2017 compared with 2016. The increase in money market balances is a result of a shift in balances to more liquid accounts. Interest expense on money

market accounts increased \$57,000 to \$249,000 for 2017 compared with 2016. The average interest rate paid on money market accounts was 0.30% for 2017, an increase of three basis points compared with 2016. The balances in this category primarily comprise Select money market accounts, a product that pays a tiered rate based on account balances. With the continuation of low short-term interest rates, balances remaining in these accounts for 2017 were at higher-yielding tiers.

Interest expense on municipal interest-bearing demand accounts increased \$433,000 to \$784,000 for 2017. The average balance of municipal interest-bearing demand accounts increased \$7,992,000, or 7.8%, to \$110,052,000 and the average interest rate paid on these accounts increased 37 basis points to 0.71% for 2017 from 0.34% for 2016. Most of these accounts are indexed to the Federal funds rate with negotiated rate floors between 0.25% and 0.50%. Many of these deposits are seasonal in nature and are received during the third quarter as tax receipts are collected and are withdrawn over the course of the next year.

QNB's online e-Savings product is the largest category of savings deposits and was created to compete with other online savings accounts. Average balances grew \$13,503,000, or 8.0%, to \$181,863,000 in 2017 compared with \$168,360,000 in 2016. The rate on this product was changed from 0.55% at the end of 2016 to 0.60% in June 2017 and to 0.65% in late December 2017. The average cost of funds on these accounts was 0.50% for 2016 and 0.58% for 2017. The yield on this account may rise along with market rates

and as competition for savings balances increases. Traditional statement savings accounts and club accounts are also included in the savings category and increased on average by \$6,612,000, or 10.8%, to \$68,031,000. The average rate paid on total savings accounts was 0.46% for 2017, a six-basis point increase from 2016 while interest expense increased \$233,000, from \$923,000 to \$1,156,000 over the same period. The growth in balances appears to reflect the desire for liquidity and a better rate than short-term time deposits.

Interest expense on time deposits increased \$87,000, to \$2,885,000 in 2017, due to a four-basis point increase in yield, from 1.23% in 2016 to 1.27% in 2017. This increase was partially offset by a decrease in average balances of \$1,679,000 in 2017, to \$226,590,000. Similar to fixed-rate loans and investment securities, time deposits reprice over time and, therefore, have less of an immediate impact on costs in either a rising or falling rate environment. Unlike loans and investment securities, however, the maturity and repricing characteristics of time deposits tend to be shorter.

Time deposits at December 31, 2017 that will reprice or mature over the next 12 months includes \$250,000 in time deposits issued through 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. The average rate paid on these CDARS time deposits was 1.35%. Approximately \$95,940,000, or 42.6%, in time deposits issued by QNB will reprice or mature over the next 12 months compared with 42.5% of the portfolio at December 31, 2016. The average rate paid on these time deposits is approximately 0.83%. QNB has been attempting to extend the maturity of the time deposit portfolio by offering attractive rates at terms 36 months or greater, with moderate success. Given the short-term nature of these deposits, interest expense could increase if short-term time deposit rates were to increase suddenly or if customers select higher paying longer term time deposits.

Short-term borrowings are comprised of sweep accounts structured as repurchase agreements with our commercial customers and overnight borrowings from correspondent banks with average balances in 2017 of \$39,301,000 and \$9,371,000, respectively. Interest expense on short-term borrowings increased by \$99,000 to \$253,000 when comparing the two years. During this period average balances increased \$8,472,000 to \$48,672,000, and the average rate paid increased 14 basis points, from 0.38% to 0.52%.

#### 2016 versus 2015

Total interest expense for 2016 was \$4,733,000 compared with \$4,506,000 for 2015, an increase of \$227,000. Interest expense on total deposits increased \$190,000 and interest expense on borrowed funds increased \$37,000 when comparing the two years. The rate paid on both interest-bearing deposits and interest-bearing liabilities increased one basis point, when comparing the two periods. Deposit and borrowing yields are expected to increase as short-term interest rates begin to rise and the competition for deposits increases.

Average non-interest-bearing demand accounts increased \$11,433,000, or 11.9%, to \$107,579,000 for 2016. Business checking accounts average balances increased by \$10,336,000, or 13.5%, when comparing the two years. Average interest-bearing demand accounts increased \$19,256,000, or 14.3%, to \$153,598,000 for 2016 compared with 2015, with interest expense on interest-bearing demand accounts increasing \$26,000 to \$315,000 for 2016. The average rate paid remained unchanged at 0.21% for 2015 and 2016. The average balance in QNB-Rewards checking was \$44,918,000 and the related interest expense was \$249,000 for an average cost of funds of 0.56%. In comparison, the average balance of the QNB-Rewards accounts for 2015 was \$39,967,000 yielding 0.58%. The average balance of other interest-bearing demand accounts included in this category increased from \$94,375,000 for 2015 to \$108,680,000 for 2016. The average rate paid on these balances was 0.06% for both years.

Average money market accounts increased \$5,843,000, or 8.9%, to \$71,256,000 for 2016 compared with 2015. Interest expense on money market accounts increased \$34,000 to \$192,000 for 2016 compared with 2015. The average interest rate paid on money market accounts was 0.27% for 2016, an increase of three basis points compared

with 2015.

Interest expense on municipal interest-bearing demand accounts decreased \$38,000 to \$351,000 for 2016. The average balance of municipal interest-bearing demand accounts decreased \$13,915,000, or 12.0%, to \$102,060,000, while the average interest rate paid on these accounts was 0.34% for both 2016 and 2015.

Online eSavings account average balances grew \$7,579,000, or 4.7%, to \$168,360,000 in 2016 compared with \$160,781,000 in 2015. The rate on this product was 0.50% during 2015 and was changed to 0.55% in late December 2016. The average cost of funds on these accounts was 0.46% for 2015 and 0.50% for 2016. Traditional statement savings accounts and club accounts are also included in the savings category and increased on average by \$4,639,000, or 8.2%, to \$61,419,000. The average rate paid on total savings accounts was 0.40% for 2016, a three-basis point increase from 2015 while interest expense increased \$117,000, from \$806,000 to \$923,000 over the same period.

Interest expense on time deposits increased \$51,000, to \$2,798,000 in 2016, due to a six-basis point increase in yield, from 1.17% in 2015 to 1.23% in 2016. This increase was partially offset by a decrease in average balances of \$6,095,000 in 2016, to \$228,269,000.

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Short-term borrowings are comprised of sweep accounts structured as repurchase agreements with our commercial customers and overnight borrowings from correspondent banks with average balances in 2016 of \$38,835,000 and \$1,365,000, respectively. Interest expense on short-term borrowings increased by \$37,000 to \$154,000 when comparing the two years. During this period, average balances increased \$8,289,000 to \$40,200,000 while the average rate paid increased one basis point, from 0.37% to 0.38%.

#### Provision for Loan Losses

The provision for loan losses represents management's determination of the amount necessary to be charged to operations to bring the allowance for loan losses to a level that represents management's best estimate of the known and inherent losses in the existing loan portfolio. QNB recorded a provision for loan losses of \$1,400,000, \$30,000 and \$200,000 for the twelve-month periods ended December 31, 2017, 2016 and 2015, respectively. Excluding the \$220,000 reversal in allowance for loan losses associated with the sale of the indirect lease finance portfolio, the 2016 provision would have been \$250,000. Net loan charge-offs were \$953,000, or 0.14% of total average loans for 2017 compared with \$190,000, or 0.03% of total average loans in 2016 and \$647,000, or 0.11%, in 2015. The majority of the loans charged off during 2017 had specific reserves established during the allowance for loan loss calculation process prior to the decision to charge-off the loans. Deterioration in credit quality or significant growth in the loan portfolio may result in a higher provision for loan losses in 2018.

#### Non-Interest Income

##### Non-interest income comparison

| Year ended December 31,                   | 2017         | 2016         | 2015         | Change from prior year |              |              |        |   |
|---|--------------|--------------|--------------|------------------------|--------------|--------------|--------|---|
|   |              |              |              | \$ Change              | % Change     |              |        |   |
|   | 2017 to 2016 | 2016 to 2015 | 2017 to 2016 | 2016 to 2015           | 2017 to 2016 | 2016 to 2015 |        |   |
| Fees for services to customers            | \$1,668      | \$1,621      | \$1,657      | \$47                   | \$ (36)      | 2.9          | % -2.2 | % |
| ATM and debit card                        | 1,749        | 1,651        | 1,571        | 98                     | 80           | 5.9          | 5.1    |   |
| Retail brokerage and advisory             | 436          | 603          | 686          | (167)                  | (83)         | -27.7        | -12.1  |   |
| Bank-owned life insurance                 | 345          | 308          | 307          | 37                     | 1            | 12.0         | 0.3    |   |
| Merchant                                  | 345          | 334          | 298          | 11                     | 36           | 3.3          | 12.1   |   |
| Net gain (loss) on trading activities     | 27           | (40)         | 33           | 67                     | (73)         | 167.5        | -221.2 |   |
| Net gain on sale of investment securities | 1,500        | 674          | 783          | 826                    | (109)        | 122.6        | -13.9  |   |
| Net gain on sale of loans                 | 375          | 320          | 356          | 55                     | (36)         | 17.2         | -10.1  |   |
| Loss on sale of indirect lease financing  |              |              |              |                        |              |              |        |   |
| portfolio                                 | —            | (223)        | —            | 223                    | (223)        | 100.0        | -100%  |   |
| Other                                     | 442          | 419          | 341          | 23                     | 78           | 5.5          | 22.9   |   |
| Total                                     | \$6,887      | \$5,667      | \$6,032      | \$1,220                | \$ (365)     | 21.5         | % -6.1 | % |

#### 2017 versus 2016

QNB, through its core banking business, generates various fees and service charges. Total non-interest income includes service charges on deposit accounts, ATM and check card income, retail brokerage and advisory income, income on bank-owned life insurance, merchant income and gains and losses on investment securities and residential mortgage loans. Total non-interest income was \$6,887,000 in 2017 compared with \$5,667,000 in 2016, an increase of \$1,220,000. Excluding the loss on sale of indirect finance leasing portfolio of \$223,000 in 2016, the increase in non-interest income was \$997,000, comparing 2017 to 2016.

Fees for services to customers are primarily comprised of service charges on deposit accounts. These fees were \$1,668,000 for 2017, an increase of \$47,000, or 2.9%, from 2016. Overdraft income, which represented approximately 76% and 75% of total fees for services to customers in 2017 and 2016, respectively, increased by \$44,000, or 3.6%, when comparing 2017 to 2016. The increase in overdraft income primarily reflects an increase in the number of overdraft occurrences as well as a reduction in overdraft fees forgiven.

ATM and debit card income is primarily comprised of transaction income on debit cards and ATM cards and ATM surcharge income for the use of QNB's ATM machines by non-QNB customers. ATM and debit card income was \$1,749,000 in 2017, an increase of \$98,000, or 5.9%, from the amount recorded in 2016. Debit card interchange income increased \$103,000, or 6.5%, to \$1,694,000 in 2017, while ATM surcharge income and monthly card fees income decreased \$5,000, to \$55,000. The growth in checking accounts and card usage contributed to the increase in debit card income, including the QNB Rewards checking product, a high-yield checking account which requires, among other terms, the posting of a minimum of twelve debit card purchase transactions per statement cycle to receive the high interest rate.

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QNB provides securities and advisory services under the name QNB Financial Services through Investment Professionals, Inc., an independent third-party registered Broker/Dealer and Registered Investment Advisor. QNB receives 75% to 88% of the revenue generated, depending on volume, but is also responsible for salaries and expenses of two advisors who are QNB employees. Retail brokerage and advisory revenue was \$436,000 for 2017 compared with \$603,000 in 2016, a decline of \$167,000, or 27.7%. There were less sales in front-loaded products, such as annuities and alternative investments (which include private equity, hedge funds, managed futures, real estate “REITs”, commodities and derivatives contracts) in 2017 than in 2016, resulting in a \$260,000 reduction of revenues. In 2017 there was a transition to move toward advanced advisory fees based on assets under management in lieu of fees per transaction; advisory fees increased \$106,000 comparing 2017 to 2016. In 2017, the net income provided by these services was \$13,000, compared with \$104,000 in net income for 2016.

Income on bank-owned life insurance (“BOLI”) represents the earnings and death benefits on life insurance policies in which the Bank is the beneficiary. The insurance carriers reset the rates on these policies annually taking into consideration the interest rate environment as well as mortality costs. The existing policies have rate floors which minimize how low the earnings rate can go. Some of these policies are currently at their floor. Income on these policies during 2017 was \$345,000, including a death benefit of \$52,000, compared to \$308,000 for 2016.

Merchant income represents fees charged to merchants for the Bank’s handling of credit card or charge sales. Merchant income was \$345,000 for 2017, an increase of \$11,000, or 3.3%, from the amount reported in 2016. The increase in merchant income is primarily a result of increased card sales of approximately \$6 million as the economy improved and the acquisition of 38 new merchant customers during 2017.

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, changes in spread relationships in different sectors, and for liquidity purposes. Management continually reviews strategies that will result in an increase in the yield or improvement in the structure of the investment portfolio, including monitoring credit and concentration risk in the portfolio. In addition, the Corporation owns a small portfolio of equity securities for the purpose of generating both dividend income and capital appreciation.

Net gains on investment securities increased \$826,000 to \$1,500,000 for the year ended December 31, 2017, compared with \$674,000 for the year ended December 31, 2016, primarily due to market conditions which resulted in greater opportunities for profitable sales in 2017 compared with 2016. The prolonged decline in market value of one equity security in 2017 and two equity securities in 2016 resulted in recording other than temporary impairment charges of \$80,000 and \$192,000, respectively. Gains, net of other-than-temporary impairment, from equity securities were \$1,477,000 and \$566,000 in 2017 and 2016, respectively. With the strong performance in the U.S. equity markets during the latter half of 2016 and 2017, QNB elected to sell some equity holdings and recognize gains. Net gains on the sale of fixed income securities were \$23,000 and \$108,000 for 2017 and 2016, respectively. Both the 2017 and 2016 fixed income gains were primarily from the sale of fast paying, lower-yielding or odd-lot mortgage-backed and CMO securities as well as low yielding agency bonds that were likely to be called in the next two years. In June 2017, QNB Bank sold five non-performing pooled trust preferred securities (“PreTSL”), 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 PreTSLs, and subsequently applied any cashflow received to the balance of these non-performing, nonaccrual assets. Improvement in market prices for these PreTSLs 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.

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.

In October 2016, the Company sold its interest in these third-party originated finance contracts and recorded a loss of \$223,000.

The net gain on residential mortgage sales is directly related to the volume of mortgages sold and the timing of the sales relative to the interest rate environment. Residential mortgage loans to be sold are identified at origination. The net gain on the sale of residential mortgage loans was \$276,000 and \$320,000 for 2017 and 2016, respectively. Mortgage refinance activity decreased in 2017, as rate volatility prompted borrowers to delay borrowing. Proceeds from the sale of residential mortgages were \$9,041,000 and \$9,204,000 for the years ended December 31, 2017 and 2016, respectively. Included in the gains on the sale of residential mortgages in 2017 and 2016 are \$66,000 and \$69,000, respectively, related to the recognition of mortgage servicing assets. The remaining \$99,000 gain on sale of loans in 2017 is attributed to QNB's portion of a purchased participation loan with no carrying balance that was sold.

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QNB retains servicing rights for residential mortgages sold in the secondary market. A servicing fee is retained on all mortgage loans sold and serviced. QNB recognizes its obligation to service financial assets that are retained in a transfer of assets in the form of a servicing asset. The servicing asset is amortized in proportion to, and over, the period of net servicing income or loss. On a quarterly basis, servicing assets are assessed for impairment based on their fair value. Mortgage servicing income of \$114,000 for 2017 and \$125,000 for 2016 is included in other non-interest income.

Other non-interest income, excluding mortgage servicing income, was \$328,000 for 2017, an increase of \$34,000 from the amount recorded in 2016. Increased revenues from letters of credit, credit cards, check sale commissions, and merchant loss recoveries of \$50,000, \$8,000, \$7,000, and \$6,000, respectively, were partially offset by a reduction in sales tax refunds of \$36,000, when comparing 2017 to 2016.

#### 2016 versus 2015

Total non-interest income was \$5,667,000 in 2016 compared with \$6,032,000 in 2015, a decrease of \$365,000. Excluding the loss on sale of indirect finance leasing portfolio of \$223,000, the decline in non-interest income is \$142,000, comparing 2016 to 2015.

Fees for services to customers were \$1,621,000 for 2016, a decrease of \$36,000, or 2.2%, from 2015. Overdraft income, which represented approximately 75% and 74% of total fees for services to customers in 2016 and 2015, respectively, decreased by \$21,000, or 1.7%, when comparing 2016 to 2015. ATM and debit card income was \$1,651,000 in 2016, an increase of \$80,000, or 5.1%, from the amount recorded in 2015. Debit card interchange income increased \$85,000, or 5.6%, to \$1,591,000 in 2016, while ATM surcharge income and monthly card fees income decreased \$5,000, to \$60,000.

Retail brokerage and advisory revenue was \$603,000 for 2016 compared with \$686,000 in 2015, a decline of \$83,000, or 12.1%. The reduction in fee income was due to the increase in products with trailing fee income as opposed to upfront fees. Income on BOLI policies during 2016 was \$308,000, a slight increase when compared to \$307,000 for 2015. Merchant income was \$334,000 for 2016, an increase of \$36,000, or 12.1%, from the amount reported in 2015.

Net gains on investment securities decreased \$109,000 to \$674,000 for the year ended December 31, 2016, compared with \$783,000 for the year ended December 31, 2015, primarily due to market conditions which resulted in fewer opportunities for profitable sales in 2016 compared with 2015. The prolonged decline in market value of two equity securities resulted in recording \$192,000 in other than temporary impairment in 2016. There were \$55,000 in OTTI charges in 2015, related to the prolonged decline in market value of one equity security. Gains, net of other-than-temporary impairment, from equity securities were \$566,000 and \$636,000, in 2016 and 2015, respectively.

The net gain on the sale of residential mortgage loans was \$320,000 and \$356,000 for 2016 and 2015, respectively. Proceeds from the sale of residential mortgages were \$9,204,000 and \$10,903,000 for the years ended December 31, 2016 and 2015, respectively. Included in the gains on the sale of residential mortgages in 2016 and 2015 are \$69,000 and \$80,000, respectively, related to the recognition of mortgage servicing assets. Mortgage servicing income of \$125,000 for 2016 and \$129,000 for 2015 is included in other non-interest income.

Other non-interest income was \$419,000 for 2016, an increase of \$78,000 from the amount recorded in 2015. Increased revenues from letters of credit, credit cards, title insurance company, sales tax refunds and reduced loss on sale for OREO, repossessed assets and furniture and equipment of \$7,000, \$9,000, \$17,000, \$47,000, and \$19,000, respectively, were the primary contributors to the increase, when comparing 2016 to 2015.

## Non-Interest Expense

## Non-interest expense comparison

| Year ended December 31,         | 2017     | 2016     | 2015     | Change from prior year |              |              |              |
|---------------------------------|----------|----------|----------|------------------------|--------------|--------------|--------------|
|                                 |          |          |          | \$ Change              | % Change     |              |              |
|                                 |          |          |          | 2017 to 2016           | 2016 to 2015 | 2017 to 2016 | 2016 to 2015 |
| Salaries and employee benefits  | \$13,121 | \$12,011 | \$12,076 | \$1,110                | \$ (65)      | 9.2 %        | -0.5 %       |
| Net occupancy                   | 1,789    | 1,750    | 1,762    | 39                     | (12)         | 2.2          | -0.7         |
| Furniture and equipment         | 1,859    | 1,753    | 1,726    | 106                    | 27           | 6.0          | 1.6          |
| Marketing                       | 914      | 806      | 805      | 108                    | 1            | 13.4         | 0.1          |
| Third party services            | 1,608    | 1,691    | 1,703    | (83)                   | (12)         | -4.9         | -0.7         |
| Telephone, postage and supplies | 804      | 752      | 731      | 52                     | 21           | 6.9          | 2.9          |
| State taxes                     | 687      | 666      | 681      | 21                     | (15)         | 3.2          | -2.2         |
| FDIC insurance premiums         | 577      | 568      | 631      | 9                      | (63)         | 1.6          | -10.0        |
| Other                           | 2,361    | 2,166    | 2,283    | 195                    | (117)        | 9.0          | -5.1         |
| Total                           | \$23,720 | \$22,163 | \$22,398 | \$1,557                | \$ (235)     | 7.0 %        | -1.0 %       |

## 2017 versus 2016

Non-interest expense is comprised of costs related to salaries and employee benefits, net occupancy, furniture and equipment, marketing, third party services, FDIC insurance premiums, regulatory assessments and taxes and various other operating expenses. Total non-interest expense was \$23,720,000 in 2017, an increase of \$1,557,000, or 7.0%, from the \$22,163,000 recorded in 2016. QNB's overhead efficiency ratio, which represents the percentage of each dollar of revenue that is used for non-interest expense, is calculated by taking non-interest expense divided by net operating revenue. QNB's efficiency ratios for 2017, 2016 and 2015 were 58.0%, 61.9%, and 63.7%, respectively.

Salaries and benefits expense is the largest component of non-interest expense. QNB monitors, using various surveys, the competitive salary and benefit information in its markets and makes adjustments when appropriate. Salaries and benefits expense for 2017 was \$13,121,000, an increase of \$1,110,000 compared with \$12,011,000 reported in 2016. Salary expense for 2017 was \$10,596,000, an increase of \$1,078,000 compared with \$9,518,000 reported in 2016. Included in salary expense in 2017 was incentive compensation plus related payroll taxes of \$617,000, a \$418,000 increase over incentive compensation in 2016. Benefit expense for 2017 was \$2,525,000, an increase of \$32,000, or 1.3%, from the amount recorded in 2016 with payroll taxes increasing \$52,000 as salary expense increased. Retirement plan matching and safe harbor increased \$56,000 compared to 2016; QNB utilized unvested forfeited 401(k) contributions to offset retirement plan matching in 2017. Post-retirement life insurance expense decreased \$71,000 due to a death claim which reduced the post-retirement liability.

Net occupancy and furniture and equipment expense increased \$145,000, to \$3,648,000 when comparing 2017 to 2016, due primarily to increased software, building and equipment maintenance and branch rent, offset in part by lower depreciation.

Marketing expense was \$914,000 for 2017, a \$108,000 increase from the expense recorded in 2016. Marketing expenses related to public relations increased \$107,000 for the year ended December 31, 2017 compared with 2016. QNB contributions and sponsorships for not-for-profit organizations, events and clubs in the communities it serves is included in public relations expense.

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 decreased \$83,000 when comparing the two periods, due to decreased legal services and other third-party services.

Telephone, postage and supplies expense increased \$52,000, or 6.9%, to \$804,000 in 2017, compared with 2016. Supplies expense decreased \$11,000 in 2017, as additional supplies related to EMV chip debit card production, anticipated throughout 2017, were purchased in 2016. Telecommunications expense increased \$41,000 due increased data line capacity. Postage expense increased \$22,000.

FDIC insurance premium expense increased \$9,000, or 1.6%, in 2017. The premium assessment formula for small institutions was changed by the FDIC and implemented in late 2016 and is based on asset growth and related risk assumptions determined by the FDIC as well as capital. Small institutions, for FDIC premium assessments purposes, are defined as those with total consolidated assets less than \$10 billion.

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State tax expense represents the payment of the Pennsylvania Shares Tax, Pennsylvania sales and use tax and the Pennsylvania capital stock tax. State tax expense was \$687,000 and \$666,000 for the years 2017 and 2016, respectively. The Pennsylvania Shares Tax is based primarily on the equity of the Bank and comprises all but \$2,000 of the expense in this category. The increase in Pennsylvania Shares Tax is a result of growth of the Bank's capital.

Other operating expenses for the twelve months ended December 31, 2017 increased \$195,000, or 9.0%, primarily due to check card expense, offset in part by a reduction in foreclosure expense.

#### 2016 versus 2015

Total non-interest expense was \$22,163,000 in 2016, a decrease of \$235,000, or 1.0%, from the \$22,398,000 recorded in 2015. Salaries and benefits expense for 2016 was \$12,011,000, a decrease of \$65,000 compared with \$12,076,000 reported in 2015. Salary expense for 2016 was \$9,518,000, a decrease of \$21,000 compared with \$9,539,000 reported in 2015. Included in salary expense in 2016 was incentive compensation plus related payroll taxes of \$199,000, a \$96,000 decrease over incentive compensation in 2015. Benefit expense for 2016 was \$2,493,000, a decrease of \$44,000, or 1.7%, from the amount recorded in 2015, with medical benefits decreasing \$59,000, or 7.4%, due to insurance reimbursements for medical claims paid in prior periods and higher employee-paid share of health insurance. Payroll taxes and post-retirement life insurance expense increased \$21,000 and \$25,000, respectively, while retirement plan matching and safe harbor, and tuition reimbursements declined \$28,000 and \$13,000, respectively, in 2016.

Net occupancy and furniture and equipment expense increased \$15,000 to \$3,503,000 when comparing 2016 to 2015, due primarily to increased software and building maintenance, offset in part by lower depreciation, utilities and rental expense.

Marketing expense was \$806,000 for 2016, a \$1,000 increase from the expense recorded in 2015. Marketing expenses related to public relations and advertising increased \$18,000 for the year ended December 31, 2016 compared with 2015, offset in part by decreased sales promotional expense

Telephone, postage and supplies expense increased \$21,000, or 2.9%, to \$752,000 in 2016, compared with 2015. Supplies expense increased \$8,000 in 2016, as additional supplies related to EMV chip debit card production, anticipated throughout 2017, were purchased in 2016. Telecommunications expense increased \$25,000 due to upgrades in network infrastructure. Postage expense decreased \$12,000, due to ongoing efforts to utilize digital delivery of various documents.

FDIC insurance premium expense decreased \$63,000, or 10.0%, in 2016, due to a change in the premium assessment formula announced by the FDIC in 2016, establishing reduced premium assessment formulas for small institutions.

State tax expense was \$666,000 and \$681,000 for the years 2016 and 2015, respectively. The Pennsylvania Shares Tax is based primarily on the equity of the Bank and comprises all but \$1,000 of the expense in this category. Reduction in Pennsylvania Shares Tax is a result of a deduction utilized due to apportionment of income to New Jersey, and payment of New Jersey state income taxes.

Other operating expenses for the twelve months ended December 31, 2016 decreased \$117,000, or 5.1%, primarily due to decreased debit card expenses. Debit card expenses in 2015 included a \$208,000 contract termination fee related to card platform upgrades which occurred during 2016. Excluding this contract termination expense, debit card expenses increased \$93,000, of which \$61,000 was increased card loss expense, due to increased card compromises in 2016.

#### Income Taxes

Applicable income tax expense and effective tax rates were \$5,900,000, or 41.6%, for 2017 compared with \$3,054,000, or 25.5%, for 2016. Under the 2017 Tax Reform Act, the corporate income tax rate was reduced from 34% to 21%; therefore, QNB recorded a charge reflecting the revaluation of its net deferred tax assets from 34% to 21% at December 31, 2017 resulting in additional tax expense of \$2,054,000.

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## Summary Impact of 2017 Tax Reform Act

|   | Year<br>ended<br>12/31/17 |
|---|---------------------------|
| Non-GAAP adjusted net income excluding impact of tax    |                           |
| legislation   | \$ 10,343                 |
| Tax provision, revaluation of net deferred tax asset    | (2,054 )                  |
| Reported Net Income (GAAP)                              | \$ 8,289                  |
| Non-GAAP earnings per share, excluding impact of tax    |                           |
| legislation   | \$ 3.00                   |
| Effect of tax legislation on diluted earnings per share | (0.59 )                   |
| Reported Diluted Earnings per Share (GAAP)              | \$ 2.41                   |

Non-GAAP financial measures should be viewed in addition to, and not as an alternative for, our reported results prepared in accordance with GAAP. In the event of disclosure or release of non-GAAP financial measures, the SEC Regulation G requires: (i) the presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP and (ii) a reconciliation of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure calculated and presented in accordance with GAAP.

For the year ended December 31, 2017, the effective tax rate excluding this charge was 27.1%, compared with 25.5% for 2016. The higher effective tax rate year over year is predominately a result of tax-exempt income from loans and securities comprising a smaller proportional share of pre-tax income than the prior year and greater state tax expense. QNB expects the effective tax rate in 2018 to be less than the 21% corporate rate, due to its holdings of tax-free assets, including municipal bonds, municipal loans, and life insurance contracts. For a more comprehensive analysis of income tax expense and deferred taxes, refer to Note 11 in the Notes to Consolidated Financial Statements.

Applicable income taxes and effective tax rates were \$3,054,000, or 25.5%, for 2016 and \$2,570,000, or 23.8%, for 2015. The increase in effective tax rate was predominately a result of tax-exempt income from loans and securities comprising a smaller proportional share of pre-tax income.

## Financial Condition

## ASSETS

The following table presents total assets at the dates indicated:

| Year ended December 31,              | 2017     | 2016     | Change from prior year |         |
|--------------------------------------|----------|----------|------------------------|---------|
|                                      |          |          | Amount                 | Percent |
| Cash and cash equivalents            | \$16,331 | \$10,721 | \$5,610                | 52.3 %  |
| Investment securities                | 379,545  | 394,071  | (14,526 )              | -3.7    |
| Restricted investment in bank stocks | 1,501    | 1,017    | 484                    | 47.6    |
| Loans held-for-sale                  | —        | 789      | (789 )                 | -100.0  |

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|                             |             |             |          |       |
|-----------------------------|-------------|-------------|----------|-------|
| Loans receivable            | 733,283     | 633,079     | 100,204  | 15.8  |
| Allowance for loan losses   | (7,841 )    | (7,394 )    | (447 )   | -6.0  |
| Premises and equipment, net | 8,495       | 8,683       | (188 )   | -2.2  |
| Bank-owned life insurance   | 10,894      | 11,297      | (403 )   | -3.6  |
| Accrued interest receivable | 3,545       | 3,128       | 417      | 13.3  |
| Other assets                | 6,584       | 7,750       | (1,166 ) | -15.0 |
| Total assets                | \$1,152,337 | \$1,063,141 | \$89,196 | 8.4 % |

Cash and interest-earning deposits

Total cash and cash equivalents increased \$5,610,000 from \$10,721,000 at December 31, 2016 to \$16,331,000 at December 31, 2017. QNB had interest-bearing balances at the Federal Reserve Bank of \$863,000 at December 31, 2017 compared with \$261,000 at December 31, 2016. Proceeds received from the maturity, prepayment and sales of investment securities and the growth in deposits more than offset the funding needs for loan growth. While increasing rates significantly slowed the prepayments on mortgage-backed securities and CMOs during 2017, deposit growth was strong.



## Investment Securities and Other Short-Term Investments

At December 31, 2017 and 2016, QNB had no Federal funds sold. With the Federal funds rate between 0.75% and 1.50%, excess funds for liquidity purposes are kept at the Federal Reserve, which was paying 0.75% until the Federal Open Market Committee raised the targeted Fed Funds rate by 25 basis points three times in 2017 in mid-March 2017, mid-June 2017 and in mid-December 2017. These funds carry a 0% risk weighting for risk-based capital calculation purposes.

| Investment Portfolio History<br>December 31,                      | 2017             | 2016             | 2015             |
|---|------------------|------------------|------------------|
| <b>Trading Securities</b>   |                  |                  |                  |
| State and municipal   | —                | \$3,596          | \$4,189          |
| <b>Total trading securities</b>                                   | <b>—</b>         | <b>\$3,596</b>   | <b>\$4,189</b>   |
| <b>Investment Securities Available-for-Sale</b>                   |                  |                  |                  |
| U.S. Government agency  | \$70,524         | \$76,650         | \$61,779         |
| State and municipal   | 76,804           | 72,295           | 78,954           |
| <b>U.S. Government agencies and sponsored enterprises (GSEs):</b> |                  |                  |                  |
| Mortgage-backed   | 142,703          | 145,301          | 136,681          |
| Collateralized mortgage obligations (CMOs)                        | 76,302           | 77,415           | 65,610           |
| Pooled trust preferred  | 215              | 2,281            | 2,653            |
| Corporate debt  | 8,022            | 8,030            | 9,004            |
| Equity  | 4,975            | 8,503            | 7,234            |
| <b>Total investment securities available-for-sale</b>             | <b>\$379,545</b> | <b>\$390,475</b> | <b>\$361,915</b> |
| <b>Investment Securities Held-to-Maturity</b>                     |                  |                  |                  |
| State and municipal   | \$—              | \$—              | \$147            |
| <b>Total investment securities held-to-maturity</b>               | <b>\$—</b>       | <b>\$—</b>       | <b>\$147</b>     |
| <b>Total investment securities</b>                                | <b>\$379,545</b> | <b>\$394,071</b> | <b>\$366,251</b> |

At December 31, 2017, approximately 76% of QNB's investment securities were either U.S. Government agency debt securities, U.S. Government agency issued mortgage-backed securities or CMOs. As of December 31, 2017, QNB held no securities of any one issue or any one issuer (excluding the U.S. Government and its agencies) that were in excess of 10% of shareholders' equity.

The QNB investment portfolio represents a significant portion of earning assets and interest income. QNB actively manages the investment portfolio in an attempt to maximize earnings, while considering liquidity needs, interest rate risk and credit risk. Proceeds from the sale of investments were \$42,509,000 in 2017 compared with \$32,573,000 during 2016.

In addition to the proceeds from the sale of investment securities, proceeds from maturities, calls and prepayments of securities were \$52,994,000 in 2017 compared with \$107,425,000 in 2016. Volume of sales, calls and maturities in 2016 reflects the low interest rate environment that has existed for approximately the previous eight years, which resulted in a significant amount of agency and municipal bonds being called as well as an increase in the amount of prepayments on mortgage-backed securities and CMOs. The decrease of the investment portfolio as a percent of total assets in 2017 is due to loan growth. During 2017, \$85,265,000 of investment securities were purchased compared with \$174,943,000 during 2016.

The balance of U.S. Government agency securities decreased \$6,126,000 to \$70,524,000 at December 31, 2017 and represents 18.6% of the investment portfolio compared with 19.5% at December 31, 2016. Sales of lower yielding

bonds and proceeds from called agency bonds were reinvested back into this portfolio because of the attractive yields relative to amortizing securities. The seasonal inflow of municipal deposits was invested in Agencies, as well. U.S. Government agency issued CMO and MBS balances decreased \$3,711,000 to \$219,005,000 and represents 57.7% of the portfolio compared with 56.5% at December 31, 2016. These bonds provide monthly cash flow to be reinvested in either loans or other securities, potentially at higher yields as rates increase.

The balance of municipal securities increased \$4,509,000 to \$76,804,000 at December 31, 2017, representing 20.2% of the investment portfolio compared with 19.3% at December 31, 2016. QNB focuses on the financial performance of the underlying issuer for municipal bond purchases in addition to the bond rating of the issuer or the rating of bond insurer, if present. Twenty-six bonds with a book value of \$12,158,000 were called or matured in 2017 and purchased municipal securities had lower yields than the bonds they replaced, which contributed to the decline in the yield on the portfolio. The demand for tax-exempt municipal securities is expected to decline as the tax-equivalent yield become less favorable compared to other securities with similar risk-based capital asset-weighting characteristics.

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QNB owns collateralized debt obligations (“CDO”) in the form of pooled trust preferred securities. These securities are comprised mainly of securities issued by banks or bank holding companies, and to a lesser degree, insurance companies. In most cases, QNB owns the mezzanine tranches of these securities. 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. 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. The trust preferred security the Bank continues to hold with a carrying balance of \$215,000 at December 31, 2017 was returned to accrual status during the second quarter 2017 and represents the senior-most obligation of the trust. There was no credit-related other-than-temporary impairment charge during 2017, 2016 or 2015. Future estimates of fair value of the remaining security could require recording additional OTTI charges through earnings. For additional detail on these securities see Notes 4 and 17 of the Notes to Consolidated Financial Statements.

Equity securities decreased \$3,528,000 to \$4,975,000 at December 31, 2017 from \$8,503,000 at December 31, 2016. QNB sold \$14,422,000 in equity securities for a net gain of \$1,477,000, inclusive of realized OTTI of \$80,000; QNB purchased \$9,998,000 in equities during 2017.

QNB accounts for its investments by classifying securities into three categories. Securities that QNB has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses, net of tax, excluded from earnings and reported as a separate component of shareholders’ equity. Management determines the appropriate classification of securities at the time of purchase.

#### Investment Portfolio Maturities and Weighted Average Yields

|   | One<br>year<br>or less | After one<br>year     |                      | After five<br>years  |                      | After<br>ten<br>years | Total    |
|---|------------------------|-----------------------|----------------------|----------------------|----------------------|-----------------------|----------|
|   |                        | through<br>five years | through<br>ten years | through<br>ten years | through<br>ten years |                       |          |
| December 31, 2017                               |                        |                       |                      |                      |                      |                       |          |
| <b>Investment Securities Available-for-Sale</b> |                        |                       |                      |                      |                      |                       |          |
| U.S. Government agency:                         |                        |                       |                      |                      |                      |                       |          |
| Fair value                                      | \$1,988                | \$43,473              | \$25,063             | —                    | —                    | —                     | \$70,524 |
| Weighted average yield                          | 1.45 %                 | 1.72 %                | 1.92 %               | —                    | —                    | —                     | 1.79 %   |
| State and municipal:                            |                        |                       |                      |                      |                      |                       |          |
| Fair value                                      | 5,935                  | 14,676                | 32,094               | \$24,099             | —                    | —                     | 76,804   |
| Weighted average yield                          | 3.73 %                 | 3.98 %                | 3.90 %               | 3.73 %               | —                    | —                     | 3.85 %   |
| Mortgage-backed:                                |                        |                       |                      |                      |                      |                       |          |
| Fair value                                      | —                      | 93,163                | 49,540               | —                    | —                    | —                     | 142,703  |
| Weighted average yield                          | 0.00 %                 | 2.07 %                | 2.27 %               | —                    | —                    | —                     | 2.14 %   |
| Collateralized mortgage obligations (CMOs):     |                        |                       |                      |                      |                      |                       |          |

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|                         |         |           |  |           |  |          |  |           |
|-------------------------|---------|-----------|--|-----------|--|----------|--|-----------|
| Fair value              |         | 50,556    |  | 25,746    |  | —        |  | 76,302    |
| Weighted average yield  | 0.00 %  | 1.97 %    |  | 2.10 %    |  | —        |  | 2.02 %    |
| Pooled trust preferred: |         |           |  |           |  |          |  |           |
| Fair value              | —       | —         |  | —         |  | 215      |  | 215       |
| Weighted average yield  | —       | —         |  | —         |  | 3.90 %   |  | —         |
| Corporate debt:         |         |           |  |           |  |          |  |           |
| Fair value              | 2,002   | 5,009     |  | 1,011     |  | —        |  | 8,022     |
| Weighted average yield  | 1.80 %  | 2.22 %    |  | 2.40 %    |  | —        |  | 2.14 %    |
| Equity:                 |         |           |  |           |  |          |  |           |
| Fair value              | —       | —         |  | —         |  | 4,975    |  | 4,975     |
| Weighted average yield  | —       | —         |  | —         |  | 3.55 %   |  | 3.55 %    |
| Total fair value        | \$9,925 | \$206,877 |  | \$133,454 |  | \$29,289 |  | \$379,545 |
| Weighted average yield  | 2.88 %  | 2.11 %    |  | 2.55 %    |  | 3.70 %   |  | 2.41 %    |

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Securities are assigned to categories based on stated contractual maturity except for mortgage-backed securities and CMOs which are based on anticipated payment periods and state and municipal securities which are based on pre-refunded date, if applicable. Tax-exempt securities were adjusted to a tax-equivalent basis and are based on the marginal Federal corporate tax rate of 34 percent and a Tax Equity and Financial Responsibility Act (“TEFRA”) adjustment for the cost of funds. Weighted average yields on investment securities available-for-sale are based on amortized cost.

#### Investment Securities - Trading

In 2014, QNB established a small percentage of its investment portfolio as trading in an effort to boost yields and 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, since its inception in 2014. The fair value of the trading portfolio was \$3,596,000 at December 31, 2016. QNB held trading securities of \$3,596,000 and an additional \$1,499,000 in a brokerage cash account at December 31, 2016. QNB recorded a net gain of \$27,000 for 2017 and a net loss of \$40,000 for 2016 in non-interest income.

#### Investments Available-For-Sale

Available-for-sale investment securities include securities that management intends to use as part of its liquidity and asset/liability management strategy. These securities may be sold in response to changes in market interest rates, changes in the securities prepayment or credit risk, the need for liquidity, or growth in loan demand. At December 31, 2017, the fair value of investment securities available-for-sale was \$379,545,000, or \$6,191,000 below the amortized cost of \$385,736,000. This compares to a fair value of \$390,475,000, or \$5,693,000 below the amortized cost of \$396,168,000, at December 31, 2016. The available-for-sale portfolio, excluding equity securities and the pooled trust preferred securities, had a weighted average maturity of approximately 4.3 years at December 31, 2017 and 3.9 years at December 31, 2016. The weighted average tax-equivalent yield was 2.36% and 2.34% at December 31, 2017 and 2016, respectively.

The weighted average maturity is based on the stated contractual maturity or likely call date of all securities except for MBS and CMOs, which are based on estimated average life. The maturity of the portfolio could become shorter if interest rates declined and prepayments on MBS and CMOs increased or securities are called. However, the estimated average life could lengthen if interest rates were to increase and principal payments on MBS and CMOs slowed or securities anticipated to be called extend past their call date.

#### Investments Held-To-Maturity

QNB’s sole held-to-maturity security, with an amortized cost of \$147,000, matured in 2016.

#### Loans

QNB’s primary business is to accept deposits and to make 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 has comprehensive policies and procedures that define and govern commercial and retail loan originations and the management of risk. All loans are underwritten in a manner that emphasizes the borrowers’ capacity to pay. The measurement of capacity to pay delineates the potential risk of non-payment or default. The higher potential for default determines the need for and amount of collateral required. QNB makes unsecured commercial loans when the capacity to pay is considered substantial. As capacity lessens, collateral is required to provide a secondary source of

repayment and to mitigate the risk of loss. Various policies and procedures provide guidance to the lenders on such factors as amount, terms, price, maturity and appropriate collateral levels. Each risk factor is considered critical to ensuring that QNB receives an adequate return for the risk undertaken, and that the risk of loss is minimized.

QNB manages the risk associated with commercial loans by having lenders work in tandem with credit analysts while maintaining independence between personnel. In addition, a Bank loan committee and a committee of the Board of Directors review and approve certain loan requests on a weekly basis. At December 31, 2017, there were no concentrations of loans exceeding 10% of total loans other than disclosed in the Loan Portfolio table.

QNB will be moving from an eight-grade risk rating system to a ten-grade system in 2018; further disaggregating the credit quality of the loan portfolio to enhance credit risk strategies.

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QNB's commercial lending activity is focused on small businesses within the local community. Commercial purpose loans 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 group 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. Commercial and industrial loans represent commercial purpose loans that are either secured by collateral other than real estate or unsecured.

Commercial loans secured by commercial real estate include commercial purpose loans collateralized at least in part by commercial real estate. Some of these loans may not be for the express purpose of conducting commercial real estate transactions. Commercial loans secured by residential real estate are commercial purpose loans generally secured by the business owner's residence or residential investment properties owned by the borrower and rented to tenants. Commercial loans secured by either commercial real estate or residential real estate are originated primarily within the Eastern Pennsylvania market area, are within the Bank's underwriting criteria, and generally include the guarantee of the borrowers. 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 and commercial construction 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.

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.

The Company originates fixed rate and adjustable-rate residential real estate loans that are secured by 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%. To reduce interest rate risk, substantially all originations of fixed-rate loans to individuals for 1-4 family residential mortgages with maturities of 15 years or greater are generally sold in the secondary market. Mortgage loan origination activity declined in 2017 with \$7,976,000 in residential mortgages originated for sale during 2017, compared with \$8,686,000 for 2016. There was \$0 in residential mortgage loans held-for-sale at December 31, 2017, and \$789,000 in residential mortgage loans held-for-sale at December 31, 2016. These loans are carried at the lower of aggregate cost or market.

The home equity portfolio consists of fixed-rate home equity loans and variable rate home equity lines of credit. These loans are often in a junior lien position and therefore carry a higher risk than first lien 1-4 family residential loans. Risks associated with loans secured by residential properties, either first lien residential mortgages or home equity loans and lines, 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 loans secured by residential real estate because they may be unsecured, or, if they are secured, the value of the collateral may be difficult to assess or 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, the value of the collateral.

Total loans, excluding loans held-for-sale, at December 31, 2017 were \$733,283,000, an increase of \$100,204,000, or 15.8%, from December 31, 2016. This follows a 2.9% increase in outstanding loans in 2016. A key financial ratio, loans to deposits, improved slightly to 73.8% at December 31, 2017, compared with 69.3% at December 31, 2016. QNB continues to be committed to make loans available to credit worthy consumers and businesses.

The Allowance for Loan Losses Allocation table on page 41 shows the percentage composition of the loan portfolio over the past five years. There was very little change in the composition of the portfolio between the periods ended December 31, 2016 and 2017. Loans secured by commercial real estate represent the largest sector of the portfolio, decreasing slightly from 40.3% of the portfolio at December 31, 2016 to 39.1% of the portfolio at December 31, 2017, as the balances in this sector grew by \$31,679,000, or 12.4%, from \$255,188,000 at December 31, 2016 to \$286,867,000 at December 31, 2017. While loans secured by commercial real estate represent a significant portion of the total portfolio, the collateral is diversified, including investment properties, manufacturing facilities, office buildings, hospitals, retirement and nursing home facilities, warehouses and owner-occupied facilities. Commercial real estate loans have drawn the attention of the regulators in recent years as a potential source of risk. QNB monitors these types of



loans closely, obtaining updated appraisals on loans classified substandard or worse. As detailed in the Allowance for Loan Losses table, QNB had no charge-offs in this category in 2017 or 2016 compared with \$84,000 in 2015. The 2015 charge-offs were due primarily to the sale of collateral for impaired loans.

Commercial loans secured by residential real estate increased by \$2,972,000, or 4.3%, to \$71,703,000 at December 31, 2017 and at 9.8% represent a slightly smaller share of the overall portfolio than the 10.9% at December 31, 2016. Some of the properties that serve as collateral for these loans are located outside the Bank's market area and have experienced vacancies and significant declines in market value. Charge-offs in this category have significantly decreased over the past three years. Non-accrual commercial loans secured by residential real estate were \$1,458,000, \$1,866,000, and \$1,803,000 at December 31, 2017, 2016, and 2015, respectively, and loan charge-offs were \$23,000, \$120,000, and \$531,000, in 2017, 2016 and 2015, respectively. In 2017, all of the \$23,000 in charge-offs were out-of-market investments properties compared with approximately \$96,000 of the \$120,000 charge-offs in 2016 that were out-of-market investment properties.

Commercial and industrial loans, the second largest sector of the portfolio, experienced growth in balances of \$36,957,000, or 33.5%, to \$147,190,000 at December 31, 2017. This followed a decline in this category of \$14,164,000, or 11.4%, in 2016. Commercial and industrial loans represented 20.1% of the portfolio at year-end 2017 compared with 17.4% at December 31, 2016. This category of loans generally presents a greater risk than loans secured by real estate since these loans are either secured by accounts receivable, inventory or equipment, or are unsecured. During 2017, nonaccrual commercial and industrial loan balances decreased \$1,431,000 to \$3,367,000, the majority of which is due to the partial charge-off of one credit of \$896,000 which was downgraded in 2017. In 2017, 2016, and 2015, charge-offs were \$960,000, \$140,000, and \$56,000, respectively.

| Loan Portfolio<br>December 31,     | 2017             | 2016             | 2015             | 2014             | 2013             |
|------------------------------------|------------------|------------------|------------------|------------------|------------------|
| <b>Commercial:</b>                 |                  |                  |                  |                  |                  |
| Commercial and industrial          | \$147,190        | \$110,233        | \$124,397        | \$118,845        | \$111,339        |
| Construction                       | 51,157           | 39,268           | 27,372           | 23,471           | 15,929           |
| Secured by commercial real estate  | 286,867          | 255,188          | 235,171          | 203,534          | 190,602          |
| Secured by residential real estate | 71,703           | 68,731           | 63,164           | 53,077           | 47,672           |
| State and political subdivisions   | 38,087           | 35,260           | 40,285           | 44,104           | 33,773           |
| Loans to depository institutions   | —                | —                | —                | —                | 1,250            |
| Indirect lease financing           | —                | —                | 10,371           | 7,685            | 8,364            |
| <b>Retail:</b>                     |                  |                  |                  |                  |                  |
| 1-4 family residential mortgages   | 55,818           | 47,124           | 42,833           | 37,147           | 29,730           |
| Home equity loans and lines        | 75,576           | 71,525           | 67,384           | 63,213           | 59,977           |
| Consumer                           | 6,680            | 5,670            | 4,286            | 4,175            | 3,116            |
| <b>Total loans</b>                 | <b>733,078</b>   | <b>632,999</b>   | <b>615,263</b>   | <b>555,251</b>   | <b>501,752</b>   |
| Net unearned costs (fees)          | 205              | 80               | 7                | 31               | (36 )            |
| <b>Loans receivable</b>            | <b>\$733,283</b> | <b>\$633,079</b> | <b>\$615,270</b> | <b>\$555,282</b> | <b>\$501,716</b> |

Loan Maturities and Interest Sensitivity

| December 31, 2017 | One year<br>or less | After<br>one<br>year<br>through | After<br>five years | Total |
|-------------------|---------------------|---------------------------------|---------------------|-------|
|-------------------|---------------------|---------------------------------|---------------------|-------|

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|                                    | five<br>years    |                 |                  |                  |
|------------------------------------|------------------|-----------------|------------------|------------------|
| <b>Commercial:</b>                 |                  |                 |                  |                  |
| Commercial and industrial          | \$89,389         | \$40,145        | \$17,656         | \$147,190        |
| Construction                       | 19,380           | 9,884           | 21,893           | 51,157           |
| Secured by commercial real estate  | 5,892            | 11,636          | 269,339          | 286,867          |
| Secured by residential real estate | 7,688            | 789             | 63,226           | 71,703           |
| State and political subdivisions   | 4                | 8,091           | 29,992           | 38,087           |
| <b>Retail:</b>                     |                  |                 |                  |                  |
| 1-4 family residential mortgages   | 1,906            | 26              | 53,886           | 55,818           |
| Home equity loans and lines        | 7,499            | 4,432           | 63,645           | 75,576           |
| Consumer                           | 515              | 1,907           | 4,258            | 6,680            |
| <b>Total</b>                       | <b>\$132,273</b> | <b>\$76,910</b> | <b>\$523,895</b> | <b>\$733,078</b> |

Demand loans and loans with no stated maturity are included in one year or less. Table details final maturity.

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The following shows the amount of loans due after one year that have fixed interest rates and variable or adjustable interest rates at December 31, 2017:

Loans with fixed predetermined interest rates: \$79,938,000

Loans with variable or adjustable interest rates: \$520,867,000

Construction loans increased 30.3% from \$39,268,000, or 6.2% of the portfolio at December 31, 2016, to \$51,157,000, or 7.0% of the portfolio at December 31, 2017. These loans are primarily to developers and builders for the construction of residential units or commercial buildings or to businesses for the construction of owner-occupied facilities. This portfolio is diversified among different types of collateral including: 1-4 family residential construction, medical and retirement home facilities, office buildings, hotels and land for development loans. Construction loans are generally made only on projects that have municipal approval. These loans are usually originated to include a short construction period followed by permanent financing provided through a commercial mortgage after construction is complete. Once construction is complete, the balance is moved to the secured by commercial real estate category if the permanent financing is provided by the Bank. The growth in the portfolio in 2017 is related to construction loans for several business expansions in the Bank's market footprint. There were no charge-offs in the construction loan portfolio since 2011, and no construction loans on non-accrual since 2014.

Loans to state and political subdivisions increased \$2,827,000, or 8.0%, from \$35,260,000 at December 31, 2016 to \$38,087,000 at December 31, 2017. This sector declined from 5.6% of the total loan portfolio at December 31, 2016 to 5.2% at December 31, 2017. Many municipalities, counties and school districts refinanced their existing bonds or bank debt and, as a result, QNB had an opportunity to successfully bid on many of these local issues. The increase in 2017 was due to some of the commitments for large projects won during 2016 that started to fund during the first quarter of 2017. The 2017 Tax Reform Act will make the tax effective yield on loans to state and political subdivisions less favorable than experienced historically; this could impact future growth within this portfolio.

Residential mortgage loans secured by first lien balances increased by \$8,694,000, or 18.4%, to \$55,818,000 at December 31, 2017. This followed an increase of \$4,291,000, or 10.0%, between December 31, 2015 and December 31, 2016. In 2017 and 2016, QNB retained some adjustable and fixed rate mortgages to borrowers with high credit scores and low loan-to-value ratios.

QNB desires to become the "local consumer lender of choice" and to affect this QNB goal has refocused its retail lending efforts by strengthening the management of the area, adding new product offerings and increasing marketing and promotion. This focus resulted in increased balances in home equity loans and lines of \$4,051,000, or 5.7%, to \$75,576,000 at December 31, 2017. During 2017, QNB continued to offer very attractive rates on both variable and fixed rate home equity loans and lines. These attractive rates, along with excellent customer service, including quick turnaround time, contributed to the growth in home equity balances. With continued improvement in home values as well as the local economy, it is expected that the demand for home equity loans will continue.

Consumer loan balances increased \$1,010,000 to \$6,680,000 at December 31, 2017. In 2013, QNB reentered the private student loan market through a relationship with iHelp. These student loans are either fixed or variable rate with the rate dependent on the credit scores of the student and/or the cosigner. Principal and interest protection is provided by ReliaMax, an insurance company for private student loans. As of December 31, 2017, the balance of student loans was \$3,736,000, an increase of \$1,096,000 compared with December 31, 2016.

### Non-Performing Assets

Non-performing assets include non-performing loans, OREO and repossessed assets and non-performing trust preferred securities. Non-performing assets totaled \$9,242,000, or 0.80% of total assets at December 31, 2017, a \$4,977,000 decrease over the \$14,219,000, or 1.34% of total assets at December 31, 2016. Included in non-performing

assets in 2016 is \$2,281,000, of pooled trust preferred securities, discussed in the section titled “Investment Securities and Other Short-Term Investments”. In June 2017, QNB Bank sold five non-performing pooled trust preferred securities with a \$2,235,000 carrying value. The Bank’s remaining trust preferred security was returned to accruing status in June 2017.

Total non-performing loans, which represent loans on non-accrual status, loans past due 90 days or more and still accruing interest and troubled debt restructured loans were \$9,242,000, or 1.26% of total loans at December 31, 2017 compared with \$11,938,000, or 1.89% of total loans at December 31, 2016. Loans on non-accrual status were \$7,921,000 at December 31, 2017 compared with \$10,119,000 at December 31, 2016. The reduction was primarily due to \$2,094,000 in paydowns and a \$896,000 partial charge-off related to one single credit; this was partially offset by five credits being placed on nonaccrual totaling \$827,000. In cases where there is a collateral shortfall on non-accrual loans, specific impairment reserves have been established based on updated collateral values even if the borrower continues to pay in accordance with the terms of the agreement. Of the total amount of non-accrual loans at December 31, 2017, \$5,977,000, or approximately 75% of the loans classified as non-accrual, are current or past due less than 30 days.

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QNB had no loans 90 days or more past due and still accruing at December 31, 2017 or at December 31, 2016. Total loans that are 30 days or more past due decreased \$718,000 to \$4,219,000, representing 0.58% of total loans at December 31, 2017 compared with 0.78% of total loans at December 31, 2016. Restructured loans, as defined in accounting guidance for troubled debt restructuring in ASC 310-40, that have not already been included in loans past due 90 days or more and still accruing or in non-accrual loans, totaled \$1,321,000 and \$1,819,000 at December 31, 2017 and 2016, respectively.

QNB held no OREO at December 31, 2016 or 2017. There were no repossessed assets as of December 31, 2016 or 2017.

| Non-Performing Assets                                | 2017    | 2016     | 2015     | 2014     | 2013     |
|--|---------|----------|----------|----------|----------|
| December 31,   |         |          |          |          |          |
| Loans past due 90 days or more and accruing          |         |          |          |          |          |
| Commercial:  |         |          |          |          |          |
| Commercial and industrial                            | \$—     | \$—      | \$—      | \$—      | —        |
| Construction   | —       | —        | —        | —        | —        |
| Secured by commercial real estate                    | —       | —        | —        | —        | —        |
| Secured by residential real estate                   | —       | —        | —        | —        | —        |
| State and political subdivisions                     | —       | —        | —        | —        | —        |
| Loans to depository institutions                     | —       | —        | —        | —        | —        |
| Indirect lease financing                             | —       | —        | 11       | —        | —        |
| Retail:  |         |          |          |          |          |
| 1-4 family residential mortgages                     | —       | —        | —        | —        | —        |
| Home equity loans and lines                          | —       | —        | —        | —        | —        |
| Consumer   | —       | —        | —        | —        | \$1      |
| Total loans past due 90 days or more and accruing    | —       | —        | 11       | —        | 1        |
| Non-accrual loans                                    |         |          |          |          |          |
| Commercial:  |         |          |          |          |          |
| Commercial and industrial                            | 3,367   | 4,798    | 3,433    | 2,171    | 3,956    |
| Construction   | —       | —        | —        | 337      | 1,319    |
| Secured by commercial real estate                    | 1,987   | 3,007    | 3,627    | 6,465    | 4,630    |
| Secured by residential real estate                   | 1,458   | 1,866    | 1,803    | 1,467    | 2,829    |
| State and political subdivisions                     | —       | —        | —        | —        | —        |
| Indirect lease financing                             | —       | —        | 143      | —        | 37       |
| Retail:  |         |          |          |          |          |
| 1-4 family residential mortgages                     | 882     | 266      | 287      | 225      | 401      |
| Home equity loans and lines                          | 142     | 89       | 127      | 104      | 265      |
| Consumer   | 85      | 93       | —        | 1        | 16       |
| Total non-accrual loans                              | 7,921   | 10,119   | 9,420    | 10,770   | 13,453   |
| Troubled debt restructured loans, not included above | 1,321   | 1,819    | 1,288    | 1,897    | 1,960    |
| Other real estate owned                              | —       | —        | —        | 3,025    | 2,825    |
| Repossessed assets                                   | —       | —        | —        | 21       | —        |
| Non-accrual pooled trust preferred securities        | —       | 2,281    | 2,653    | 2,439    | 2,069    |
| Total non-performing assets                          | \$9,242 | \$14,219 | \$13,372 | \$18,152 | \$20,308 |
| Total as a percent of total assets                   | 0.80 %  | 1.34 %   | 1.31 %   | 1.86 %   | 2.18 %   |

Additional loan quality information can be found in Note 5 of the Notes to the Consolidated Financial Statements included in Item 8 of this Form 10-K. Management's view is that loans classified as substandard or doubtful that are not included in the past due, non-accrual or restructured categories are potential problem loans. For some of these loans, management may have knowledge of possible credit problems that will cause management to question the ability of the borrowers to comply with the present loan repayment terms. Commercial loans classified as substandard or doubtful, which includes non-performing loans, continue to show improvement. At December 31, 2017, substandard or doubtful loans totaled \$16,647,000, a reduction of \$5,557,000, or 25.0%, from the \$22,204,000, reported as of December 31, 2016.

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## Allowance for Loan Losses

The allowance for loan losses 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 of 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 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 and the level of unallocated reserves. This analysis considers a number of relevant factors including: specific impairment reserves, historical loan loss experience, general economic conditions, levels of and trends in delinquent and non-performing loans, levels of classified loans, trends in the growth rate of loans and concentrations of credit.

Economic conditions, nationally and in QNB's market, continued to improve in 2017, and asset quality remained strong. The allowance level stated as a percent of loans receivable decreased from 1.17% at December 31, 2016 to 1.07% at December 31, 2017. The allowance for loan losses increased to \$7,841,000 at year-end 2017 from \$7,394,000 at year-end 2016, primarily due to the increase in loans receivable over the same period.

## Allowance for Loan Losses Allocation

| December 31,                            | 2017           |               | 2016           |               | 2015           |               | 2014           |               | 2013           |               |
|---|----------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|
|   | Percent        |               | Percent        |               | Percent        |               | Percent        |               | Percent        |               |
|   | gross          |               | gross          |               | gross          |               | gross          |               | gross          |               |
|   | Amount         | loans         | Amount         | loans         | Amount         | loans         | Amount         | loans         | Amount         | loans         |
| Balance at end of period applicable to: |                |               |                |               |                |               |                |               |                |               |
| Commercial:                             |                |               |                |               |                |               |                |               |                |               |
| Commercial and industrial               | \$2,711        | 20.1 %        | \$1,459        | 17.4 %        | \$1,521        | 20.2 %        | \$1,892        | 21.4 %        | \$2,044        | 22.2 %        |
| Construction                            | 563            | 7.0           | 449            | 6.2           | 286            | 4.4           | 297            | 4.2           | 439            | 3.2           |
| Secured by commercial real estate       | 2,410          | 39.1          | 2,646          | 40.3          | 2,411          | 38.2          | 2,700          | 36.7          | 2,898          | 38.0          |
| Secured by residential real estate      | 816            | 9.8           | 1,760          | 10.9          | 1,812          | 10.3          | 1,630          | 9.6           | 1,632          | 9.5           |
| State and political subdivisions        | 114            | 5.2           | 123            | 5.6           | 222            | 6.5           | 221            | 7.9           | 186            | 6.7           |
| Loans to depository institutions        | —              | —             | —              | —             | —              | —             | —              | —             | 4              | 0.2           |
| Indirect lease financing                | —              | —             | —              | —             | 164            | 1.7           | 93             | 1.4           | 103            | 1.7           |
| Retail:                                 |                |               |                |               |                |               |                |               |                |               |
| 1-4 family residential mortgages        | 444            | 7.6           | 366            | 7.4           | 350            | 7.0           | 312            | 6.7           | 303            | 5.9           |
| Home equity loans and lines             | 357            | 10.3          | 353            | 11.3          | 428            | 11.0          | 453            | 11.4          | 583            | 12.0          |
| Consumer                                | 57             | 0.9           | 76             | 0.9           | 76             | 0.7           | 85             | 0.7           | 64             | 0.6           |
| Unallocated                             | 369            |               | 162            |               | 284            |               | 318            |               | 669            |               |
| <b>Total</b>                            | <b>\$7,841</b> | <b>100.0%</b> | <b>\$7,394</b> | <b>100.0%</b> | <b>\$7,554</b> | <b>100.0%</b> | <b>\$8,001</b> | <b>100.0%</b> | <b>\$8,925</b> | <b>100.0%</b> |

Gross loans represent loans before unamortized net loan fees and costs. Percent gross loans lists the percentage of each loan type to total loans.

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 may not be classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration all the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral, if the loan is collateral dependent. At December 31, 2017 and 2016, the recorded investment in loans for which impairment has been identified totaled \$13,584,000 and \$15,006,000, respectively, of which \$11,125,000 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 \$2,459,000 and \$4,097,000 at December 31, 2017 and 2016, respectively. At December 31, 2017 and



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2016, the related allowance for loan losses associated with these loans was \$1,392,000 and \$1,198,000, respectively. See Note 5 to the Notes to Consolidated Financial Statements included in Item 8 of this Form 10-K for additional detail of impaired loans.

Allowance for Loan Losses

|   | 2017      | 2016      | 2015      | 2014      | 2013      |
|---|-----------|-----------|-----------|-----------|-----------|
| Allowance for loan losses:                  |           |           |           |           |           |
| Balance, January 1                          | \$7,394   | \$7,554   | \$8,001   | \$8,925   | \$9,772   |
| Charge-offs                                 |           |           |           |           |           |
| Commercial:                                 |           |           |           |           |           |
| Commercial and industrial                   | 960       | 140       | 56        | 17        | 68        |
| Construction                                | —         | —         | —         | —         | —         |
| Secured by commercial real estate           | —         | —         | 84        | 70        | 639       |
| Secured by residential real estate          | 23        | 120       | 531       | 1,069     | 401       |
| State and political subdivisions            | —         | —         | —         | —         | —         |
| Indirect lease financing                    | —         | 52        | 21        | 39        | 2         |
| Retail:                                     |           |           |           |           |           |
| 1-4 family residential mortgages            | —         | —         | —         | 95        | —         |
| Home equity loans and lines                 | —         | —         | —         | 156       | 234       |
| Consumer                                    | 92        | 92        | 95        | 167       | 77        |
| Total charge-offs                           | 1,075     | 404       | 787       | 1,613     | 1,421     |
| Recoveries                                  |           |           |           |           |           |
| Commercial:                                 |           |           |           |           |           |
| Commercial and industrial                   | 34        | 37        | 38        | 67        | 28        |
| Construction                                | —         | —         | —         | —         | —         |
| Secured by commercial real estate           | 8         | 8         | 9         | 3         | 1         |
| Secured by residential real estate          | 38        | 112       | 26        | 48        | 60        |
| State and political subdivisions            | —         | —         | —         | —         | 1         |
| Indirect lease financing                    | —         | 9         | 16        | 14        | 30        |
| Retail:                                     |           |           |           |           |           |
| 1-4 family residential mortgages            | —         | —         | —         | 1         | —         |
| Home equity loans and lines                 | 10        | 16        | 22        | 110       | 28        |
| Consumer                                    | 32        | 32        | 29        | 46        | 26        |
| Total recoveries                            | 122       | 214       | 140       | 289       | 174       |
| Net charge-offs                             | (953 )    | (190 )    | (647 )    | (1,324 )  | (1,247 )  |
| Provision for loan losses                   | 1,400     | 30        | 200       | 400       | 400       |
| Balance, December 31                        | \$7,841   | \$7,394   | \$7,554   | \$8,001   | \$8,925   |
| Total loans (excluding loans held-for-sale) |           |           |           |           |           |
| Average                                     | \$682,292 | \$604,757 | \$574,015 | \$523,825 | \$482,112 |
| Year-end                                    | 733,283   | 633,079   | 615,270   | 555,282   | 501,716   |
| Ratios:                                     |           |           |           |           |           |
| Net charge-offs to:                         |           |           |           |           |           |
| Average loans                               | 0.14      | % 0.03    | % 0.11    | % 0.25    | % 0.26    |
| Loans at year-end                           | 0.13      | 0.03      | 0.11      | 0.24      | 0.25      |
| Allowance for loan losses                   | 12.15     | 2.57      | 8.56      | 16.55     | 13.97     |
| Provision for loan losses                   | 68.07     | 633.33    | 323.50    | 331.00    | 311.75    |

|                               |      |   |      |   |      |   |      |   |      |   |
|-------------------------------|------|---|------|---|------|---|------|---|------|---|
| Allowance for loan losses to: |      |   |      |   |      |   |      |   |      |   |
| Average loans                 | 1.15 | % | 1.22 | % | 1.32 | % | 1.53 | % | 1.85 | % |
| Loans at year-end             | 1.07 |   | 1.17 |   | 1.23 |   | 1.44 |   | 1.78 |   |

QNB had net loan charge-offs of \$953,000, or 0.14% of average loans for 2017 compared with \$190,000, or 0.03% of average loans for 2016 and \$647,000 or 0.11% of average loans for 2015. The majority of charge-offs recorded during these periods had specific reserves established during the allowance for loan loss calculation process prior to the decision to charge-off the loan. The increase in commercial and industrial charge-offs in 2017 is primarily related to a single credit.

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Management believes the allowance for loan losses of \$7,841,000 is adequate as of December 31, 2017, in relation to the estimate of known and inherent losses in the portfolio.

#### Premises and equipment

Premises and equipment, net of depreciation decreased \$188,000 to \$8,495,000 at December 31, 2017, as depreciation more than offset the net purchases during 2017.

#### Other assets

Other assets, as presented in the table on page 33, decreased \$1,166,000 from \$7,750,000 at December 31, 2016 to \$6,584,000 at December 31, 2017. Most of the decrease in other assets relates to a \$2,054,000 decrease to the deferred tax asset resulting from the 2017 Tax Reform Act rate change from 34% to 21% for QNB. The detail of the net deferred tax asset can be found in Note 11 in the Notes to Consolidated Financial Statements.

### LIABILITIES

The following table presents total liabilities at the dates indicated:

| Year ended December 31,  | 2017        | 2016      | Change from prior year |         |   |
|--------------------------|-------------|-----------|------------------------|---------|---|
|                          |             |           | Amount                 | Percent |   |
| Deposits                 | \$993,948   | \$913,355 | \$80,593               | 8.8     | % |
| Short-term borrowings    | 55,756      | 52,660    | 3,096                  | 5.9     |   |
| Accrued interest payable | 384         | 335       | 49                     | 14.6    |   |
| Other liabilities        | 3,679       | 3,224     | 455                    | 14.1    |   |
| Total liabilities        | \$1,053,767 | \$969,574 | \$84,193               | 8.7     | % |

#### Deposits

QNB primarily attracts deposits from within its market area by offering various deposit products. These deposits are in the form of time deposits, which include certificates of deposit and individual retirement accounts ("IRA"s) which have a stated maturity, and non-maturity deposit accounts, which include: non-interest bearing demand accounts, interest-bearing demand accounts, money market accounts and savings accounts.

Total deposits increased \$80,593,000, or 8.8%, to \$993,948,000 at December 31, 2017. This follows an increase of \$23,569,000, or 2.6%, between 2015 and 2016. QNB has experienced growth in part due to market disruption created by bank mergers in its footprint throughout 2016 and 2017. The growth in deposits as well as the mix of deposits continues to be impacted by customers' reactions to the industry, regulations and the interest rate environment. Many customers are looking for transaction accounts that provide liquidity and pay a reasonable amount of interest. Time deposit balances declined slightly. Customers appear to be looking for the safety of FDIC insured deposits and the stability of a strong local community bank.

Contributing to the increase in total deposits was growth in non-interest bearing demand accounts, which increased \$10,202,000, or 8.6%, to \$129,212,000 at December 31, 2017. This followed growth of \$20,467,000, or 20.8%, between December 31, 2015 and December 31, 2016. These deposits are primarily comprised of business checking accounts and are volatile depending on the timing of deposits and withdrawals. QNB has been successful in attracting new customers and expanding relationships with existing customers, which not only contributes to the increase in

balances but also provides an opportunity for fee income.

Interest-bearing demand accounts, retail and business interest checking and municipal accounts increased \$41,716,000, or 16.3%, to \$297,470,000 at December 31, 2017. All segments experienced growth in 2017. Municipal accounts increased \$25,398,000. While QNB has been successful in developing relationships with several school districts and municipalities as well as expanding existing relationships, the balances in these accounts are seasonal in nature and can be volatile on a daily basis. Most of the school district taxes are collected during the third quarter of the year and are disbursed over a nine-month period.

Business checking increased from \$16,861,000 at December 31, 2016 to \$19,937,000 at December 31, 2017. Rewards checking balances increased from \$49,428,000 at December 31, 2016 to \$55,071,000 at December 31, 2017, and Select 50 balances increased from \$77,959,000 to \$81,877,000 over this same period. Personal interest-bearing balances also increased from \$18,739,000 at December 31, 2016 to \$22,421,000 at December 31, 2017. QNB continues to open a significant number of new checking accounts.

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Money Market accounting increased from \$74,762,000 at December 31, 2016 to \$84,562,000 at December 31, 2017 due to increases in both personal and business accounts.

Total savings account balances increased \$19,275,000, or 8.1%, to \$257,522,000 at December 31, 2017. This increase is due primarily to an increase in the online eSavings account of \$11,877,000, or 6.8%, to \$186,196,000 at December 31, 2017. The rate on eSavings accounts was changed from 0.55% at the end of 2016 to 0.60% in June 2017 and to 0.65% in late December 2017.

Total time deposit account balances were \$225,182,000 at December 31, 2017, a decrease of \$400,000, or 0.2%, from the amount reported at December 31, 2016. As time deposits matured during the past two years, they were frequently reinvested in the high yielding and liquid Rewards or Select 50 checking, money market or eSavings accounts which, in many instances, paid a rate higher than what was offered on short-term time deposits.

To continue to attract and retain deposits, QNB plans to remain competitive with respect to rates and to continue to deliver products with terms and features that appeal to customers. The QNB Rewards checking and online eSavings accounts are examples of such products.

| Year ended December 31,               | 2017             | 2016            | 2015            |
|---------------------------------------|------------------|-----------------|-----------------|
| Three months or less                  | \$11,842         | \$11,618        | \$12,124        |
| Over three months through six months  | 10,937           | 8,211           | 11,624          |
| Over six months through twelve months | 21,972           | 15,970          | 13,691          |
| Over twelve months                    | 55,946           | 58,413          | 54,686          |
| <b>Total</b>                          | <b>\$100,697</b> | <b>\$94,212</b> | <b>\$92,125</b> |

### Average Deposits by Major Classification

|                                    | 2017             |               | 2016             |               | 2015             |               |
|------------------------------------|------------------|---------------|------------------|---------------|------------------|---------------|
|                                    | Balance          | Rate          | Balance          | Rate          | Balance          | Rate          |
| Demand, non-interest bearing       | \$121,819        | —             | \$107,579        | —             | \$96,146         | —             |
| Interest-bearing demand            | 169,940          | 0.21 %        | 153,598          | 0.21 %        | 134,342          | 0.21 %        |
| Municipals interest-bearing demand | 110,052          | 0.71          | 102,060          | 0.34          | 115,975          | 0.34          |
| Money market                       | 84,203           | 0.30          | 71,256           | 0.27          | 65,413           | 0.24          |
| Savings                            | 249,894          | 0.46          | 229,779          | 0.40          | 217,561          | 0.37          |
| Time                               | 128,603          | 1.18          | 133,407          | 1.12          | 141,869          | 1.09          |
| Time of \$100,000 or more          | 97,987           | 1.40          | 94,862           | 1.37          | 92,495           | 1.30          |
| <b>Total</b>                       | <b>\$962,498</b> | <b>0.56 %</b> | <b>\$892,541</b> | <b>0.51 %</b> | <b>\$863,801</b> | <b>0.51 %</b> |

### Short-term borrowings

Short-term borrowings comprising commercial sweep accounts and overnight FHLB borrowings grew \$3,096,000, or 5.9%, to \$55,756,000 at December 31, 2017. Overnight FHLB borrowings increased \$6,590,000, to \$13,911,000 at December 31, 2017. Commercial sweeps declined \$3,494,000, or 7.7%, to \$41,845,000 at December 31, 2017.

### 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.

An additional source of liquidity is provided by the Bank's membership in the FHLB. At December 31, 2017, the Bank had a maximum borrowing capacity with the FHLB of approximately \$271,109,000, net of the \$13,911,000 outstanding at year-end 2017 and \$350,000 FHLB-issued letter of credit. The maximum borrowing capacity changes as a function of qualifying collateral assets. QNB had \$7,321,000 in FHLB borrowings at December 31, 2016. In addition, the Bank maintains four unsecured Federal funds lines with four correspondent banks totaling \$46,000,000. At December 31, 2017 and 2016, there were no outstanding borrowings under these lines. Future availability under these lines is subject to the policies of the granting banks and may be withdrawn. As part of its contingency funding plan, QNB successfully tested its ability to borrow from these sources during the fourth quarter of 2017.

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Total cash and cash equivalents, trading and available-for-sale securities and loans held-for-sale totaled \$395,876,000 at December 31, 2017 and \$405,581,000 at December 31, 2016. At December 31, 2017 and 2016, investment securities totaling \$202,887,000 and \$166,628,000, respectively, were pledged as collateral for repurchase agreements and public deposits. This decrease in liquid sources is primarily the result of a \$14,526,000 decrease in trading and available-for-sale securities. Management anticipates that these liquid sources are adequate to meet normal fluctuations in loan demand or deposit withdrawals. It is anticipated that the investment portfolio will continue to provide sufficient liquidity as municipal bonds are called and as principal and interest payments on mortgage-backed and CMO securities provide steady cash flow. An increase in interest rates, however, would result in decreased cash flow available from the investment portfolio.

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. QNB had \$250,000 in CDARS time deposits at December 31, 2017.

#### Other liabilities

Other liabilities comprise accrued expenses including salaries, post-retirement life insurance benefits and income taxes, deferred revenue, and ATM/debit card processing clearing. This category increased \$455,000 to \$3,679,000 at December 31, 2017.

#### SHAREHOLDERS' EQUITY

The following table presents total shareholders' equity at the dates indicated:

| Year ended December 31,                   | 2017     | 2016     | Change from prior year |         |
|---|----------|----------|------------------------|---------|
|   |          |          | Amount                 | Percent |
| Common stock                              | \$2,258  | \$2,235  | \$23                   | 1.0 %   |
| Surplus                                   | 18,691   | 17,418   | 1,273                  | 7.3     |
| Retained earnings                         | 84,183   | 80,147   | 4,036                  | 5.0     |
| Accumulated other comprehensive loss, net |          |          |                        |         |
| of tax                                    | (4,086 ) | (3,757 ) | (329 )                 | -8.8    |
| Treasury stock                            | (2,476 ) | (2,476 ) | —                      | —       |
| Total shareholders' equity                | \$98,570 | \$93,567 | \$5,003                | 5.3 %   |

Total shareholders' equity increased \$5,003,000, or 5.3%, to \$98,570,000 at December 31, 2017 with retained earnings -- net income less dividends paid -- contributing \$4,036,000 and the dividend reinvestment and stock purchase plan, employee stock purchase plan and stock option plan contributing \$1,194,000. Accumulated other comprehensive income decreased \$329,000, resulting from the decrease in fair value of the available-for-sale investment portfolio caused by increasing interest rates at the end of 2017. QNB remains “well capitalized” based on FDIC requirements.

QNB will adopt ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, and ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 202), in 2018 as discussed in Note 1. The implementation of ASU 2016-01 and ASU 2018-02 will result in reclasses within Shareholders Equity from “Accumulated other comprehensive loss, net of tax” to “Retained earnings” of a \$254,000 net loss and a \$805,000 net gain, respectively.

#### 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 December 31, 2017 was \$98,570,000, or 8.55% of total assets, compared with shareholders’ equity of \$93,567,000, or 8.80% of total assets, at December 31, 2016. Shareholders’ equity at December 31, 2017 included a negative adjustment of \$4,086,000 related to unrealized holding losses, net of taxes, on investment securities available for sale. At December 31, 2016, shareholders’ equity included a negative adjustment of \$3,757,000, related to unrealized holding losses, net of taxes, on investment securities available-for-sale. Excluding these adjustments, shareholders’ equity to total assets would have been 8.88% and 9.12% at December 31, 2017 and 2016, respectively.

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Average shareholders' equity and average total assets were \$101,496,000 and \$1,117,163,000 for 2017, an increase of 7.4% and 8.3%, respectively, from 2016 average equity and average total assets of \$94,472,000 and \$1,031,198,000, respectively. The ratio of average total equity to total average assets was 9.09% for 2017, compared with 9.16% for 2016.

QNB is subject to restrictions on the payment of dividends to its shareholders pursuant to the Pennsylvania Business Corporation Law of 1988 as amended (the BCL). The BCL operates generally to preclude dividend payments, if the effect thereof would render QNB insolvent, as defined. As a practical matter, QNB's payment of dividends is contingent upon its ability to obtain funding in the form of dividends from the Bank. Under Pennsylvania banking law, the Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2017, the retained earnings of the Bank totaling \$90,532,000 was available for dividends without prior Pennsylvania Department of Banking approval, subject to the regulatory capital requirements discussed below. The approval of the Federal Reserve is required for a state bank member in the Federal Reserve system to pay dividends if the total of all dividends declared in any calendar year exceeds the Bank's net profits (as defined) for that year combined with its retained net profits for the preceding two calendar years. Under this formula, the Bank can declare dividends in 2018 without approval of the Federal Reserve of approximately \$9,650,000 plus an additional amount equal to the Bank's net profits for 2018 up to the date of any such dividend declaration. QNB paid dividends to its shareholders of \$1.24 per share, \$1.20 per share, and \$1.16 per share, in 2017, 2016, and 2015, respectively.

QNB is 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. QNB is subject to various regulatory capital requirements as issued by Federal regulatory authorities. 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 held by banks. 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 will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets and 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 and the Bank have enough capital to meet the buffer if it were fully phased in at December 31, 2017.

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 \$973,000 and \$983,000 to capital during 2017 and 2016, respectively.

The Board of Directors has authorized the repurchase of up to 100,000 shares of QNB's common stock in open market or privately negotiated transactions. The repurchase authorization does not bear a termination date. As of December 31, 2017 and 2016, 57,883 shares were repurchased under this authorization at an average price of \$16.97 and a total cost of \$982,000. There were no shares repurchased under the plan since the first quarter of 2009.

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The Federal Deposit Insurance Corporation Improvement Act of 1991 established five capital level designations ranging from “well capitalized” to “critically undercapitalized.” At December 31, 2017 and 2016, management believes that the Company and the Bank met all capital adequacy requirements to which they are subject and have met the “well capitalized” criteria.

| Capital Analysis  |             |             |
|---|-------------|-------------|
| December 31,  | 2017        | 2016        |
| Regulatory Capital  |             |             |
| Shareholders' equity  | \$98,570    | \$93,567    |
| Net unrealized securities losses, net of tax                                      | 4,086       | 3,757       |
| Net unrealized losses on available-for-sale equity securities, net of tax         | (212)       | —           |
| Disallowed goodwill and other disallowed intangible assets                        | (6)         | (4)         |
| Common equity tier I capital  | 102,438     | 97,320      |
| Tier 1 capital  | 102,438     | 97,320      |
| Allowable portion: Allowance for loan losses and reserve for unfunded commitments |             |             |
|   | 7,914       | 7,453       |
| Unrealized gains on equity securities, net of tax                                 | —           | 47          |
| Total regulatory capital  | \$110,352   | \$104,820   |
| Risk-weighted assets  | \$881,503   | \$822,210   |
| Quarterly average assets for leverage capital purposes                            | \$1,153,721 | \$1,061,976 |

| Capital Ratios                                      |        |        |
|---|--------|--------|
| December 31,  | 2017   | 2016   |
| Common equity tier I capital / risk-weighted assets | 11.62% | 11.84% |
| Tier 1 capital / risk-weighted assets               | 11.62% | 11.84% |
| Total regulatory capital / risk-weighted assets     | 12.52% | 12.75% |
| Tier 1 capital / average assets (leverage ratio)    | 8.88 % | 9.16 % |

Contractual Obligations, Commitments, and Off-Balance Sheet Arrangements

QNB has various financial obligations, including contractual obligations and commitments, which may require future cash payments.

The following table presents, as of December 31, 2017, significant contractual obligations to third parties by payment date and the amounts and expected maturities of significant commitments. Further discussion of the nature of each obligation can be found in the Notes to Consolidated Financial Statements. The Company’s reserve for unfunded commitments totaled \$73,000 at December 31, 2017 and \$59,000 at December 31, 2016.

| December 31, 2017 | One year or less | After one | After three | After | Total |
|-------------------|------------------|-----------|-------------|-------|-------|
|-------------------|------------------|-----------|-------------|-------|-------|

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|   |           | year     | years    | five     |           |
|---|-----------|----------|----------|----------|-----------|
|   |           | through  | through  | years    |           |
|   |           | three    | five     |          |           |
|   |           | years    | years    |          |           |
| Time deposits                               | \$96,190  | \$64,651 | \$64,341 | —        | \$225,182 |
| Short-term borrowings                       | 55,756    | —        | —        | —        | 55,756    |
| Operating leases                            | 576       | 1,156    | 685      | \$5,596  | 8,013     |
| Commitments to extend credit <sup>(a)</sup> | 245,649   | 14,276   | 115      | 53,501   | 313,541   |
| Standby letters of credit                   | 14,326    | 752      | 133      | —        | 15,211    |
| Total                                       | \$412,497 | \$80,835 | \$65,274 | \$59,097 | \$617,703 |

(a) Includes available amounts for overdraft protection program in one year or less

Commitments to extend credit, including loan commitments, standby letters of credit, and commercial letters of credit do not necessarily represent future cash requirements, as these commitments often expire without being drawn upon. The Company does not currently have any commitments for significant capital expenditures or other purchase obligations.

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## 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 to a greater extent than its earning assets (loans and securities). A liability sensitive balance sheet will produce relatively less net interest income when interest rates rise and more net interest income when they decline. Based on our simulation analysis, management believes QNB's interest sensitivity position at December 31, 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 Federal Reserve.

The following table shows the estimated impact of changes in interest rates on net interest income as of December 31, 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 |              |        |
|---|--------------|--------|
| Change in interest rates (basis points) | December 31, |        |
|   | 2017         | 2016   |
| +300                                    | -7.7%        | -10.4% |
| +200                                    | -5.0%        | -6.8%  |
| +100                                    | -2.3%        | -3.3%  |
| -100                                    | -3.3%        | *NM    |

\*certain short-term 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 December 31, 2017 QNB did not have any hedging transactions in place such as interest rate swaps, caps or floors.

#### RECENTLY ISSUED ACCOUNTING STANDARDS

Refer to Note 1 of the Notes to Consolidated Financial Statements for discussion of recently issued accounting standards.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Disclosure of the Company's significant accounting policies is included in Note 1 to Consolidated Financial Statements. Additional information is contained in Management's Discussion and Analysis and the Notes to Consolidated Financial Statements for the most sensitive of these issues. 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

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allowance for loan losses, the determination of the valuation of other real estate owned, other-than-temporary impairments on investment securities, the determination of impairment of restricted bank stock, the valuation of deferred tax assets, stock-based compensation and income taxes. QNB bases its estimates on historical experience and various other factors and assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

#### Other-than-Temporary Investment Security Impairment

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

The Company follows the accounting guidance in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 320-10 as it relates to the recognition and presentation of other-than-temporary impairment (“OTTI”). This accounting guidance specifies that (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 non-credit portion of a previous other-than-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

#### Allowance for Loan Losses

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

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

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized in order to assess and monitor the degree of risk in the loan portfolio. QNB’s lending and credit administration staff are charged with reviewing the loan portfolio and identifying changes in the economy or in a borrower’s circumstances which may affect the ability to repay debt or the value of pledged collateral. A loan classification and review system exists that identifies those loans with a higher than normal risk of 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.

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#### 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

At December 31, 2017, QNB sponsored stock-based compensation plans, administered by a Board committee, under which both qualified and nonqualified stock options may be granted periodically to certain employees. QNB accounts for all awards granted under stock-based compensation plans in accordance with ASC 718, Compensation – Stock Compensation. Compensation cost has been measured using the fair value of an award on the grant date and is recognized over the service period, which is usually the vesting period. The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the option and each vesting date. QNB estimates the fair value of stock options on the date of the grant using the Black-Scholes option pricing model. The model requires the use of numerous assumptions, many of which are highly subjective in nature.

#### Income Taxes

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

#### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required in response to this item is set forth in Item 7, above.



ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following audited financial statements are set forth in this Annual Report on Form 10-K on the following pages:

|  |         |
|--|---------|
| <u>Report of Independent Registered Public Accounting Firm</u> | Page 53 |
| <u>Consolidated Balance Sheets</u>                             | Page 55 |
| <u>Consolidated Statements of Income</u>                       | Page 56 |
| <u>Consolidated Statements of Comprehensive Income</u>         | Page 57 |
| <u>Consolidated Statements of Shareholders' Equity</u>         | Page 58 |
| <u>Consolidated Statements of Cash Flows</u>                   | Page 59 |
| <u>Notes to Consolidated Financial Statements</u>              | Page 60 |

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Management's Report on Internal Control over Financial Reporting

March 16, 2018

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2017, in relation to criteria for effective internal control over financial reporting as described in "Internal Control Integrated Framework (2013)," issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management concludes that, as of December 31, 2017, the Company's system of internal control over financial reporting is effective and meets the criteria of the "Internal Control Integrated Framework (2013)."

Baker Tilly Virchow Krause, LLP, an independent registered public accounting firm, has audited the Company's consolidated financial statements as of and for the year ended December 31, 2017 and the effectiveness of the Company's internal control over financial reporting as of December 31, 2017, as stated in their report, which are included herein.

|                         |                            |
|-------------------------|----------------------------|
| /s/ David W. Freeman    | /s/ Janice McCracken Erkes |
| David W. Freeman        | Janice McCracken Erkes     |
| Chief Executive Officer | Chief Financial Officer    |

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of QNB Corp.:

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of QNB Corp. and subsidiary (the "Company") as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows, for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework: (2013) issued by COSO.

Basis for Opinion

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Assessment of Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.



Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinion.

#### Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Baker Tilly Virchow Krause, LLP

Allentown, Pennsylvania

We have served as the Company's auditor since 2007.

March 16, 2018

## CONSOLIDATED BALANCE SHEETS

| December 31,   | (in thousands, except share data) |             |
|--|-----------------------------------|-------------|
|  | 2017                              | 2016        |
| <b>Assets</b>  |                                   |             |
| Cash and due from banks  | \$10,793                          | \$8,897     |
| Interest-bearing deposits in banks   | 5,538                             | 1,824       |
| Total cash and cash equivalents  | 16,331                            | 10,721      |
| <b>Investment securities</b>   |                                   |             |
| Trading  | —                                 | 3,596       |
| Available-for-sale (amortized cost \$385,736 and \$396,168)                        | 379,545                           | 390,475     |
| Restricted investment in bank stocks   | 1,501                             | 1,017       |
| Loans held-for-sale  | —                                 | 789         |
| Loans receivable   | 733,283                           | 633,079     |
| Allowance for loan losses  | (7,841 )                          | (7,394 )    |
| Net loans  | 725,442                           | 625,685     |
| Bank-owned life insurance  | 10,894                            | 11,297      |
| Premises and equipment, net  | 8,495                             | 8,683       |
| Accrued interest receivable  | 3,545                             | 3,128       |
| Net deferred tax assets  | 3,319                             | 5,473       |
| Other assets   | 3,265                             | 2,277       |
| Total assets   | \$1,152,337                       | \$1,063,141 |
| <b>Liabilities</b>   |                                   |             |
| <b>Deposits</b>  |                                   |             |
| Demand, non-interest bearing   | \$129,212                         | \$119,010   |
| Interest-bearing demand  | 297,470                           | 255,754     |
| Money market   | 84,562                            | 74,762      |
| Savings  | 257,522                           | 238,247     |
| Time   | 124,485                           | 131,370     |
| Time of \$100 or more  | 100,697                           | 94,212      |
| Total deposits   | 993,948                           | 913,355     |
| Short-term borrowings  | 55,756                            | 52,660      |
| Accrued interest payable   | 384                               | 335         |
| Other liabilities  | 3,679                             | 3,224       |
| Total liabilities  | 1,053,767                         | 969,574     |
| <b>Shareholders' Equity</b>  |                                   |             |
| Common stock, par value \$0.625 per share; authorized 10,000,000 shares; 3,612,677 |                                   |             |
| shares and 3,576,270 shares issued; 3,448,108 and 3,411,701 shares outstanding     | 2,258                             | 2,235       |
| Surplus  | 18,691                            | 17,418      |
| Retained earnings  | 84,183                            | 80,147      |
| Accumulated other comprehensive loss, net of tax                                   | (4,086 )                          | (3,757 )    |
| Treasury stock, at cost; 164,569 shares  | (2,476 )                          | (2,476 )    |
| Total shareholders' equity   | 98,570                            | 93,567      |
| Total liabilities and shareholders' equity   | \$1,152,337                       | \$1,063,141 |

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

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## CONSOLIDATED STATEMENTS OF INCOME

| Year ended December 31,   | (in thousands, except per share data) |               |               |
|---|---------------------------------------|---------------|---------------|
|   | 2017                                  | 2016          | 2015          |
| <b>Interest income</b>  |                                       |               |               |
| Interest and fees on loans  | \$29,740                              | \$25,525      | \$24,356      |
| <b>Interest and dividends on investment securities (AFS &amp; HTM):</b>       |                                       |               |               |
| Taxable   | 6,270                                 | 5,454         | 5,219         |
| Tax-exempt  | 1,957                                 | 1,949         | 2,009         |
| Interest on trading securities  | 45                                    | 138           | 163           |
| Interest on interest-bearing balances and other interest income               | 90                                    | 171           | 128           |
| <b>Total interest income</b>  | <b>38,102</b>                         | <b>33,237</b> | <b>31,875</b> |
| <b>Interest expense</b>   |                                       |               |               |
| <b>Interest on deposits</b>   |                                       |               |               |
| Interest-bearing demand   | 1,137                                 | 666           | 678           |
| Money market  | 249                                   | 192           | 158           |
| Savings   | 1,156                                 | 923           | 806           |
| Time  | 1,512                                 | 1,497         | 1,548         |
| Time of \$100 or more   | 1,373                                 | 1,301         | 1,199         |
| Interest on short-term borrowings   | 253                                   | 154           | 117           |
| <b>Total interest expense</b>   | <b>5,680</b>                          | <b>4,733</b>  | <b>4,506</b>  |
| <b>Net interest income</b>  | <b>32,422</b>                         | <b>28,504</b> | <b>27,369</b> |
| Provision for loan losses   | 1,400                                 | 30            | 200           |
| <b>Net interest income after provision for loan losses</b>                    | <b>31,022</b>                         | <b>28,474</b> | <b>27,169</b> |
| <b>Non-interest income</b>  |                                       |               |               |
| Total other-than-temporary impairment loss on investment securities           | (80 )                                 | (192 )        | (55 )         |
| Less: Portion of loss recognized in other comprehensive income (before taxes) | —                                     | —             | —             |
| <b>Net other-than temporary impairment losses on investment securities</b>    | <b>(80 )</b>                          | <b>(192 )</b> | <b>(55 )</b>  |
| Net gain on sale of investment securities                                     | 1,580                                 | 866           | 838           |
| Net gain on investment securities   | 1,500                                 | 674           | 783           |
| Net (loss) gain on trading activities   | 27                                    | (40 )         | 33            |
| Fees for services to customers  | 1,668                                 | 1,621         | 1,657         |
| ATM and debit card  | 1,749                                 | 1,651         | 1,571         |
| Retail brokerage and advisory   | 436                                   | 603           | 686           |
| Bank-owned life insurance   | 345                                   | 308           | 307           |
| Merchant  | 345                                   | 334           | 298           |
| Net gain on sale of loans   | 375                                   | 320           | 356           |
| Loss on sale of indirect lease financing portfolio                            | —                                     | (223 )        | —             |
| Other   | 442                                   | 419           | 341           |
| <b>Total non-interest income</b>  | <b>6,887</b>                          | <b>5,667</b>  | <b>6,032</b>  |
| <b>Non-interest expense</b>   |                                       |               |               |
| Salaries and employee benefits  | 13,121                                | 12,011        | 12,076        |
| Net occupancy   | 1,789                                 | 1,750         | 1,762         |
| Furniture and equipment   | 1,859                                 | 1,753         | 1,726         |
| Marketing   | 914                                   | 806           | 805           |



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|                                 |         |         |         |
|---------------------------------|---------|---------|---------|
| Third party services            | 1,608   | 1,691   | 1,703   |
| Telephone, postage and supplies | 804     | 752     | 731     |
| State taxes                     | 687     | 666     | 681     |
| FDIC insurance premiums         | 577     | 568     | 631     |
| Other                           | 2,361   | 2,166   | 2,283   |
| Total non-interest expense      | 23,720  | 22,163  | 22,398  |
| Income before income taxes      | 14,189  | 11,978  | 10,803  |
| Provision for income taxes      | 5,900   | 3,054   | 2,570   |
| Net income                      | \$8,289 | \$8,924 | \$8,233 |
| Earnings per share - basic      | \$2.42  | \$2.64  | \$2.47  |
| Earnings per share - diluted    | \$2.41  | \$2.63  | \$2.46  |
| Cash dividends per share        | \$1.24  | \$1.20  | \$1.16  |

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

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## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| Year ended December 31,  | (in thousands) |           |         |          |           |         |          |           |         |
|--------------------------|----------------|-----------|---------|----------|-----------|---------|----------|-----------|---------|
|                          | 2017           |           |         | 2016     |           |         | 2015     |           |         |
|                          | Before         | Tax       | Net of  | Before   | Tax       | Net of  | Before   | Tax       | Net of  |
|                          | tax            | expense   | tax     | tax      | expense   | tax     | tax      | expense   | tax     |
|                          | amount         | (benefit) | amount  | amount   | (benefit) | amount  | amount   | (benefit) | amount  |
| Net income               | \$14,189       | \$5,900   | \$8,289 | \$11,978 | \$3,054   | \$8,924 | \$10,803 | \$2,570   | \$8,233 |
| Other comprehensive      |                |           |         |          |           |         |          |           |         |
| (loss) income:           |                |           |         |          |           |         |          |           |         |
| Net unrealized holding   |                |           |         |          |           |         |          |           |         |
| (losses) gains on        |                |           |         |          |           |         |          |           |         |
| securities:              |                |           |         |          |           |         |          |           |         |
| Unrealized holding       |                |           |         |          |           |         |          |           |         |
| (losses) gains           |                |           |         |          |           |         |          |           |         |
| arising during           |                |           |         |          |           |         |          |           |         |
| the period               | 1,002          | 341       | 661     | (4,192)  | (1,426)   | (2,766) | (1,419)  | (483)     | (936)   |
| Reclassification         |                |           |         |          |           |         |          |           |         |
| adjustment for           |                |           |         |          |           |         |          |           |         |
| gains included           |                |           |         |          |           |         |          |           |         |
| in net income            | (1,500)        | (510)     | (990)   | (674)    | (229)     | (445)   | (783)    | (266)     | (517)   |
| Other comprehensive loss | (498)          | (169)     | (329)   | (4,866)  | (1,655)   | (3,211) | (2,202)  | (749)     | (1,453) |
| Total comprehensive      |                |           |         |          |           |         |          |           |         |
| income                   | \$13,691       | \$5,731   | \$7,960 | \$7,112  | \$1,399   | \$5,713 | \$8,601  | \$1,821   | \$6,780 |

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

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

| (in thousands, except share and per share data)                               | Number of |          | Common    | Retained  | Accumulated |                            | Total     |
|---|-----------|----------|-----------|-----------|-------------|----------------------------|-----------|
|   | Shares    | Stock    |           |           | Surplus     | Other Comprehensive Income |           |
| Balance, December 31, 2014  | 3,316,658 | \$ 2,176 | \$ 14,819 | \$ 70,928 | \$ 907      | \$(2,476)                  | \$ 86,354 |
| Net income  |           | —        | —         | 8,233     | —           | —                          | 8,233     |
| Other comprehensive loss, net of tax  |           | —        | —         | —         | (1,453)     | —                          | (1,453)   |
| Cash dividends declared (\$1.16 per share)                                    |           | —        | —         | (3,872)   | —           | —                          | (3,872)   |
| Stock issued in connection with dividend reinvestment and stock purchase plan | 30,667    | 19       | 852       | —         | —           | —                          | 871       |
| Stock issued for employee stock purchase plan                                 | 3,186     | 2        | 81        | —         | —           | —                          | 83        |
| Stock issued for options exercised  | 9,283     | 6        | 115       | —         | —           | —                          | 121       |
| Tax benefit of stock options exercised  |           | —        | 21        | —         | —           | —                          | 21        |
| Stock-based compensation expense  |           | —        | 85        | —         | —           | —                          | 85        |
| Balance, December 31, 2015  | 3,359,794 | \$ 2,203 | \$ 15,973 | \$ 75,289 | \$ (546)    | \$(2,476)                  | \$ 90,443 |
| Net income  |           | —        | —         | 8,924     | —           | —                          | 8,924     |
| Other comprehensive loss, net of tax  |           | —        | —         | —         | (3,211)     | —                          | (3,211)   |
| Cash dividends declared (\$1.20 per share)                                    |           | —        | —         | (4,066)   | —           | —                          | (4,066)   |
| Stock issued in connection with dividend reinvestment and stock purchase plan | 31,595    | 19       | 964       | —         | —           | —                          | 983       |
| Stock issued for employee stock purchase plan                                 | 2,932     | 2        | 79        | —         | —           | —                          | 81        |
| Stock issued for options exercised  | 17,380    | 11       | 297       | —         | —           | —                          | 308       |
| Tax benefit of stock options exercised  |           | —        | 17        | —         | —           | —                          | 17        |
| Stock-based compensation expense  |           | —        | 88        | —         | —           | —                          | 88        |
| Balance, December 31, 2016  | 3,411,701 | \$ 2,235 | \$ 17,418 | \$ 80,147 | \$ (3,757)  | \$(2,476)                  | \$ 93,567 |
| Net income  |           | —        | —         | 8,289     | —           | —                          | 8,289     |
| Other comprehensive loss, net of tax  |           | —        | —         | —         | (329)       | —                          | (329)     |
| Cash dividends declared (\$1.24 per share)                                    |           | —        | —         | (4,253)   | —           | —                          | (4,253)   |
|   | 25,048    | 16       | 957       | —         | —           | —                          | 973       |

|   |           |          |           |           |             |             |           |
|---|-----------|----------|-----------|-----------|-------------|-------------|-----------|
| Stock issued in connection with dividend reinvestment and stock purchase plan |           |          |           |           |             |             |           |
| Stock issued for employee stock purchase plan                                 | 2,660     | 2        | 89        | —         | —           | —           | 91        |
| Stock issued for options exercised  | 8,699     | 5        | 125       | —         | —           | —           | 130       |
| Stock-based compensation expense  |           | —        | 102       | —         | —           | —           | 102       |
| Balance, December 31, 2017  | 3,448,108 | \$ 2,258 | \$ 18,691 | \$ 84,183 | \$ (4,086 ) | \$ (2,476 ) | \$ 98,570 |

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| Year ended December 31,   | (in thousands) |           |           |
|---|----------------|-----------|-----------|
|   | 2017           | 2016      | 2015      |
| <b>Operating Activities</b>   |                |           |           |
| Net income  | \$8,289        | \$8,924   | \$8,233   |
| Adjustments to reconcile net income to net cash provided by operating activities:                 |                |           |           |
| Depreciation and amortization   | 821            | 891       | 1,024     |
| Provision for loan losses   | 1,400          | 30        | 200       |
| Net gain on investment securities available-for-sale  | (1,500 )       | (674 )    | (783 )    |
| Net (gain) loss on sale of other real estate owned, repossessed assets and premises and equipment | (1 )           | (2 )      | 17        |
| Net gain on sale of loans   | (276 )         | (320 )    | (356 )    |
| Loss on sale of indirect lease financing portfolio  | —              | 223       | —         |
| Gain on sale of loan held for investment  | (99 )          | —         | —         |
| Proceeds from sales of residential mortgages held-for-sale  | 9,041          | 9,204     | 10,903    |
| Origination of residential mortgages held-for-sale  | (7,976 )       | (8,686 )  | (11,154 ) |
| Income on bank-owned life insurance   | (345 )         | (308 )    | (307 )    |
| Stock-based compensation expense  | 102            | 88        | 85        |
| Net decrease in trading securities  | 3,596          | 593       | 18        |
| Deferred income tax (benefit) provision   | 2,322          | (145 )    | —         |
| Net increase (decrease) in income taxes payable   | (154 )         | 48        | 77        |
| Net (increase) decrease in accrued interest receivable  | (417 )         | (566 )    | 6         |
| Amortization of mortgage servicing rights and change in valuation allowance                       | 82             | 75        | 80        |
| Net amortization of premiums and discounts on investment securities                               | 1,694          | 1,846     | 2,094     |
| Net increase (decrease) in accrued interest payable   | 49             | 5         | (14 )     |
| Increase in other assets  | (887 )         | (363 )    | (71 )     |
| Increase (decrease) in other liabilities  | 421            | 469       | (936 )    |
| Net cash provided by operating activities   | 16,162         | 11,332    | 9,116     |
| <b>Investing Activities</b>   |                |           |           |
| Proceeds from payments, maturities and calls of investment securities available-for-sale          |                |           |           |
|   | 52,994         | 107,278   | 94,372    |
| Proceeds from maturities of investment securities held-to-maturity                                | —              | 147       | —         |
| Proceeds from the sale of investment securities available-for-sale                                | 42,509         | 32,573    | 47,960    |
| Purchases of investment securities available-for-sale   | (85,265 )      | (174,943) | (132,048) |
| Proceeds from redemption of investment in restricted bank stock                                   | 6,318          | 1,482     | 1,319     |
| Purchase of restricted bank stock   | (6,802 )       | (1,991 )  | (1,180 )  |
| Net increase in loans   | (101,157)      | (26,567 ) | (60,850 ) |
| Proceeds from sale of indirect lease financing portfolio held for investment                      | —              | 8,345     | —         |
| Net purchases of premises and equipment   | (634 )         | (317 )    | (580 )    |
| Proceeds from sale of loans held for investment   | 99             | —         | —         |
| Redemption of bank-owned life insurance   | 754            | —         | —         |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Proceeds from sales of other real estate owned and repossessed assets | 2         | 2         | 3,245     |
| Net cash used in investing activities                                 | (91,182 ) | (53,991 ) | (47,762 ) |
| <b>Financing Activities</b>   |           |           |           |
| Net increase in non-interest bearing deposits                         | 10,202    | 20,467    | 11,623    |
| Net increase in interest-bearing deposits                             | 70,391    | 3,102     | 26,571    |
| Net increase in short-term borrowings                                 | 3,096     | 15,497    | 1,974     |
| Tax benefit from exercise of stock options                            | —         | 17        | 21        |
| Cash dividends paid, net of reinvestment                              | (3,731 )  | (3,556 )  | (3,445 )  |
| Proceeds from issuance of common stock                                | 672       | 862       | 648       |
| Net cash provided by financing activities                             | 80,630    | 36,389    | 37,392    |
| Increase (decrease) in cash and cash equivalents                      | 5,610     | (6,270 )  | (1,254 )  |
| Cash and cash equivalents at beginning of year                        | 10,721    | 16,991    | 18,245    |
| Cash and cash equivalents at end of period                            | \$16,331  | \$10,721  | \$16,991  |
| <b>Supplemental Cash Flow Disclosures</b>                             |           |           |           |
| Interest paid   | \$5,631   | \$4,728   | \$4,520   |
| Income taxes paid   | 3,731     | 3,132     | 2,479     |
| <b>Non-cash transactions:</b>   |           |           |           |
| Transfer of loans to repossessed assets or other real estate owned    | —         | —         | 215       |
| Unsettled trades to purchase securities                               | —         | —         | 494       |

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies

Business

QNB Corp. (the “Company”), through its wholly-owned subsidiary, QNB Bank (the “Bank”), has been serving the residents and businesses of Bucks, Lehigh, and Montgomery counties in Pennsylvania since 1877. The Bank is a locally managed community bank that provides a full range of commercial, retail banking and retail brokerage services. The Bank encounters vigorous competition for market share in the communities it serves from bank holding companies, other community banks, thrift institutions, credit unions and other non-bank financial organizations such as mutual fund companies, insurance companies and brokerage companies. The Company manages its business as a single operating segment.

The Bank is a Pennsylvania chartered commercial bank. The Company and the Bank are subject to regulations of certain state and Federal agencies. These regulatory agencies periodically examine the Company and the Bank for adherence to laws and regulations.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. The consolidated entity is referred to herein as “QNB”. All significant inter-company accounts and transactions have been eliminated in the consolidated financial statements.

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

Use of Estimates

These statements 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. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the determination of the valuation of other real estate owned, the fair value of financial instruments, other-than-temporary impairment of investment securities, the determination of impairment of restricted bank stock and the valuation of deferred tax assets 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.

Significant Group Concentrations of Credit Risk

Most of the Company’s activities are with customers located within Bucks, Montgomery and Lehigh Counties in southeastern Pennsylvania. Note 4 discusses the types of investment securities in which the Company invests. Note 5 discusses the types of lending in which the Company engages. The Company does not have any significant

concentrations to any one industry or customer. Although the Company has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.

#### Cash and Cash Equivalents

For purposes of the statement of cash flows, cash and cash equivalents consist of cash on hand, cash items in process of collection, amounts due from banks, interest-bearing deposits in the Federal Reserve Bank and other banks and Federal funds sold. QNB maintains a portion of its interest-bearing deposits at various commercial financial institutions. At times, the balances exceed the FDIC insured limits.

#### Trading Securities

The Company engages in trading activities for its own account. Interest and dividends are included in interest income. Debt and equity securities that are bought and held principally for the purpose of selling in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. In 2014, QNB sold approximately \$5,000,000 in available-for-sale municipal securities and established a trading account with a broker consisting of municipal securities and a brokerage cash account. At December 31, 2016, the balance of municipal securities at fair value was \$3,596,000 and the amount in the brokerage cash account was \$1,499,000 . These trading securities were sold during 2017.



## Investment Securities

Investment securities that QNB has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost. Interest and dividends are included in interest income. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses, net of tax, excluded from earnings and reported in other comprehensive income or loss, a separate component of shareholders' equity. Management determines the appropriate classification of securities at the time of purchase.

Available-for-sale securities include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in credit ratings, changes in market interest rates and related changes in the securities' prepayment risk or to meet liquidity needs.

Premiums and discounts on debt securities are recognized in interest income using a constant yield method. Gains and losses on sales of available-for-sale securities are recorded on the trade date and are computed on the specific identification method and included in non-interest income.

## Other-than-Temporary Impairment of Investment Securities

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 prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support realizable value equal to or greater than 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 to fair value and a corresponding charge to earnings is recognized.

The Company follows the accounting guidance in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 320-10 as it relates to the recognition and presentation of other-than-temporary impairment ("OTTI"). This accounting guidance specifies that (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 non-credit portion of a previous other-than-temporary impairment would be amortized prospectively over the remaining life of the security based on the timing of future estimated cash flows of the security.

## Restricted Investment in Bank Stock

Restricted bank stock is comprised of restricted stock of the Federal Home Loan Bank of Pittsburgh ("FHLB") in the amount of \$1,489,000 and the Atlantic Community Bankers Bank in the amount of \$12,000 at December 31, 2017. Federal law requires a member institution of the FHLB to hold stock of its district bank according to a predetermined formula. These restricted securities are carried at cost.

## Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at the principal amount outstanding, net of deferred loan fees and costs. Interest income is accrued on the

principal amount outstanding. Loan origination and commitment fees and related direct costs are deferred and amortized to income over the term of the respective loan and loan commitment period as a yield adjustment.

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

#### Non-Performing Assets

Non-performing assets are comprised of accruing loans past due 90 days or more, non-accrual loans and investment securities, restructured loans, other real estate owned and repossessed assets. Non-accrual loans and investment securities are those on which the accrual of interest has ceased. Loans and indirect lease financing loans are placed on non-accrual status immediately if, in the opinion

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of management, collection is doubtful, or when principal or interest is past due 90 days or more and collateral is insufficient to cover principal and interest. Interest accrued, but not collected at the date a loan is placed on non-accrual status, is reversed and charged against interest income. Subsequent cash receipts are applied either to the outstanding principal or recorded as interest income, depending on management's assessment of the ultimate collectability of principal and interest. Loans are returned to an accrual status when the borrower's ability to make periodic principal and interest payments has returned to normal (i.e. brought current with respect to principal or interest or restructured) and the paying capacity of the borrower and/or the underlying collateral is deemed sufficient to cover principal and interest.

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.

Accounting for impairment in the performance of a loan is required when it is probable that all amounts, including both principal and interest, will not be collected in accordance with the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, at the loan's observable market price or the fair value of the collateral if the loans are collateral dependent. Impairment criteria are applied to the loan portfolio exclusive of smaller homogeneous loans such as residential mortgage and consumer loans which are evaluated collectively for impairment.

Loans are fully charged-off or charged down to net realizable value (fair value of collateral less estimated costs to sell) when deemed uncollectible due to bankruptcy or other factors, or when they reach a defined number of days past due based on loan product, industry practice, terms and other factors.

Loans are considered past due when contractually required principal or interest payments have not been made on the due dates.

#### Allowance for Loan Losses

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

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

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

- External factor effects, such as legal and regulatory requirements.
- 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.
- Nature and volume of the portfolio including growth.
- Experience, ability, and depth of lending management and staff.
- Volume and severity of past due, classified and nonaccrual loans.
- Quality of the Company's loan review system, and the degree of oversight by the Company's Board of Directors.
- Existence and effect of any concentrations of credit and changes in the level of such concentrations.

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

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

Management emphasizes loan quality and close monitoring of potential problem credits. Credit risk identification and review processes are utilized in order to assess and monitor the degree of risk in the loan portfolio. QNB's lending and credit administration staff are charged with reviewing the loan portfolio and identifying changes in the economy or in a borrower's circumstances which may affect the ability to repay debt or the value of pledged collateral. A loan classification and review system exists that identifies those loans with a higher than normal risk of 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 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.

#### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through the sale of financial assets. When mortgage loans are sold, a portion of the cost of originating the loan is allocated to the servicing rights based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The Company subsequently measures servicing rights using the amortization method where servicing rights are amortized in proportion to and over the period of estimated net servicing income. On a quarterly basis, an independent third party determines the fair value of QNB's servicing assets. These assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the valuation allowance may be recorded as an increase to income. Capitalized servicing rights are reported in other assets and are amortized into other non-interest income in proportion

to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan and are recorded as other non-interest income when earned and netted against the amortization of mortgage servicing rights.

#### 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 from operations and changes in the valuation allowance are included in net expenses from foreclosed assets. At both December 31, 2017 and 2016, the Company had no foreclosed assets.

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## Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are calculated principally on an accelerated or straight-line basis over the estimated useful lives of the assets, or the shorter of the estimated useful life or lease term for leasehold improvements, as follows:

|                         |                |
|-------------------------|----------------|
| Buildings               | 10 to 39 years |
| Furniture and equipment | 3 to 15 years  |
| Leasehold improvements  | 5 to 30 years  |

Expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses upon disposition are reflected in earnings as realized.

## Bank-Owned Life Insurance

The Bank invests in bank-owned life insurance (“BOLI”) as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by the Bank on a select group of employees. The Bank is the owner and beneficiary of the policies. Income from the increase in cash surrender value of the policies as well as the receipt of death benefits is included in non-interest income on the consolidated statement of income. The BOLI policies are an asset that can be liquidated, if necessary, with associated tax costs. However, QNB intends to hold these policies and, accordingly, has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

The Company follows the accounting guidance for postretirement benefit aspects of endorsement split-dollar life insurance arrangements which applies to life insurance arrangements that provide an employee with a specified benefit that is not limited to the employee’s active service period, including certain bank-owned life insurance policies. It requires an employer to recognize a liability and related compensation costs for future benefits that extend to postretirement periods. The expense recorded during 2017, 2016 and 2015 was approximately \$23,000, \$94,000 and \$69,000, respectively, and is included in non-interest expense under salaries and benefits expense. The decrease in 2017 is related to a death claim, reducing the post-retirement liability. The increase in 2016 is due to updated life expectancy assumptions for the actuarial calculations.

## Stock-Based Compensation

At December 31, 2017, QNB sponsored 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 FASB 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.

Stock-based compensation expense was approximately \$102,000, \$88,000 and \$85,000 for the years ended December 31, 2017, 2016 and 2015, respectively. There was no tax benefit recognized related to this compensation for the years ended December 31, 2017, 2016 and 2015.

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

| Year ended December 31, | 2017  | 2016  | 2015  |
|-------------------------|-------|-------|-------|
| Risk free interest rate | 1.48% | 1.14% | 1.06% |
| Dividend yield          | 3.19% | 3.78% | 3.86% |
| Volatility              | 17.9% | 22.6% | 26.7% |
| Expected life (years)   | 4.2   | 4.2   | 5.0   |

The weighted average fair value per share of options granted during 2017, 2016 and 2015 was \$3.88, \$3.79 and \$4.38, respectively. The risk-free interest rate was selected based upon yields of U.S. Treasury issues with a term equal to the expected life of the option being valued. Historical information was the primary basis for the selection of the expected dividend yield, expected volatility and expected lives of the options.

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## Income Taxes

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

In connection with the accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions, QNB has evaluated its tax positions as of December 31, 2017. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has more than a 50 percent likelihood of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. Under the "more-likely-than-not" threshold guidelines, QNB believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. As of December 31, 2017, QNB had no material unrecognized tax benefits or accrued interest and penalties. QNB's policy is to account for interest as a component of interest expense and penalties as a component of other expense. The Company and its subsidiary are subject to U.S. Federal income tax as well as income tax of the Commonwealth of Pennsylvania and the State of New Jersey. Tax years from 2014 to date remain subject to examination by the tax authorities.

## Treasury Stock

Common stock shares repurchased are recorded as treasury stock at cost.

## Earnings Per Share

Basic earnings per share excludes any dilutive effects of options and is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share gives effect to all dilutive potential common shares that were outstanding during the period. Potential common shares that may be issued by the Company relate solely to outstanding stock options and are determined using the treasury stock method.

Treasury shares are not deemed outstanding for earnings per share calculations.

## Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business entity during a period due to transactions and other events and circumstances, excluding those resulting from investments by and distributions to owners. Comprehensive income (loss) consists of net income and other comprehensive income (loss). For QNB, the primary component of other comprehensive income (loss) is the unrealized holding gains or losses on available-for-sale investment securities and unrealized losses on available-for-sale investment securities related to factors other than credit on debt securities.

## Revenue Recognition

The Company recognizes revenue in the consolidated statements of income as it is earned and when collectability is reasonably assured. The primary source of revenue is interest income from interest earning assets, which is recognized on the accrual basis of accounting using the effective interest method. The recognition of revenues from interest earning assets is based upon formulas from underlying loan agreements, securities contracts or other similar contracts. Non-interest income is recognized on the accrual basis of accounting as services are provided or as transactions occur. Non-interest income includes fees from brokerage and advisory service, deposit accounts, merchant services, ATM and debit card fees, mortgage banking activities, and other miscellaneous services and transactions.

#### Advertising Costs

Advertising costs are recorded in the period they are incurred within operating expenses in non-interest expense in the consolidated statements of income.

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## Financial Instruments with Off-Balance-Sheet Risk

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of these instruments. The Company uses the same credit policies in making commitments and contractual obligations as it does for on-balance-sheet instruments. The Company reflects its estimate of credit risk for these instruments in other liabilities on the consolidated balance sheet with the corresponding expense recorded in other operating expenses in the consolidated statement of income.

## Subsequent Events

QNB has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2017 through the date the consolidated financial statements are being issued for items that should potentially be recognized or disclosed in these consolidated financial statements.

## 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 Company is expected to use the modified retrospective method for transition in which the cumulative effect will be recognized at the date of adoption with no restatement of comparative periods presented. QNB expects that the adoption of ASU 2014-09 will not have a material impact on the consolidated financial statements or on the Company's internal controls over financial reporting.

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.

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

This ASU is effective for public companies for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. If QNB had adopted this guidance for the year ended December 31, 2017 it would have resulted in an increase in net income of \$645,000. There would have been no impact on shareholder's equity as the equity securities held by QNB are already recorded at fair value through accumulated other comprehensive income (loss); however, QNB will reclass a net loss of \$254,000 from accumulated other comprehensive loss to retained earnings on January 1, 2018. Based on an evaluation of our deferred tax asset and considering the effect of the new guidance, management believes that deferred tax assets related to AFS debt securities are realizable and no valuation allowance would be required. Management believes the potential effect of using exit versus entry price is most relevant for fair value disclosures of loans, which considers the impact of credit risk on fair value. The Company expects to use the modified retrospective method for transition in which the cumulative effect will be recognized at the date of adoption with no restatement of comparative periods presented.

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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 required to use a modified retrospective approach for leases that exist at or are initiated on or after January 1, 2019. Full retrospective application is prohibited. Under the modified retrospective approach, QNB will apply the new standards to all new contracts initiated on or after the effective date; and, for contracts which have remaining obligations as of the effective date, an adjustment to the opening balance of QNB's retained earnings account will be recorded. QNB will need to determine, retrospectively, the adjustment to the 2017 and 2018 financial statements to reflect the application of the new guidance. QNB evaluated the provisions of ASU 2016-02, but expects to report increased assets and liabilities as a result of reporting additional leases as a right-of-use asset and lease liabilities with a minimal adjustment to shareholders equity on the Company's consolidated statement of financial condition. QNB anticipates an increase to cash provided by operating activities and an offsetting increase to cash used by financing activities. The evaluation of the ASU 2016-02 impact will be adjusted based on new leases, termination and modifications to existing leases, and finalization of key assumptions, such as discount rate. QNB does not expect the adoption of ASU 2016-02 to have a material impact on the 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

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

For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the new guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. QNB is currently assessing the potential impact on our consolidated financial statements; however, due to the significant differences in the revised guidance from existing GAAP, the implementation of this guidance may result in material changes in our accounting for credit losses on financial instruments.

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.

On February 2, 2018, the FASB issued ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 202). The amendments in this ASU affect any entity that is required to apply the provisions of Topic 220, Income Statement—Reporting Comprehensive Income, and has items of other comprehensive income for which the related tax effects are presented in other comprehensive income as required by GAAP. The amendments in this ASU allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the 2017 Tax Reform Act; eliminates the stranded tax effects resulting from the 2017 Tax Reform Act. The amendments in this ASU are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of the amendments in this update is permitted, including adoption in any interim period, for public business entities for reporting periods for which financial statements have not yet been issued. The amendments in this ASU should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the 2017 Tax Reform Act is recognized. The effect of adoption at QNB would result in a reclassification of \$805,000 from accumulated other comprehensive loss to retained earnings in the consolidated statement of shareholders' equity. The Company expects to adopt the provisions of ASU 2018-02 in the first quarter of 2018.

#### Note 2 – Earnings Per Share and Share Repurchase Plan

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

| Year ended December 31,  | 2017      | 2016      | 2015      |
|--|-----------|-----------|-----------|
| Numerator for basic and diluted earnings per share - net income    | \$8,289   | \$8,924   | \$8,233   |
| Denominator for basic earnings per share - weighted average shares |           |           |           |
| outstanding  | 3,428,970 | 3,386,766 | 3,337,505 |
| Effect of dilutive securities - employee stock options             | 16,841    | 9,073     | 13,034    |

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Denominator for diluted earnings per share - adjusted weighted average

|                              |           |           |           |
|------------------------------|-----------|-----------|-----------|
| shares outstanding           | 3,445,811 | 3,395,839 | 3,350,539 |
| Earnings per share - basic   | \$2.42    | \$2.64    | \$2.47    |
| Earnings per share - diluted | \$2.41    | \$2.63    | \$2.46    |

There were 25,000, 23,500, and 21,000 stock options that were anti-dilutive as of December 31, 2017, 2016, and 2015 respectively. These stock options were not included in the above calculation.

On January 24, 2008, QNB announced that the Board of Directors authorized the repurchase of up to 50,000 shares of its common stock in open market or privately negotiated transactions. On February 9, 2009, the Board of Directors approved increasing the authorization to 100,000 shares. The repurchase authorization does not bear a termination date. There were no shares repurchased during the years ended December 31, 2017 or 2016. As of December 31, 2017 and 2016, 57,883 shares were repurchased under this authorization at an average price of \$16.97 and a total cost of \$982,000 and were recorded to Treasury stock.



## Note 3 – Cash and Cash Equivalents

Included in cash and cash equivalents are reserves in the form of deposits with the Federal Reserve Bank of Philadelphia. As of December 31, 2017 and 2016 QNB was not required to maintain reserves with the Federal Reserve Bank of Philadelphia.

## Note 4 - Investment Securities

## Trading

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

Trading securities, at fair value, at December 31, 2017 and 2016 were as follows:

| Fair Value                     | 2017 | 2016    |
|--------------------------------|------|---------|
| Year ended December 31,        |      |         |
| State and municipal securities | \$ — | \$3,596 |

## Available-For-Sale

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

|  | Fair value | Gross unrealized holding gains | Gross unrealized holding losses | Amortized cost |
|--|------------|--------------------------------|---------------------------------|----------------|
| December 31, 2017  |            |                                |                                 |                |
| U.S. Government agency                                     | \$70,524   | \$ —                           | \$ (1,948 )                     | \$72,472       |
| State and municipal  | 76,804     | 717                            | (113 )                          | 76,200         |
| U.S. Government agencies and sponsored enterprises (GSEs): |            |                                |                                 |                |
| Mortgage-backed  | 142,703    | 195                            | (2,401 )                        | 144,909        |
| Collateralized mortgage obligations (CMOs)                 | 76,302     | 29                             | (2,292 )                        | 78,565         |
| Pooled trust preferred                                     | 215        | —                              | (26 )                           | 241            |
| Corporate debt   | 8,022      | 6                              | (37 )                           | 8,053          |

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|  |           |        |             |            |
|--|-----------|--------|-------------|------------|
| Equity   | 4,975     | 28     | (349 )      | 5,296      |
| Total investment securities available-for-sale | \$379,545 | \$ 975 | \$ (7,166 ) | \$ 385,736 |

|   | Fair<br>value | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Amortized<br>cost |
|---|---------------|---|--|-------------------|
| December 31, 2016   |               |   |  |                   |
| 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<br>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        |

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The amortized cost and fair value of securities available-for-sale by contractual maturity at December 31, 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 state and municipal securities which are based on pre-refunded date, if applicable.

|  | Fair value | Amortized cost |
|--|------------|----------------|
| December 31, 2017                              |            |                |
| Due in one year or less                        | \$9,925    | \$9,924        |
| Due after one year through five years          | 206,877    | 210,575        |
| Due after five years through ten years         | 133,454    | 135,725        |
| Due after ten years                            | 24,314     | 24,216         |
| Equity securities                              | 4,975      | 5,296          |
| Total investment securities available-for-sale | \$379,545  | \$385,736      |

Proceeds from sales of investment securities available-for-sale were \$42,509,000, \$32,573,000 and \$47,960,000 for the years ended December 31, 2017, 2016, and 2015, respectively.

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.

| December 31, 2017 | Gross realized gains | Gross realized losses | Other-than-temporary impairment losses | Net     |
|-------------------|----------------------|-----------------------|--|---------|
|                   |                      |                       |  | gains   |
| Equity securities | \$1,557              | —                     | \$ (80 )                               | \$1,477 |
| Debt securities   | 581                  | \$ (558 )             | —                                      | 23      |
| Total             | \$2,138              | \$ (558 )             | \$ (80 )                               | \$1,500 |

| December 31, 2016 | Gross realized gains | Gross realized losses | Other-than-temporary impairment losses | Net   |
|-------------------|----------------------|-----------------------|--|-------|
|                   |                      |                       |  | gains |
| Equity securities | \$758                | —                     | \$ (192 )                              | \$566 |
| Debt securities   | 181                  | \$ (73 )              | —                                      | 108   |
| Total             | \$939                | \$ (73 )              | \$ (192 )                              | \$674 |

December 31, 2015

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|                   | Gross<br>realized<br>gains | Gross<br>realized<br>losses | Other-than-<br>temporary<br>impairment<br>losses | Net<br>gains |
|-------------------|----------------------------|-----------------------------|--|--------------|
| Equity securities | \$714                      | \$ (23 )                    | \$ (55 )   | \$636        |
| Debt securities   | 229                        | (82 )                       | —  | 147          |
| Total             | \$943                      | \$ (105 )                   | \$ (55 )   | \$783        |

The tax expense applicable to the net realized gains were \$510,000, \$229,000 and \$266,000 for the years ended December 31, 2017, 2016, and 2015, respectively.

There were no other-than-temporary impairment charges recognized for debt securities still held by QNB for the years ended December 31, 2017, 2016, or 2015.

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

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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 consolidated statement of income, but is recognized in other comprehensive income (loss). 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 (loss).

The following table presents a rollforward of the credit loss component recognized in earnings. The credit loss component of the amortized cost represents the difference between the present value of expected future cash flows and the amortized cost basis of the security prior to considering credit losses. The beginning balance represents the credit loss component for debt securities for which OTTI occurred prior to 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 in 2017, 2016, or 2015. The following table presents a summary of the cumulative credit-related other-than-temporary impairment charges recognized as components of earnings for debt securities still held by QNB:

| Year ended December 31,                          | 2017    | 2016    | 2015    |
|--|---------|---------|---------|
| Balance, beginning of year                       | \$1,153 | \$1,153 | \$1,153 |
| Reductions: sale, collateralized debt obligation | (1,152) | —       | —       |
| Additions:                                       |         |         |         |
| Initial credit impairments                       | —       | —       | —       |
| Subsequent credit impairments                    | —       | —       | —       |
| Balance, end of year                             | \$1     | \$1,153 | \$1,153 |

At December 31, 2017 and 2016, investment securities available-for-sale totaling \$202,887,000 and \$166,628,000, respectively, were pledged as collateral for repurchase agreements and deposits of public funds.

Securities that have been in a continuous unrealized loss position are as follows:

December 31, 2017

|  | No. of securities | Less than 12 months<br>Fair value | Unrealized losses | 12 months or longer<br>Fair value | Unrealized losses | Total<br>Fair value | Unrealized losses |
|--|-------------------|-----------------------------------|-------------------|-----------------------------------|-------------------|---------------------|-------------------|
| U.S. Government agency                 | 53                | \$10,828                          | \$ (155 )         | \$59,696                          | \$ (1,793 )       | \$70,524            | \$ (1,948 )       |
| State and municipal                    | 37                | 10,577                            | (49 )             | 4,446                             | (64 )             | 15,023              | (113 )            |
| U.S. Government agencies and sponsored |                   |                                   |                   |                                   |                   |                     |                   |

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|                                     |     |           |             |           |             |           |             |
|-------------------------------------|-----|-----------|-------------|-----------|-------------|-----------|-------------|
| enterprises (GSEs):                 |     |           |             |           |             |           |             |
| Mortgage-backed                     | 99  | 61,069    | (705 )      | 72,318    | (1,696 )    | 133,387   | (2,401 )    |
| Collateralized mortgage obligations |     |           |             |           |             |           |             |
| (CMOs)                              | 70  | 21,660    | (349 )      | 52,833    | (1,943 )    | 74,493    | (2,292 )    |
| Pooled trust preferred              | 1   | —         | —           | 215       | (26 )       | 215       | (26 )       |
| Corporate debt                      | 4   | 3,018     | (20 )       | 988       | (17 )       | 4,006     | (37 )       |
| Equity                              | 11  | 2,727     | (277 )      | 275       | (72 )       | 3,002     | (349 )      |
| Total                               | 275 | \$109,879 | \$ (1,555 ) | \$190,771 | \$ (5,611 ) | \$300,650 | \$ (7,166 ) |

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December 31, 2016

|  | No. of securities | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |
|--|-------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  |                   | Fair value          | Unrealized losses | Fair value          | Unrealized losses | 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 other issuers, for OTTI 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 December 31, 2017 in U.S. Government securities, state and municipal securities, mortgage-backed securities, CMOs and corporate debt securities are primarily the result of interest rate fluctuations. If held to maturity, these bonds will mature at par, and QNB will not realize a loss. QNB 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. QNB evaluated the near-term prospects of the issuers in relation to the severity and duration of the impairment as well as the individual issuer's financial condition, industry, geographic and legal environment. Based on that evaluation the Company recorded impairment charges of \$80,000 to non-interest income for equity holdings during 2017. QNB has the ability and intent to hold the remaining securities in an unrealized loss position at December 31, 2017 until recovery and does not consider the remaining equity securities to be other-than-temporarily impaired.

QNB holds one trust preferred security, PreTSL IV. In 2017, PreTSL IV was reclassified from impaired to a performing asset: 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. This security has been in an unrealized loss position for more than twelve months. The pooled trust preferred securities are available-for-sale securities and are carried at fair value.

The following table provides additional information related to pooled trust preferred security (PreTSLs) as of December 31, 2017:

| Deal | Class | Book | Fair | Unrealized | Realized | Total | Moody's | Current | Current | Actual | Total |
|------|-------|------|------|------------|----------|-------|---------|---------|---------|--------|-------|
|------|-------|------|------|------------|----------|-------|---------|---------|---------|--------|-------|

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|        | value      | value | gains (losses) | OTTI     | recognized | Fitch   | number     | number     | deferrals    | performing  |         |
|--------|------------|-------|----------------|----------|------------|---------|------------|------------|--------------|-------------|---------|
|        |            |       |                | credit   | OTTI       | ratings | of         | of         | and defaults | collateral  |         |
|        |            |       |                | loss     | credit     |         | performing | performing | as a % of    | as a % of   |         |
|        |            |       | (YTD 2017)     | loss     | loss       |         | banks      | insurance  | total        | outstanding |         |
|        |            |       |                |          |            |         |            | companies  | collateral   | bonds       |         |
| PreTSL |            |       |                |          |            |         |            |            |              |             |         |
| IV     | Mezzanine* | \$241 | \$215          | \$ (26 ) | \$ (1 )    | \$ (1 ) | Ba1/BB     | 5          | —            | 18.0 %      | 143.0 % |

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 \$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 the 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 twelve months ended December 31, 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.

#### Note 5 - Loans Receivable and the Allowance for Loan Losses

Major classes of loans are as follows:

| December 31,                       | 2017             | 2016             |
|------------------------------------|------------------|------------------|
| <b>Commercial:</b>                 |                  |                  |
| Commercial and industrial          | \$147,190        | \$110,233        |
| Construction                       | 51,157           | 39,268           |
| Secured by commercial real estate  | 286,867          | 255,188          |
| Secured by residential real estate | 71,703           | 68,731           |
| State and political subdivisions   | 38,087           | 35,260           |
| <b>Retail:</b>                     |                  |                  |
| 1-4 family residential mortgages   | 55,818           | 47,124           |
| Home equity loans and lines        | 75,576           | 71,525           |
| Consumer                           | 6,680            | 5,670            |
| <b>Total loans</b>                 | <b>733,078</b>   | <b>632,999</b>   |
| Net unearned costs                 | 205              | 80               |
| <b>Loans receivable</b>            | <b>\$733,283</b> | <b>\$633,079</b> |

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 express 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 December 31, 2017 and 2016, overdrafts were \$126,000 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 December 31, 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.

In October 2016, the Company sold its interest in third-party originated lease financing receivables, recording a loss on sale of \$223,000, which was essentially offset by a \$220,000 reversal of the allowance for loan losses associated with this sold portfolio. The lease financing receivables comprised loans to small businesses collateralized by equipment to borrowers within Pennsylvania and in states contiguous to Pennsylvania. QNB was not the lessor and did not service these loans.

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

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

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

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

- 1 - Excellent - no apparent risk
- 2 - Good - minimal risk
- 3 - Acceptable - average risk
- 4 - Watch List - greater than average risk
- 5 - Special Mention - potential weaknesses
- 6 - Substandard - well defined weaknesses
- 7 - Doubtful - full collection unlikely
- 8 - Loss - considered uncollectible

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 commercial loans, loans to state and political subdivisions and indirect lease financing 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 December 31, 2017 and 2016:

|                                    | Special           |                  |                  |             |                   |
|------------------------------------|-------------------|------------------|------------------|-------------|-------------------|
| December 31, 2017                  | Pass              | mention          | Substandard      | Doubtful    | Total             |
| Commercial:                        |                   |                  |                  |             |                   |
| Commercial and industrial          | \$ 139,820        | \$ 863           | \$ 6,507         | \$ —        | \$ 147,190        |
| Construction                       | 51,156            | —                | 1                | —           | 51,157            |
| Secured by commercial real estate  | 268,069           | 10,569           | 8,229            | —           | 286,867           |
| Secured by residential real estate | 69,571            | 222              | 1,910            | —           | 71,703            |
| State and political subdivisions   | 38,087            | —                | —                | —           | 38,087            |
| <b>Total</b>                       | <b>\$ 566,703</b> | <b>\$ 11,654</b> | <b>\$ 16,647</b> | <b>\$ —</b> | <b>\$ 595,004</b> |

|                                    | Special           |                 |                  |             |                   |
|------------------------------------|-------------------|-----------------|------------------|-------------|-------------------|
| December 31, 2016                  | Pass              | 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            |
| <b>Total</b>                       | <b>\$ 480,374</b> | <b>\$ 6,102</b> | <b>\$ 22,204</b> | <b>\$ —</b> | <b>\$ 508,680</b> |

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 December 31, 2017 and 2016:

| December 31, 2017                | Performing        | Non-performing  | Total             |
|----------------------------------|-------------------|-----------------|-------------------|
| Retail:                          |                   |                 |                   |
| 1-4 family residential mortgages | \$ 54,936         | \$ 882          | \$ 55,818         |
| Home equity loans and lines      | 75,433            | 143             | 75,576            |
| Consumer                         | 6,595             | 85              | 6,680             |
| <b>Total</b>                     | <b>\$ 136,964</b> | <b>\$ 1,110</b> | <b>\$ 138,074</b> |

| 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             |
| <b>Total</b>                     | <b>\$ 123,871</b> | <b>\$ 448</b>  | <b>\$ 124,319</b> |



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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 (excluding deferred fees and costs) summarized by the past due status, regardless of whether the loan is on non-accrual status, as of December 31, 2017 and 2016:

|                                  | 90 days or          |                     |                 | Total past due loans | Current          | Total loans receivable |
|----------------------------------|---------------------|---------------------|-----------------|----------------------|------------------|------------------------|
|                                  | 30-59 days past due | 60-89 days past due | more past due   |                      |                  |                        |
| December 31, 2017                |                     |                     |                 |                      |                  |                        |
| <b>Commercial:</b>               |                     |                     |                 |                      |                  |                        |
| Commercial and industrial        | \$ 25               | \$ 429              | \$ 57           | \$ 511               | \$146,679        | \$ 147,190             |
| Construction                     | —                   | —                   | —               | —                    | 51,157           | 51,157                 |
| Secured by commercial            |                     |                     |                 |                      |                  |                        |
| real estate                      | 899                 | —                   | 730             | 1,629                | 285,238          | 286,867                |
| Secured by residential           |                     |                     |                 |                      |                  |                        |
| real estate                      | 24                  | —                   | 210             | 234                  | 71,469           | 71,703                 |
| State and political subdivisions | —                   | —                   | —               | —                    | 38,087           | 38,087                 |
| <b>Retail:</b>                   |                     |                     |                 |                      |                  |                        |
| 1-4 family residential           |                     |                     |                 |                      |                  |                        |
| mortgages                        | 744                 | 152                 | 504             | 1,400                | 54,418           | 55,818                 |
| Home equity loans and lines      | 251                 | 44                  | 119             | 414                  | 75,162           | 75,576                 |
| Consumer                         | 23                  | 8                   | —               | 31                   | 6,649            | 6,680                  |
| <b>Total</b>                     | <b>\$ 1,966</b>     | <b>\$ 633</b>       | <b>\$ 1,620</b> | <b>\$ 4,219</b>      | <b>\$728,859</b> | <b>\$ 733,078</b>      |

|                                  | 90 days or          |                     |               | Total past due loans | Current   | Total loans receivable |
|----------------------------------|---------------------|---------------------|---------------|----------------------|-----------|------------------------|
|                                  | 30-59 days past due | 60-89 days past due | more past due |                      |           |                        |
| December 31, 2016                |                     |                     |               |                      |           |                        |
| <b>Commercial:</b>               |                     |                     |               |                      |           |                        |
| 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                 |
| <b>Retail:</b>                   |                     |                     |               |                      |           |                        |
| 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                 |

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|          |          |        |          |          |            |            |
|----------|----------|--------|----------|----------|------------|------------|
| 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 December 31, 2017 and 2016:

| December 31, 2017                  | 90 days or more past |             |
|------------------------------------|----------------------|-------------|
|                                    | due (still accruing) | Non-accrual |
| <b>Commercial:</b>                 |                      |             |
| Commercial and industrial          | \$ —                 | \$ 3,367    |
| Construction                       | —                    | —           |
| Secured by commercial real estate  | —                    | 1,987       |
| Secured by residential real estate | —                    | 1,458       |
| State and political subdivisions   | —                    | —           |
| <b>Retail:</b>                     |                      |             |
| 1-4 family residential mortgages   | —                    | 882         |
| Home equity loans and lines        | —                    | 142         |
| Consumer                           | —                    | 85          |
| Total                              | \$ —                 | \$ 7,921    |



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90 days or more past

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

Activity in the allowance for loan losses for the years ended December 31, 2017, 2016 and 2015 are as follows:

| Year ended December 31, 2017          | Balance,<br>beginning<br>of<br>period | Provision<br>for<br>(credit<br>to)<br>loan<br>losses | Charge-offs        | Recoveries    | Balance,<br>end<br>of<br>period |
|---------------------------------------|---------------------------------------|--|--------------------|---------------|---------------------------------|
| <b>Commercial:</b>                    |                                       |  |                    |               |                                 |
| Commercial and industrial             | \$ 1,459                              | \$ 2,178   | \$ (960 )          | \$ 34         | \$ 2,711                        |
| Construction                          | 449                                   | 114  | —                  | —             | 563                             |
| Secured by commercial<br>real estate  | 2,646                                 | (244 )   | —                  | 8             | 2,410                           |
| Secured by residential<br>real estate | 1,760                                 | (959 )   | (23 )              | 38            | 816                             |
| State and political subdivisions      | 123                                   | (9 )   | —                  | —             | 114                             |
| <b>Retail:</b>                        |                                       |  |                    |               |                                 |
| 1-4 family residential<br>mortgages   | 366                                   | 78   | —                  | —             | 444                             |
| Home equity loans and lines           | 353                                   | (6 )   | —                  | 10            | 357                             |
| Consumer                              | 76                                    | 41   | (92 )              | 32            | 57                              |
| Unallocated                           | 162                                   | 207  | N/A                | N/A           | 369                             |
| <b>Total</b>                          | <b>\$ 7,394</b>                       | <b>\$ 1,400</b>                                      | <b>\$ (1,075 )</b> | <b>\$ 122</b> | <b>\$ 7,841</b>                 |

| Year ended December 31, 2016 | Balance, | Provision<br>for | Charge-offs | Recoveries | Balance,<br>end |
|------------------------------|----------|------------------|-------------|------------|-----------------|
|------------------------------|----------|------------------|-------------|------------|-----------------|

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|                                  | beginning<br>of<br>period | (credit<br>to)<br>loan<br>losses |                  |               | of<br>period    |
|----------------------------------|---------------------------|----------------------------------|------------------|---------------|-----------------|
| <b>Commercial:</b>               |                           |                                  |                  |               |                 |
| Commercial and industrial        | \$ 1,521                  | \$ 41                            | \$ (140 )        | \$ 37         | \$ 1,459        |
| Construction                     | 286                       | 163                              | —                | —             | 449             |
| Secured by commercial            |                           |                                  |                  |               |                 |
| real estate                      | 2,411                     | 227                              | —                | 8             | 2,646           |
| Secured by residential           |                           |                                  |                  |               |                 |
| real estate                      | 1,812                     | (44 )                            | (120 )           | 112           | 1,760           |
| State and political subdivisions | 222                       | (99 )                            | —                | —             | 123             |
| Indirect lease financing         | 164                       | (121 )                           | (52 )            | 9             | —               |
| <b>Retail:</b>                   |                           |                                  |                  |               |                 |
| 1-4 family residential           |                           |                                  |                  |               |                 |
| mortgages                        | 350                       | 16                               | —                | —             | 366             |
| Home equity loans and lines      | 428                       | (91 )                            | —                | 16            | 353             |
| Consumer                         | 76                        | 60                               | (92 )            | 32            | 76              |
| Unallocated                      | 284                       | (122 )                           | N/A              | N/A           | 162             |
| <b>Total</b>                     | <b>\$ 7,554</b>           | <b>\$ 30</b>                     | <b>\$ (404 )</b> | <b>\$ 214</b> | <b>\$ 7,394</b> |

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| Year ended December 31, 2015     | Balance,<br>beginning<br>of<br>period | Provision<br>for<br>(credit<br>to)<br>loan<br>losses | Charge-offs      | Recoveries    | Balance,<br>end<br>of<br>period |
|----------------------------------|---------------------------------------|--|------------------|---------------|---------------------------------|
| <b>Commercial:</b>               |                                       |  |                  |               |                                 |
| Commercial and industrial        | \$ 1,892                              | \$ (353 )  | \$ (56 )         | \$ 38         | \$ 1,521                        |
| Construction                     | 297                                   | (11 )  | —                | —             | 286                             |
| <b>Secured by commercial</b>     |                                       |  |                  |               |                                 |
| real estate                      | 2,700                                 | (214 )   | (84 )            | 9             | 2,411                           |
| <b>Secured by residential</b>    |                                       |  |                  |               |                                 |
| real estate                      | 1,630                                 | 687  | (531 )           | 26            | 1,812                           |
| State and political subdivisions | 221                                   | 1  | —                | —             | 222                             |
| Indirect lease financing         | 93                                    | 76   | (21 )            | 16            | 164                             |
| <b>Retail:</b>                   |                                       |  |                  |               |                                 |
| <b>1-4 family residential</b>    |                                       |  |                  |               |                                 |
| mortgages                        | 312                                   | 38   | —                | —             | 350                             |
| Home equity loans and lines      | 453                                   | (47 )  | —                | 22            | 428                             |
| Consumer                         | 85                                    | 57   | (95 )            | 29            | 76                              |
| Unallocated                      | 318                                   | (34 )  | N/A              | N/A           | 284                             |
| <b>Total</b>                     | <b>\$ 8,001</b>                       | <b>\$ 200</b>  | <b>\$ (787 )</b> | <b>\$ 140</b> | <b>\$ 7,554</b>                 |

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

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

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

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

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.

Performing TDRs (not reported as non-accrual or past due 90 days or more and still accruing) totaled \$1,321,000 and \$1,819,000 as of December 31, 2017 and 2016, respectively. Non-performing TDRs totaled \$2,994,000 and \$3,555,000 as of December 31, 2017 and 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. There were charge-offs resulting from loans modified as TDRs of \$3,000, \$0 and \$5,000 during the years ended December 31, 2017, 2016 and 2015, respectively.

| December 31,                             | 2017           |               | 2016           |               |
|--|----------------|---------------|----------------|---------------|
|  | Unpaid         |               | Unpaid         |               |
|  | principal      | Related       | principal      | Related       |
|  | balance        | allowance     | balance        | allowance     |
| TDRs with no specific allowance recorded | \$3,448        | —             | \$3,992        | —             |
| TDRs with an allowance recorded          | 867            | \$ 235        | 1,382          | \$ 761        |
| <b>Total</b>                             | <b>\$4,315</b> | <b>\$ 235</b> | <b>\$5,374</b> | <b>\$ 761</b> |

There were no newly identified TDRs during the year ended December 31, 2017. As of December 31, 2017 and 2016, QNB had commitments of \$0 and \$30,000, respectively, to lend additional funds to customers with loans whose terms have been modified in troubled debt restructurings.

The following table presents loans, by loan class, modified as TDRs during the years ended December 31, 2017 and 2016. The pre-modification outstanding recorded investment disclosed represents the carrying amounts immediately prior to the modification of the loan. The post-modification outstanding recorded investment is net of loan repayments.

| Year ended December 31, | 2017             |                   | 2016             |                   |
|-------------------------|------------------|-------------------|------------------|-------------------|
|                         | Pre-modification | Post-modification | Pre-modification | Post-modification |
|                         | outstanding      | outstanding       | outstanding      | outstanding       |
|                         | Number of        | recorded          | Number of        | recorded          |
|                         | contracts        | investment        | contracts        | investment        |

Commercial:

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|                                    |   |    |   |    |   |    |    |       |    |       |
|------------------------------------|---|----|---|----|---|----|----|-------|----|-------|
| Commercial and industrial          | — | \$ | — | \$ | — | 7  | \$ | 1,099 | \$ | 1,020 |
| Secured by commercial real estate  | — |    | — |    | — | 2  |    | 1,296 |    | 1,251 |
| Secured by residential real estate | — |    | — |    | — | 5  |    | 1,156 |    | 1,126 |
| Retail:                            |   |    |   |    |   |    |    |       |    |       |
| 1-4 family residential mortgages   | — |    | — |    | — | 1  |    | 193   |    | 193   |
| Consumer                           | — |    | — |    | — | 1  |    | 96    |    | 93    |
| Total                              | — | \$ | — | \$ | — | 16 | \$ | 3,840 | \$ | 3,683 |

The following table presents loans modified as TDRs, included above, within the previous 12 months from December 31, 2017 and 2016, for which there was a payment default, past due 60 days or more, during the respective year end.

| Year ended December 31,            | 2017                  | 2016                  |
|------------------------------------|-----------------------|-----------------------|
|                                    | Number                | Number                |
| TDRs Subsequently Defaulted        | of Recorded contracts | of Recorded contracts |
| Commercial:                        | investment            | investment            |
| Secured by residential real estate | — \$ —                | 1 \$ 111              |

The company had three mortgages secured by residential real estate with a recorded investment of \$421,000 for which foreclosure proceedings were in process as of December 31, 2017. There were no mortgage loans secured by residential real estate for which foreclosure proceedings were in process at December 31, 2016.

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

|                                  | Allowance for Loan Losses |            |                 | Loans Receivable |               |               |
|----------------------------------|---------------------------|------------|-----------------|------------------|---------------|---------------|
|                                  | Balance related           |            | Balance related | Balance          |               | Balance       |
|                                  | to loans                  | to loans   | to loans        | individually     | collectively  | individually  |
|                                  |                           |            | individually    | collectively     | individually  | collectively  |
|                                  |                           |            | evaluated for   | evaluated for    | evaluated for | evaluated for |
| December 31, 2017                | Balance                   | impairment | impairment      | Balance          | impairment    | impairment    |
| <b>Commercial:</b>               |                           |            |                 |                  |               |               |
| Commercial and industrial        | \$2,711                   | \$ 1,260   | \$ 1,451        | \$147,190        | \$ 6,498      | \$ 140,692    |
| Construction                     | 563                       | —          | 563             | 51,157           | 1             | 51,156        |
| Secured by commercial            |                           |            |                 |                  |               |               |
| real estate                      | 2,410                     | —          | 2,410           | 286,867          | 3,874         | 282,993       |
| Secured by residential           |                           |            |                 |                  |               |               |
| real estate                      | 816                       | 84         | 732             | 71,703           | 1,744         | 69,959        |
| State and political subdivisions | 114                       | —          | 114             | 38,087           | —             | 38,087        |
| <b>Retail:</b>                   |                           |            |                 |                  |               |               |
| 1-4 family residential           |                           |            |                 |                  |               |               |
| mortgages                        | 444                       | 8          | 436             | 55,818           | 1,218         | 54,600        |
| Home equity loans and lines      | 357                       | 40         | 317             | 75,576           | 164           | 75,412        |
| Consumer                         | 57                        | —          | 57              | 6,680            | 85            | 6,595         |
| Unallocated                      | 369                       | N/A        | N/A             | N/A              | N/A           | N/A           |
| Total                            | \$7,841                   | \$ 1,392   | \$ 6,080        | \$733,078        | \$ 13,584     | \$ 719,494    |

|                           | Allowance for Loan Losses |            |                 | Loans Receivable |               |               |
|---------------------------|---------------------------|------------|-----------------|------------------|---------------|---------------|
|                           | Balance related           |            | Balance related | Balance          |               | Balance       |
|                           | to loans                  | to loans   | to loans        | individually     | collectively  | individually  |
|                           |                           |            | individually    | collectively     | individually  | collectively  |
|                           |                           |            | evaluated for   | evaluated for    | evaluated for | evaluated for |
| December 31, 2016         | Balance                   | impairment | impairment      | Balance          | impairment    | impairment    |
| <b>Commercial:</b>        |                           |            |                 |                  |               |               |
| Commercial and industrial | \$1,459                   | \$ 696     | \$ 763          | \$110,233        | \$ 5,134      | \$ 105,099    |
| Construction              | 449                       | —          | 449             | 39,268           | 224           | 39,044        |
| Secured by commercial     | 2,646                     | —          | 2,646           | 255,188          | 6,383         | 248,805       |

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|                                  |         |          |          |           |           |            |
|----------------------------------|---------|----------|----------|-----------|-----------|------------|
| real estate                      |         |          |          |           |           |            |
| 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 table summarizes additional information regarding impaired loans by loan portfolio class as of December 31, 2017 and 2016:

|   | December 31, 2017 |                 |                | December 31, 2016 |                 |                |
|---|-------------------|-----------------|----------------|-------------------|-----------------|----------------|
|   | Recorded          |                 |                | Recorded          |                 |                |
|   | investmentUnpaid  |                 |                | investmentUnpaid  |                 |                |
|   | (after            | principal       | Related        | (after            | principal       | Related        |
|   | charge-offs)      | balance         | allowance      | charge-offs)      | balance         | allowance      |
| <b>With no specific allowance recorded:</b> |                   |                 |                |                   |                 |                |
| <b>Commercial:</b>                          |                   |                 |                |                   |                 |                |
| Commercial and industrial                   | \$5,070           | \$5,461         | \$ —           | \$2,482           | \$2,862         | \$ —           |
| Construction                                | 1                 | 1               | —              | 224               | 234             | —              |
| <b>Secured by commercial</b>                |                   |                 |                |                   |                 |                |
| real estate                                 | 3,874             | 4,464           | —              | 6,383             | 6,367           | —              |
| <b>Secured by residential</b>               |                   |                 |                |                   |                 |                |
| real estate                                 | 914               | 1,239           | —              | 1,046             | 1,438           | —              |
| <b>Retail:</b>                              |                   |                 |                |                   |                 |                |
| <b>1-4 family residential</b>               |                   |                 |                |                   |                 |                |
| mortgages                                   | 1,057             | 1,108           | —              | 570               | 589             | —              |
| Home equity loans and lines                 | 124               | 168             | —              | 111               | 174             | —              |
| Consumer                                    | 85                | 90              | —              | 93                | 95              | —              |
| <b>Total</b>                                | <b>\$11,125</b>   | <b>\$12,531</b> | <b>\$ —</b>    | <b>\$10,909</b>   | <b>\$11,759</b> | <b>\$ —</b>    |
| <b>With an allowance recorded:</b>          |                   |                 |                |                   |                 |                |
| <b>Commercial:</b>                          |                   |                 |                |                   |                 |                |
| Commercial and industrial                   | \$1,428           | \$2,593         | \$1,260        | \$2,652           | \$2,812         | \$696          |
| Construction                                | —                 | —               | —              | —                 | —               | —              |
| <b>Secured by commercial</b>                |                   |                 |                |                   |                 |                |
| real estate                                 | —                 | —               | —              | —                 | —               | —              |
| <b>Secured by residential</b>               |                   |                 |                |                   |                 |                |
| real estate                                 | 830               | 879             | 84             | 1,267             | 1,435           | 494            |
| <b>Retail:</b>                              |                   |                 |                |                   |                 |                |
| <b>1-4 family residential</b>               |                   |                 |                |                   |                 |                |
| mortgages                                   | 161               | 163             | 8              | 178               | 193             | 8              |
| Home equity loans and lines                 | 40                | 41              | 40             | —                 | —               | —              |
| Consumer                                    | —                 | —               | —              | —                 | —               | —              |
| <b>Total</b>                                | <b>\$2,459</b>    | <b>\$3,676</b>  | <b>\$1,392</b> | <b>\$4,097</b>    | <b>\$4,440</b>  | <b>\$1,198</b> |
| <b>Total:</b>                               |                   |                 |                |                   |                 |                |
| <b>Commercial:</b>                          |                   |                 |                |                   |                 |                |

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|                             |          |          |          |          |          |          |
|-----------------------------|----------|----------|----------|----------|----------|----------|
| Commercial and industrial   | \$6,498  | \$8,054  | \$ 1,260 | \$5,134  | \$5,674  | \$ 696   |
| Construction                | 1        | 1        | —        | 224      | 234      | —        |
| Secured by commercial       |          |          |          |          |          |          |
| real estate                 | 3,874    | 4,464    | —        | 6,383    | 6,367    | —        |
| Secured by residential      |          |          |          |          |          |          |
| real estate                 | 1,744    | 2,118    | 84       | 2,313    | 2,873    | 494      |
| Retail:                     |          |          |          |          |          |          |
| 1-4 family residential      |          |          |          |          |          |          |
| mortgages                   | 1,218    | 1,271    | 8        | 748      | 782      | 8        |
| Home equity loans and lines | 164      | 209      | 40       | 111      | 174      | —        |
| Consumer                    | 85       | 90       | —        | 93       | 95       | —        |
| Total                       | \$13,584 | \$16,207 | \$ 1,392 | \$15,006 | \$16,199 | \$ 1,198 |

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The following table presents additional information regarding the average recorded investment and interest income recognized on impaired loans for the years ended December 31, 2017, 2016 and 2015:

| Year Ended December 31,     | 2017                |                            | 2016                |                            | 2015                |                            |
|-----------------------------|---------------------|----------------------------|---------------------|----------------------------|---------------------|----------------------------|
|                             | Average             |                            | Average             |                            | Average             |                            |
|                             | recorded investment | Interest income recognized | recorded investment | Interest income recognized | recorded investment | Interest income recognized |
| <b>Commercial:</b>          |                     |                            |                     |                            |                     |                            |
| Commercial and industrial   | \$ 5,301            | \$ 14                      | \$ 4,200            | \$ 58                      | \$ 6,108            | \$ 169                     |
| Construction                | 51                  | 2                          | 370                 | 18                         | 396                 | 20                         |
| Secured by commercial       |                     |                            |                     |                            |                     |                            |
| real estate                 | 5,744               | 145                        | 6,129               | 131                        | 7,370               | 149                        |
| Secured by residential      |                     |                            |                     |                            |                     |                            |
| real estate                 | 2,252               | 23                         | 1,960               | 15                         | 1,544               | —                          |
| Indirect lease financing    | —                   | —                          | 88                  | —                          | 43                  | 1                          |
| <b>Retail:</b>              |                     |                            |                     |                            |                     |                            |
| 1-4 family residential      |                     |                            |                     |                            |                     |                            |
| mortgages                   | 1,155               | 13                         | 583                 | 10                         | 448                 | 6                          |
| Home equity loans and lines | 138                 | 1                          | 129                 | 1                          | 135                 | 1                          |
| Consumer                    | 97                  | —                          | 29                  | —                          | 2                   | —                          |
| <b>Total</b>                | <b>\$ 14,738</b>    | <b>\$ 198</b>              | <b>\$ 13,488</b>    | <b>\$ 233</b>              | <b>\$ 16,046</b>    | <b>\$ 346</b>              |

Note 6 - Premises and Equipment

Premises and equipment, stated at cost less accumulated depreciation and amortization, are summarized below:

| December 31,                              | 2017      | 2016      |
|---|-----------|-----------|
| Land and buildings                        | \$ 11,464 | \$ 11,405 |
| Furniture and equipment                   | 13,599    | 13,098    |
| Leasehold improvements                    | 2,328     | 2,324     |
| Book value                                | 27,391    | 26,827    |
| Accumulated depreciation and amortization | (18,896)  | (18,144)  |
| Net book value                            | \$ 8,495  | \$ 8,683  |

Depreciation and amortization expense on premises and equipment amounted to \$821,000, \$891,000, and \$1,024,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

## Note 7 - Intangible Assets and Loan Servicing

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were \$77,170,000 and \$78,380,000 at December 31, 2017 and 2016, respectively.

The following table reflects the activity of mortgage servicing rights for the periods indicated:

| Year ended December 31,               | 2017  | 2016  | 2015  |
|---------------------------------------|-------|-------|-------|
| Balance at beginning of year          | \$498 | \$504 | \$504 |
| Mortgage servicing rights capitalized | 67    | 69    | 79    |
| Mortgage servicing rights amortized   | (83 ) | (79 ) | (87 ) |
| Fair market value adjustments         | 1     | 4     | 8     |
| Balance at end of year                | \$483 | \$498 | \$504 |

The balance of these mortgage servicing rights are included in other assets at December 31, 2017 and 2016 and the fair value of these rights was \$585,000 and \$579,000, respectively. The fair value of servicing rights was determined using discount rates ranging from 13% to 15 % for 2017 and 14% to 16% for 2016.

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The annual estimated amortization expense of intangible assets for each of the five succeeding fiscal years is as follows:

|      |      |
|------|------|
| 2018 | \$80 |
| 2019 | 69   |
| 2020 | 58   |
| 2021 | 50   |
| 2022 | 42   |

On November 26, 2014, QNB transferred its former internet domain name to a third party and recorded a gain of \$1,000,000, as disclosed in a Form 8-K filing dated December 2, 2014. As a result of the purchase of an additional domain name, QNB recorded the purchase price of \$8,000 as an intangible asset in other assets in 2014. This asset has no amortization expense as it has an indefinite life.

Note 8 - Time Deposits

The aggregate amount of time deposits, including deposits in denominations of \$100,000 or more, was \$225,182,000 and \$225,582,000 at December 31, 2017 and 2016, respectively. Time deposits that meet or exceed the FDIC insurance limit of \$250,000 at December 31, 2017 and 2016 were \$42,362,000 and \$34,446,000, respectively.

At December 31, 2017, the scheduled maturities of time deposits were as follows:

|                     |           |
|---------------------|-----------|
| 2018                | \$96,190  |
| 2019                | 30,910    |
| 2020                | 33,741    |
| 2021                | 46,109    |
| 2022                | 18,232    |
| Thereafter          | —         |
| Total time deposits | \$225,182 |

Note 9 - Short-Term Borrowings

|              |                              |                           |
|--------------|------------------------------|---------------------------|
|              | Securities sold              |                           |
|              | under agreements             | Other short - term        |
| December 31, | to repurchase <sup>(a)</sup> | borrowings <sup>(b)</sup> |

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| 2017                                   |    |        |    |        |
|--|----|--------|----|--------|
| Balance                                | \$ | 41,845 | \$ | 13,911 |
| Maximum indebtedness at any month end  |    | 43,834 |    | 33,773 |
| Daily average indebtedness outstanding |    | 39,301 |    | 9,371  |
| Average rate paid for the year         |    | 0.38   | %  | 1.09 % |
| Average rate on period-end borrowings  |    | 0.40   |    | 1.20   |
| 2016                                   |    |        |    |        |
| Balance                                | \$ | 45,339 | \$ | 7,321  |
| Maximum indebtedness at any month end  |    | 45,339 |    | 7,321  |
| Daily average indebtedness outstanding |    | 38,835 |    | 1,365  |
| Average rate paid for the year         |    | 0.37   | %  | 0.66 % |
| Average rate on period-end borrowings  |    | 0.38   |    | 0.77   |

(a) Securities sold under agreements to repurchase mature overnight. The repurchase agreements were collateralized by U.S. Government mortgage-backed securities and CMOs with an amortized cost of \$53,112,000 and \$52,920,000 and a fair value of \$51,823,000 and \$52,314,000 and at December 31, 2017 and 2016, respectively.

These securities are held in safekeeping at the Federal Reserve Bank of Philadelphia.

(b) Other short-term borrowings include Federal funds purchased and overnight borrowings from the FHLB. The Bank has four unsecured Federal funds lines granted by correspondent banks totaling \$46,000,000. Federal funds purchased under these lines were \$0 at both December 31, 2017 and 2016.

## Note 10 - Long-Term Debt

FHLB advances are collateralized by certain mortgage loans and also require the purchase of FHLB capital stock, which is included within restricted investment in bank stock on the consolidated balance sheets. QNB's FHLB stock is \$1,489,000 and \$1,005,000 at December 31, 2017 and 2016, respectively.

QNB has a maximum borrowing capacity with the FHLB of approximately \$285,370,000. At December 31, 2017 QNB had \$13,911,000 in borrowings outstanding with the FHLB reported in Note 9 as other short-term borrowings and a letter of credit issued of \$350,000. QNB had \$7,321,000 borrowings outstanding with the FHLB at December 31, 2016.

## Note 11 - Income Taxes

The Tax Cuts and Jobs Act (the "2017 Tax Reform Act") was enacted on December 22, 2017. The 2017 Tax Reform Act reduced the U.S. federal corporate tax rate for QNB from 34% to 21%. At December 31, 2017, we have completed our accounting for the tax effects relating to the re-measurement of the Company's deferred tax assets and liabilities as a result of enactment of the Act.

As presented below, we have made a reasonable estimate of the effects on our existing deferred tax balances as of December 31, 2017. We re-measured all of our deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future. We recognized \$2,054,000 in our tax provision for the year ended December 31, 2017 related to the adjustment of deferred tax balances to reflect the new corporate tax rate.

Deferred tax asset/liability (DTA/DTL) related to available for sale (AFS) securities gains/(losses) that were revalued as of December 31, 2017 created a "stranded tax effect" in Accumulated Other Comprehensive Income (AOCI) due enactment of the 2017 Tax Reform Act. The issue arose due to the nature of GAAP recognition of tax rate change effects on the AFS DTA/DTL revaluation as an adjustment to income tax provision. In February 2018, FASB issued ASU 2018-02, as discussed in Note 1. When adopted, the provisions of the ASU 2018-02 will permit retrospective recording of a one-time reclassification of \$805,000 from AOCI to retained earnings for stranded tax effects resulting from the newly enacted corporate tax rate. The amount of the reclassification represents the difference between the 34% historical corporate tax rate and the newly enacted 21% corporate tax rate. The Company expects to adopt the provisions of ASU 2018-02 in the first quarter of 2018.

The components of the provision for income taxes are as follows:

| Year ended December 31,                        | 2017    | 2016    | 2015    |
|--|---------|---------|---------|
| Current Federal income taxes                   | \$3,454 | \$3,137 | \$2,519 |
| Current state income taxes                     | 124     | 62      | 51      |
| Deferred Federal income taxes (benefits)       | 268     | (145 )  | —       |
| Net provision prior to tax reform adjustment   | 3,846   | 3,054   | 2,570   |
| DTA writeoff for change in tax rate under 2017 | 2,054   | —       | —       |

| Tax Reform    |         |         |         |
|---------------|---------|---------|---------|
| Net provision | \$5,900 | \$3,054 | \$2,570 |



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At December 31, 2017 and 2016, the tax effects of temporary differences that represent the significant portion of deferred tax assets and liabilities are as follows:

| December 31,                                       | 2017    | 2016    |
|--|---------|---------|
| Deferred tax assets                                |         |         |
| Allowance for loan losses                          | \$1,647 | \$2,514 |
| Net unrealized holding losses on investment        |         |         |
| securities available-for-sale                      | 1,255   | 1,852   |
| Impaired securities                                | —       | 448     |
| Non-credit OTTI on investment securities available |         |         |
| -for-sale  | 45      | 84      |
| Non-accrual interest income                        | 324     | 545     |
| Deferred rent                                      | 55      | 80      |
| Deferred revenue                                   | 80      | 131     |
| Incurred but not reported (IBNR) medical expense   | 18      | 42      |
| Depreciation                                       | —       | 68      |
| Bonus  | 130     | 68      |
| Other  | 16      | 27      |
| Total deferred tax assets                          | 3,570   | 5,859   |
| Deferred tax liabilities                           |         |         |
| Depreciation                                       | 24      | —       |
| Mortgage servicing rights                          | 101     | 169     |
| Net unrealized holding gains on trading investment |         |         |
| securities   | 21      | 34      |
| Prepaid expenses                                   | 95      | 168     |
| Other  | 10      | 15      |
| Total deferred tax liabilities                     | 251     | 386     |
| Net deferred tax asset                             | \$3,319 | \$5,473 |

The ability to realize 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 the above deferred tax assets.

A reconciliation of the tax provision on income before taxes computed at the statutory rate of 34% and the actual tax provision was as follows:

| Year ended December 31,                 | 2017    |        | 2016    |        | 2015    |         |
|---|---------|--------|---------|--------|---------|---------|
|   | Dollar  | %      | Dollar  | %      | Dollar  | %       |
| Provision at statutory rate             | \$4,825 | 34.0%  | \$4,073 | 34.0%  | \$3,673 | 34.0%   |
| Tax-exempt interest and dividend income | (948 )  | (6.7 ) | (1,033) | (8.6 ) | (1,126) | (10.4 ) |
| Bank-owned life insurance               | (100 )  | (0.7 ) | (105 )  | (0.9 ) | (104 )  | (1.0 )  |
| Life insurance proceeds                 | (18 )   | (0.1 ) | —       | —      | —       | —       |

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|  |         |        |         |       |         |        |
|--|---------|--------|---------|-------|---------|--------|
| Stock-based compensation expense           | 19      | 0.1    | 30      | 0.3   | 29      | 0.3    |
| State income tax                           | 82      | 0.6    | 41      | 0.3   | 34      | 0.3    |
| Other                                      | (14 )   | (0.1 ) | 48      | 0.4   | 64      | 0.6    |
| Net provision prior to tax reform          |         |        |         |       |         |        |
| adjustment                                 | 3,846   | 27.1   | 3,054   | 25.5% | 2,570   | 23.8   |
| Deferred tax revaluation for change in tax |         |        |         |       |         |        |
| rate - 2017 Tax Reform                     | 2,054   | 14.5   | —       | —     | —       | —      |
| Net Provision                              | \$5,900 | 41.6%  | \$3,054 | 25.5% | \$2,570 | 23.8 % |

## Note 12 - Employee Benefit Plans

The QNB Bank Retirement Savings Plan provides for elective employee contributions up to the maximum allowed by the IRS and a matching company contribution limited to 3%. In addition, the plan provides for safe harbor non-elective contributions of 5% of total compensation by QNB. QNB contributed a matching contribution of approximately \$259,000, \$206,000 and \$240,000 for the years ended December 31, 2017, 2016, and 2015, respectively, and a safe harbor contribution of approximately \$478,000 for 2017, \$445,000 for 2016, and \$441,000 for 2015.

QNB's Employee Stock Purchase Plan (the Plan) offers eligible employees an opportunity to purchase shares of QNB Corp. common stock at a 10% discount from the lesser of fair market value on the first or last day of each offering period (as defined by the Plan). At the 2016 Annual Meeting, shareholders approved the 2016 Employee Stock Purchase Plan (the 2016 Plan), which authorizes the issuance of 30,000 shares. As of December 31, 2017, 4,052 shares were issued under the 2016 Plan. The 2016 Plan expires May 31, 2021. The 2011 Employee Stock Purchase Plan (the 2011 Plan), which was approved by shareholders at the 2011 Annual Meeting, expired May 31, 2016. A total of 17,516 shares were issued under the 2011 plan.

Shares issued pursuant to the Plan were as follows:

| Year ended December 31, | 2017    | 2016    | 2015    |
|-------------------------|---------|---------|---------|
| Shares                  | 2,660   | 2,932   | 3,186   |
|                         | \$31.95 | \$26.73 | \$25.20 |
|                         | and     | and     | and     |
| Price per share         | \$36.18 | \$28.35 | \$26.73 |

## Note 13 - Stock Option Plan

QNB has stock option plans (the Plans) administered by a committee which consists of three or more members of QNB's Board of Directors. The Plans provide for the granting of either (i) Non-Qualified Stock Options (NQSOs) or (ii) Incentive Stock Options (ISOs). The exercise price of an option, as defined by the Plans, is the fair market value of QNB's common stock at the date of grant. The Plans provide for the exercise either in cash or in securities of the Company or in any combination thereof.

The 1998 Plan authorized the issuance of 220,500 shares. The time period by which any option is exercisable under the Plan is determined by the Committee but shall not commence before the expiration of six months after the date of grant or continue beyond the expiration of ten years after the date the option is awarded. The granted options vest after a three-year period. As of December 31, 2017, there were 225,058 options granted, 60,244 options forfeited, 164,814 options exercised and 0 options outstanding under this Plan. The 1998 Plan expired March 10, 2008.

The 2005 Plan authorizes the issuance of 200,000 shares. The terms of the 2005 Plan are identical to the 1998 Plan except the options expire five years after the grant date. As of December 31, 2017, there were 184,200 options granted, 65,350 options forfeited, 81,525 options exercised and 37,025 options outstanding under this Plan. The 2005 Plan expired 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 and no options forfeited or exercised under this Plan as of

December 31, 2017.

As of December 31, 2017, there was approximately \$88,000 of unrecognized compensation cost related to unvested stock option awards granted. That cost is expected to be recognized over the next 26 months.

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Stock option activity during 2017, 2016, and 2015 was as follows:

|                                  | Number of options | Weighted average exercise price | Weighted average remaining contractual term (in years) | Aggregate intrinsic value |
|----------------------------------|-------------------|---------------------------------|--|---------------------------|
| Outstanding at December 31, 2014 | 88,375            | \$ 23.27                        |  |                           |
| Exercised                        | (13,750)          | 18.11                           |  |                           |
| Forfeited                        | (12,750)          | 31.80                           |  |                           |
| Granted                          | 21,000            | 29.25                           |  |                           |
| Outstanding at December 31, 2015 | 82,875            | 24.33                           |  |                           |
| Exercised                        | (22,700)          | 20.90                           |  |                           |
| Forfeited                        | (9,725 )          | 25.60                           |  |                           |
| Granted                          | 23,500            | 30.40                           |  |                           |
| Outstanding at December 31, 2016 | 73,950            | 27.14                           |  |                           |
| Exercised                        | (13,125)          | 22.42                           |  |                           |
| Forfeited                        | (300 )            | 22.58                           |  |                           |
| Granted                          | 25,000            | 37.60                           |  |                           |
| Outstanding at December 31, 2017 | 85,525            | \$ 30.94                        | 2.66   | \$ 1,151                  |
| Exercisable at December 31, 2017 | 19,175            | \$ 24.48                        | 0.72   | \$ 382                    |

As of December 31, 2017, outstanding stock options consist of the following:

|                                  | Options outstanding | Exercise price | Remaining life (in years) | Options exercisable | Exercise price |
|----------------------------------|---------------------|----------------|---------------------------|---------------------|----------------|
|                                  | 6,650               | 23.20          | 0.06                      | 6,650               | \$ 23.20       |
|                                  | 12,525              | 25.16          | 1.08                      | 12,525              | 25.16          |
|                                  | 17,850              | 29.25          | 2.08                      | —                   | —              |
|                                  | 23,500              | 30.40          | 3.13                      | —                   | —              |
|                                  | 25,000              | 37.60          | 4.13                      | —                   | —              |
| Outstanding at December 31, 2017 | 85,525              | \$ 30.94       | 2.66                      | 19,175              | \$ 24.48       |

The intrinsic value related to total stock options exercised during 2017, 2016, and 2015 are as follows:

|  | 2017   | 2016   | 2015   |
|--|--------|--------|--------|
| Intrinsic value of stock options exercised | \$ 204 | \$ 234 | \$ 148 |

## Note 14 - Related Party Transactions

QNB has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal shareholders, their immediate families and affiliated companies. The following table presents activity and amounts due from directors, principal officers, and their related interests. All of these transactions were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. These transactions did not involve more than normal risk of collectability or present any other unfavorable features.

|                            |          |
|----------------------------|----------|
| Balance, December 31, 2016 | \$7,847  |
| New loans                  | 11,623   |
| Repayments                 | (6,633)  |
| Balance, December 31, 2017 | \$12,837 |

The following table provides additional information regarding transactions with related parties.

| December 31,                 | 2017    | 2016    |
|------------------------------|---------|---------|
| Commitments to extend credit | \$3,149 | \$9,344 |
| Letters of credit            | 1,000   | 1,000   |
| Deposits received            | 9,550   | 10,181  |

## Note 15 - Commitments and Contingencies

Financial instruments with off-balance sheet risk:

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:

| December 31,                                  | 2017      | 2016      |
|---|-----------|-----------|
| Commitments to extend credit and unused lines |           |           |
| of credit                                     | \$313,541 | \$277,216 |
| Standby letters of credit                     | 15,211    | 16,490    |
| Total financial instrument commitments        | \$328,752 | \$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. Standby letters of credit totaling \$14,326,000 expire within one year. 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. 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. 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 December 31, 2017 and 2016 for guarantees under standby letters of credit issued is not material.

Other commitments:

QNB has committed to various operating leases for several of their branch and office facilities. Some of these leases include renewal options as well as specific provisions relating to rent increases. The minimum annual rental

commitments under these leases outstanding at December 31, 2017 are as follows:

|            | Minimum<br>lease<br>payments |
|------------|------------------------------|
| 2018       | \$ 576                       |
| 2019       | 644                          |
| 2020       | 512                          |
| 2021       | 420                          |
| 2022       | 265                          |
| Thereafter | 5,596                        |
| Total      | \$ 8,013                     |

Some of the leases contain renewal options to extend the initial terms of the lease for periods ranging from one to ten years and certain leases allow for multiple extensions. With the exception of the renewals for a land lease related to a permanent branch site, the commitment for such renewals is not included above if they have not been exercised as of December 31, 2017. Rent expense under leases, which includes common area maintenance costs not included in the minimum lease payments above, for the years ended December 31, 2017, 2016 and 2015, was \$645,000, \$606,000 and \$621,000, respectively.

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## Note 16 - Accumulated Other Comprehensive Income (Loss)

The following shows the components of accumulated other comprehensive income (loss) during the periods ended December 31, 2017, 2016 and 2015:

| December 31,                                       | 2017      | 2016      | 2015    |
|--|-----------|-----------|---------|
| Unrealized net holding (losses) gains on           |           |           |         |
| available-for-sale securities                      | \$(6,165) | \$(5,446) | \$(568) |
| Unrealized losses on available-for-sale securities |           |           |         |
| for which a portion of an other-than-temporary     |           |           |         |
| impairment loss has been recognized in earnings    | (26 )     | (247 )    | (259)   |
| Accumulated other comprehensive (loss) income      | (6,191)   | (5,693)   | (827)   |
| Tax effect*  | 1,300     | 1,936     | 281     |
| Stranded tax effect                                | 805       | -         | -       |
| Accumulated other comprehensive income (loss),     |           |           |         |
| net of tax   | \$(4,086) | \$(3,757) | \$(546) |

\* At tax rates of 21% for 2017, 34% for 2016 and 34% for 2015

The stranded tax effect is related to the recognition of tax rate change effects on AFS DTA/DTL revaluation, resulting from the 2017 Tax Reform Act, as described in Note 11. The following table presents amounts reclassified out of accumulated other comprehensive income (loss) for the years ended December 31, 2017, 2016 and 2015:

| Details about accumulated other comprehensive income (loss)     | Amount reclassified from accumulated other comprehensive income (loss) |        |        | Affected line item in statement of income                           |
|---|--|--------|--------|---|
|   | 2017   | 2016   | 2015   |   |
| Unrealized net holding gains on available-for-sale securities   | \$ 1,580   | \$ 866 | \$ 838 | Net gain on sale of investment securities                           |
| Other-than-temporary impairment losses on investment securities | (80 )  | (192 ) | (55 )  | Net other-than-temporary impairment losses on investment securities |
| Net gain on sale of investment securities                       | 1,500  | 674    | 783    |   |

|   |        |        |        |                            |
|---|--------|--------|--------|----------------------------|
| Tax effect*                                     | (510 ) | (229 ) | (266 ) | Provision for income taxes |
| Total reclassification out of accumulated other |        |        |        |                            |
| comprehensive income (loss), net of tax         | \$ 990 | \$ 445 | \$ 517 | Net of tax                 |

\*At rate of 34% for 2017, 2016 and 2015

#### Note 17 - Fair Value Measurements and Fair Values of Financial Instruments

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

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

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

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

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

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

|   | Quoted prices   |                   |                 | Balance at end    |
|---|-----------------|-------------------|-----------------|-------------------|
|   | in active       | Significant       |                 |                   |
|   | markets         | other             | Significant     |                   |
|   | for identical   | observable        | unobservable    |                   |
|   | assets          | input             | inputs          |                   |
| December 31, 2017   | (Level 1)       | (Level 2)         | (Level 3)       | of period         |
| <b>Recurring fair value measurements</b>                          |                 |                   |                 |                   |
| <b>Securities available-for-sale</b>                              |                 |                   |                 |                   |
| U.S. Government agency securities                                 | —               | \$ 70,524         | —               | \$ 70,524         |
| State and municipal securities                                    | —               | 76,804            | —               | 76,804            |
| <b>U.S. Government agencies and sponsored enterprises (GSEs):</b> |                 |                   |                 |                   |
| Mortgage-backed securities  | —               | 142,703           | —               | 142,703           |
| Collateralized mortgage obligations (CMOs)                        | —               | 76,302            | —               | 76,302            |
| Pooled trust preferred securities                                 | —               | —                 | \$ 215          | 215               |
| Corporate debt securities   | —               | 8,022             | —               | 8,022             |
| Equity securities   | \$ 4,975        | —                 | —               | 4,975             |
| <b>Total securities available-for-sale</b>                        | <b>\$ 4,975</b> | <b>\$ 374,355</b> | <b>\$ 215</b>   | <b>\$ 379,545</b> |
| <b>Total recurring fair value measurements</b>                    | <b>\$ 4,975</b> | <b>\$ 374,355</b> | <b>\$ 215</b>   | <b>\$ 379,545</b> |
| <b>Nonrecurring fair value measurements *</b>                     |                 |                   |                 |                   |
| Impaired loans  | \$ —            | \$ —              | \$ 1,067        | \$ 1,067          |
| Mortgage servicing rights   | —               | —                 | 34              | 34                |
| <b>Total nonrecurring fair value measurements</b>                 | <b>\$ —</b>     | <b>\$ —</b>       | <b>\$ 1,101</b> | <b>\$ 1,101</b>   |

\*impairment

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|   | Quoted prices                                   |   |                                       | Balance at end<br>of period |
|---|---|---|---------------------------------------|-----------------------------|
|   | in active<br>markets<br>for identical<br>assets | Significant<br>other<br>observable<br>input | Significant<br>unobservable<br>inputs |                             |
| December 31, 2016   | (Level 1)                                       | (Level 2)                                   | (Level 3)                             |                             |
| <b>Recurring fair value measurements</b>                      |   |   |                                       |                             |
| <b>Trading Securities</b>                                     |   |   |                                       |                             |
| State and municipal securities                                | \$ —  | \$ 3,596                                    | \$ —                                  | \$ 3,596                    |
| <b>Securities available-for-sale</b>                          |   |   |                                       |                             |
| U.S. Government agency securities                             | —   | \$ 76,650                                   | —                                     | \$ 76,650                   |
| State and municipal securities                                | —   | 72,295                                      | —                                     | 72,295                      |
| U.S. Government agencies and sponsored<br>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                  |
| <b>Nonrecurring fair value measurements *</b>                 |   |   |                                       |                             |
| Impaired loans  | \$ —  | \$ —  | \$ 2,899                              | \$ 2,899                    |
| Mortgage servicing rights                                     | —   | —   | 58                                    | 58                          |
| Total nonrecurring fair value measurements                    | \$ —  | \$ —  | \$ 2,957                              | \$ 2,957                    |

## \*impairment

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 |                       |   |                                     |                  |
|--|-----------------------|---|-------------------------------------|------------------|
|  | Valuation             |   | Unobservable                        | Value or range   |
| December 31, 2017  | Fair value techniques |   | input                               | of values        |
| Impaired loans   | \$943                 | Appraisal of collateral                       | (1) Appraisal adjustments           | (2) -15% to -90% |
|  |                       |   | Liquidation expenses                | (3) -10%         |
| Impaired loans   | 124                   | Financial statement values for UCC collateral | Financial statement value discounts | (5) -25% to -50% |

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|                           |    |                      |                |            |
|---------------------------|----|----------------------|----------------|------------|
| Mortgage servicing rights | 34 | Discounted cash flow | Remaining term | 2 - 26 yrs |
|                           |    |                      | Discount rate  | 13% to 15% |

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| December 31,<br>2016      | Quantitative information about Level 3 fair value measurements |   |                                     | Value or range<br>of values |
|---------------------------|--|---|-------------------------------------|-----------------------------|
|                           | Fair value   | Valuation techniques                          | Unobservable input                  |                             |
| 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 - 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.

(4) If lendable value (lower than wholesale) is utilized then no additional discounts are taken. If lendable value is not provided, then additional discounts are applied.

(5) Values obtained from financial statements for UCC collateral (fixed assets and inventory) are discounted to estimated realizable liquidation value.

(6) Fair value is determined by the 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 year ended December 31:

|   | Fair value measurements using significant unobservable inputs (Level 3) |         |
|---|---|---------|
|   | 2017  | 2016    |
| Securities available-for-sale               |   |         |
| Balance, beginning of year                  | \$2,281   | \$2,653 |
| Payments received                           | (55 )   | (381 )  |
| Sale of securities                          | (2,026)   | —       |
| Total gains or losses (realized/unrealized) |   |         |
| Included in earnings                        | (15 )   | —       |
| Included in other comprehensive income      | 30  | 9       |

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|                                    |       |         |
|------------------------------------|-------|---------|
| Transfers in and/or out of Level 3 | —     | —       |
| Balance, end of year               | \$215 | \$2,281 |

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the years ended December 31, 2017 and 2016. There were also no transfers in or out of level 3 for the same periods. There was \$15,000 and \$0 in 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 years ended December 31, 2017 and 2016, respectively.

The Level 3 securities consist of one collateralized debt obligation security (“PreTSL”), which is backed by trust preferred securities issued by banks. As discussed in Note 4, despite the fact that there were some trades during 2017, the market for these securities at December 31, 2017 was not active and markets for similar securities also are not active. The new issue market is also inactive and there are currently very few market participants who are willing and or able to transact for these securities.



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

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at December 31, 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
- PreTSLs will be classified within Level 3 of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date.

The Bank used an independent third party to value this security using a discounted cash flow analysis. Based on management's review of the bond's five underlying issuers, there are no expected credit losses or prepayments; cashflows used were contractual based on the Bloomberg YA screen. The assumed cashflows have been discounted using an estimated market discount rate based on the 30-year swap rate. The 30-year 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% includes the risk-free rate, a credit component and a spread for illiquidity.

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 December 31, 2017 and 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.

**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. None of the impaired loans at December 31, 2017 or 2016, respectively, that had specific reserves required were partially charged-off at year end.

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

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

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

|                           | Carrying amount | Fair value | Fair value measurements                              |                                     |                                 |
|---------------------------|-----------------|------------|--|-------------------------------------|---------------------------------|
|                           |                 |            | Quoted prices in active markets for identical assets | Significant other observable inputs | Significant unobservable inputs |
| December 31, 2017         |                 |            | (Level 1)  | (Level 2)                           | (Level 3)                       |
| <b>Financial assets</b>   |                 |            |  |                                     |                                 |
| Cash and cash equivalents | \$ 16,331       | \$ 16,331  | \$ 16,331  | —                                   | —                               |
| Investment securities:    |                 |            |  |                                     |                                 |

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|                                      |            |            |            |            |         |
|--------------------------------------|------------|------------|------------|------------|---------|
| Trading                              | —          | —          | —          | —          | —       |
| Available-for-sale                   | 379,545    | 379,545    | 4,975      | \$ 374,355 | \$ 215  |
| Restricted investment in bank stocks | 1,501      | 1,501      | —          | 1,501      | —       |
| Net loans                            | 725,442    | 727,341    | —          | —          | 727,341 |
| Mortgage servicing rights            | 483        | 585        | —          | —          | 585     |
| Accrued interest receivable          | 3,545      | 3,545      | —          | 3,545      | —       |
| <b>Financial liabilities</b>         |            |            |            |            |         |
| Deposits with no stated maturities   | \$ 768,766 | \$ 768,766 | \$ 768,766 | —          | \$ —    |
| Deposits with stated maturities      | 225,182    | 223,325    | —          | \$ 223,325 | —       |
| Short-term borrowings                | 55,756     | 55,756     | 55,756     | —          | —       |
| Accrued interest payable             | 384        | 384        | —          | 384        | —       |
| <b>Off-balance sheet instruments</b> |            |            |            |            |         |
| Commitments to extend credit         | \$ —       | \$ —       | \$ —       | \$ —       | \$ —    |
| Standby letters of credit            | —          | —          | —          | —          | —       |

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| December 31, 2016                    | Carrying amount | Fair value | Fair value measurements                              |                                     |                                 |
|--------------------------------------|-----------------|------------|--|-------------------------------------|---------------------------------|
|                                      |                 |            | Quoted prices in active markets for identical assets | Significant other observable inputs | Significant unobservable inputs |
|                                      |                 |            | (Level 1)  | (Level 2)                           | (Level 3)                       |
| <b>Financial assets</b>              |                 |            |  |                                     |                                 |
| Cash and cash equivalents            | \$ 10,721       | \$ 10,721  | \$ 10,721  | —                                   | —                               |
| <b>Investment securities:</b>        |                 |            |  |                                     |                                 |
| 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                               | —                               |
| <b>Financial liabilities</b>         |                 |            |  |                                     |                                 |
| 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                                 | —                               |
| <b>Off-balance sheet instruments</b> |                 |            |  |                                     |                                 |
| Commitments to extend credit         | \$ —            | \$ —       | \$ —   | \$ —                                | \$ —                            |
| Standby letters of credit            | —               | —          | —  | —                                   | —                               |

Note 18 - Parent Company Financial Information

Condensed financial statements of QNB Corp. only:

| Balance Sheets            | 2017    | 2016 |
|---------------------------|---------|------|
| December 31,              |         |      |
| <b>Assets</b>             |         |      |
| Cash and cash equivalents | \$4,667 | \$60 |

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|  |          |          |
|--|----------|----------|
| Investment securities available-for-sale   | 4,975    | 8,503    |
| Investment in subsidiary                   | 89,258   | 85,102   |
| Other assets                               | 74       | 3        |
| Total assets                               | \$98,974 | \$93,668 |
| Liabilities                                |          |          |
| Other liabilities                          | \$404    | \$101    |
| Shareholders' equity                       |          |          |
| Total liabilities and shareholders' equity | \$98,974 | \$93,668 |

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| Statements of Income                                       |         |         |         |
|--|---------|---------|---------|
| Year ended December 31,                                    | 2017    | 2016    | 2015    |
| Dividends from subsidiary                                  | \$3,382 | \$3,093 | \$3,228 |
| Interest, dividend and other income                        | 183     | 171     | 180     |
| Securities gains   | 1,477   | 566     | 636     |
| Total income   | 5,042   | 3,830   | 4,044   |
| Expenses   | 301     | 295     | 298     |
| Income before applicable income taxes and equity in        |         |         |         |
| undistributed income of subsidiary                         | 4,741   | 3,535   | 3,746   |
| Provision for income taxes                                 | 554     | 159     | 163     |
| Income before equity in undistributed income of subsidiary | 4,187   | 3,376   | 3,583   |
| Equity in undistributed income of subsidiary               | 4,102   | 5,548   | 4,650   |
| Net income   | \$8,289 | \$8,924 | \$8,233 |

| Statements of Comprehensive Income (in thousands) |            |             |            |            |             |            |            |             |            |
|---|------------|-------------|------------|------------|-------------|------------|------------|-------------|------------|
| Year ended December 31,                           | 2017       |             |            | 2016       |             |            | 2015       |             |            |
|   | Before tax | Tax expense | Net of tax | Before tax | Tax expense | Net of tax | Before tax | Tax expense | Net of tax |
|   | amount     | (benefit)   | amount     | amount     | (benefit)   | amount     | amount     | (benefit)   | amount     |
| Net income  | \$14,189   | \$5,900     | \$8,289    | \$11,978   | \$3,054     | \$8,924    | \$10,803   | \$2,570     | \$8,233    |
| Other comprehensive (loss) income:                |            |             |            |            |             |            |            |             |            |
| Net unrealized holding (losses)                   |            |             |            |            |             |            |            |             |            |
| gains on securities:                              |            |             |            |            |             |            |            |             |            |
| Unrealized holding (losses)                       |            |             |            |            |             |            |            |             |            |
| gains arising during the                          |            |             |            |            |             |            |            |             |            |
| period  | 1,002      | 341         | 661        | (4,192)    | (1,426)     | (2,766)    | (1,419)    | (483)       | (936)      |
| Reclassification adjustment                       |            |             |            |            |             |            |            |             |            |
| for gains included in net                         |            |             |            |            |             |            |            |             |            |
| income  | (1,500)    | (510)       | (990)      | (674)      | (229)       | (445)      | (783)      | (266)       | (517)      |
| Other comprehensive (loss) income                 | (498)      | (169)       | (329)      | (4,866)    | (1,655)     | (3,211)    | (2,202)    | (749)       | (1,453)    |
| Total comprehensive income                        | \$13,691   | \$5,731     | \$7,960    | \$7,112    | \$1,399     | \$5,713    | \$8,601    | \$1,821     | \$6,780    |

| Statements of Cash Flows                                 |          |          |          |
|--|----------|----------|----------|
| Year ended December 31,                                  | 2017     | 2016     | 2015     |
| <b>Operating Activities</b>                              |          |          |          |
| Net income   | \$8,289  | \$8,924  | \$8,233  |
| Adjustments to reconcile net income to net cash provided |          |          |          |
| by operating activities:                                 |          |          |          |
| Equity in undistributed income from subsidiary           | (4,102 ) | (5,548 ) | (4,650 ) |
| Net securities gains                                     | (1,477 ) | (566 )   | (636 )   |
| Stock-based compensation expense                         | 102      | 88       | 85       |
| (Decrease) increase in other liabilities                 | 335      | (67 )    | (87 )    |
| Decrease (increase) in other assets                      | (3 )     | 3        | (2 )     |
| Deferred income tax provision                            | 98       | 14       | 13       |
| Net cash provided by operating activities                | 3,242    | 2,848    | 2,956    |
| <b>Investing activities</b>                              |          |          |          |
| Purchase of investment securities                        | (9,998 ) | (7,327 ) | (3,862 ) |
| Proceeds from sale of investment securities              | 14,422   | 7,137    | 3,713    |
| Net cash used by investing activities                    | 4,424    | (190 )   | (149 )   |
| <b>Financing activities</b>                              |          |          |          |
| Cash dividend paid                                       | (3,731 ) | (3,556 ) | (3,445 ) |
| Proceeds from issuance of common stock                   | 672      | 862      | 648      |
| Tax benefit from exercise of stock options               | -        | 17       | 21       |
| Net cash used by financing activities                    | (3,059 ) | (2,677 ) | (2,776 ) |
| (Decrease) increase in cash and cash equivalents         | 4,607    | (19 )    | 31       |
| Cash and cash equivalents at beginning of year           | 60       | 79       | 48       |
| Cash and cash equivalents at end of year                 | \$4,667  | \$60     | \$79     |



Note 19 - 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 and Federal 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 the Company, unless such loans are collateralized by specific obligations.

Both the Company and the Bank are subject to regulatory capital requirements administered by Federal bank regulatory 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 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 held by banks. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require 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 will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets and 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.

The capital amounts and classification are also subject to qualitative judgments by the regulators. Management believes, as of December 31, 2017, that the Company and the Bank met capital adequacy requirements to which they were subject.

The Bank is presently considered to be "well capitalized" under the regulatory framework. To be categorized as well capitalized, the Company and the Bank must maintain minimum ratios set forth in the table below.

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

|   | Capital levels |        | Adequately capitalized |       | Well capitalized |        |
|---|----------------|--------|------------------------|-------|------------------|--------|
|   | Actual Amount  | Ratio  | Amount                 | Ratio | Amount           | Ratio  |
| As of December 31, 2017                                 |                |        |                        |       |                  |        |
| Total risk-based capital (to risk-weighted assets):     |                |        |                        |       |                  |        |
| Consolidated  | \$110,352      | 12.52% | \$70,520               | 8.00% | \$88,150         | 10.00% |
| Bank  | 101,040        | 11.67  | 69,277                 | 8.00  | 86,596           | 10.00  |
| Tier I capital (to risk-weighted assets):               |                |        |                        |       |                  |        |
| Consolidated  | 102,438        | 11.62  | 52,890                 | 6.00  | 52,890           | 6.00   |
| Bank  | 93,126         | 10.75  | 51,957                 | 6.00  | 69,277           | 8.00   |
| Common equity tier 1 capital (to risk-weighted assets): |                |        |                        |       |                  |        |
| Consolidated  | 102,438        | 11.62  | 39,668                 | 4.50  | N/A              | N/A    |
| Bank  | 93,126         | 10.75  | 38,968                 | 4.50  | 56,287           | 6.50   |
| Tier I capital (to average assets):                     |                |        |                        |       |                  |        |
| Consolidated  | 102,438        | 8.88   | 46,149                 | 4.00  | N/A              | N/A    |
| Bank  | 93,126         | 8.14   | 45,761                 | 4.00  | 57,201           | 5.00   |
| As of December 31, 2016                                 |                |        |                        |       |                  |        |
| 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   |

## Note 20 - Consolidated Quarterly Financial Data (Unaudited)

The unaudited quarterly results of operations for the years ended 2017 and 2016 are in the following table:

|                                | Quarters Ended 2017 |         |          |         | Quarters Ended 2016 |         |          |         |
|--------------------------------|---------------------|---------|----------|---------|---------------------|---------|----------|---------|
|                                | March 31            | June 30 | Sept. 30 | Dec. 31 | March 31            | June 30 | Sept. 30 | Dec. 31 |
| Interest income                | \$9,136             | \$9,192 | \$9,830  | \$9,944 | \$8,280             | \$8,184 | \$8,287  | \$8,486 |
| Interest expense               | 1,256               | 1,334   | 1,515    | 1,575   | 1,159               | 1,165   | 1,202    | 1,207   |
| Net interest income            | 7,880               | 7,858   | 8,315    | 8,369   | 7,121               | 7,019   | 7,085    | 7,279   |
| Provision for (credit to)      |                     |         |          |         |                     |         |          |         |
| loan losses                    | 300                 | 300     | 100      | 700     | 125                 | —       | —        | (95 )   |
| Non-interest income            | 1,990               | 1,615   | 1,470    | 1,812   | 1,576               | 1,374   | 1,644    | 1,073   |
| Non-interest expense           | 5,588               | 5,942   | 6,191    | 5,999   | 5,519               | 5,593   | 5,616    | 5,435   |
| Income before income taxes     | 3,982               | 3,231   | 3,494    | 3,482   | 3,053               | 2,800   | 3,113    | 3,012   |
| Provision for income taxes     | 1,122               | 845     | 940      | 2,993   | 788                 | 702     | 821      | 743     |
| Net Income                     | \$2,860             | \$2,386 | \$2,554  | \$489   | \$2,265             | \$2,098 | \$2,292  | \$2,269 |
| Earnings Per Share - basic *   | \$0.84              | \$0.70  | \$0.74   | \$0.14  | \$0.67              | \$0.62  | \$0.68   | \$0.67  |
| Earnings Per Share - diluted * | \$0.83              | \$0.69  | \$0.74   | \$0.14  | \$0.67              | \$0.62  | \$0.67   | \$0.66  |

\*Due to rounding, quarterly earnings per share may not sum to annual earnings per share

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of QNB's Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO (its principal executive officer and principal financial officer), management has evaluated the effectiveness of the design and operation of QNB's disclosure controls and procedures as of December 31, 2017. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods required by the Securities and Exchange Commission, or the SEC, and that such information is accumulated and communicated to QNB's management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

Based on and as of the date of such evaluation, our CEO and CFO concluded that the design and operation of our disclosure controls and procedures were effective as of the end of the period covered by this Report.

b) Internal Control over Financial Reporting

Information required by this item is set forth in Management's Report and Report of Independent Registered Public Accounting Firm, both of which are incorporated by reference into this item.

c) Changes in Internal Control over Financial Reporting

On May 14, 2013, COSO issued an updated version of its Internal Control – Integrated Framework, referred to as the 2013 COSO Framework. Management's assessment of the overall effectiveness of our internal controls over financial reporting for the year ended December 31, 2017 was based on the 2013 COSO Framework.

There were no changes to the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act) during the quarter ended December 31, 2017 that materially affected, or are reasonably likely to materially affect, the Company's control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is incorporated by reference to information appearing in QNB Corp.’s definitive proxy statement to be used in connection with the 2018 Annual Meeting of Shareholders under the captions:

- “Election of Directors”
- “Governance of the Company - Code of Ethics”
- “Section 16(a) Beneficial Ownership Compliance”
- “Meetings and Committees of the Board of Directors of QNB and the Bank”
- “Executive Officers of QNB and/or the Bank”

The Company has adopted a Code of Business Conduct and Ethics applicable to its CEO, CFO and Controller as well as its long-standing Code of Ethics which applies to all directors and employees. The codes are available on the Company’s website at [www.qnbbank.com](http://www.qnbbank.com).

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is incorporated by reference to the information appearing in QNB Corp.’s definitive proxy statement to be used in connection with the 2018 Annual Meeting of Shareholders under the captions:

- “Compensation Committee Report”
- “Executive Compensation”
- “Director Compensation”
- “Compensation Tables”

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Equity Compensation Plan Information

The following table summarizes QNB’s equity compensation plan information as of December 31, 2017. Information is included for both equity compensation plans approved by QNB shareholders and equity compensation plans not approved by QNB shareholders.

| Plan Category  | Number of shares to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of shares   |
|--|---|---|--|
|  |   |   | available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c) |
| Equity compensation plans approved by QNB shareholders |   |   |  |

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|   |        |          |         |
|---|--------|----------|---------|
| 2005 Stock option plan                    | 37,025 | \$ 26.78 | —       |
| 2015 Stock option plan                    | 48,500 | 34.11    | 251,500 |
| 2016 Employee stock purchase plan         | —      | —        | 25,948  |
| Equity compensation plans not approved by |        |          |         |
| QNB shareholders                          |        |          |         |
| None                                      | —      | —        | —       |
| Total                                     | 85,525 | \$ 30.94 | 277,448 |

Additional information required by Item 12 is incorporated by reference to the information appearing in QNB Corp.'s definitive proxy statement to be used in connection with the 2018 Annual Meeting of Shareholders under the captions:

•“Security Ownership of Certain Beneficial Owners and Management”

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 is incorporated by reference to the information appearing in QNB Corp.'s definitive proxy statement to be used in connection with the 2018 Annual Meeting of Shareholders under the captions:

- “Certain Relationships and Related Party Transactions”
- “Governance of the Company - Director Independence”

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 is incorporated by reference to the information appearing in QNB Corp.'s definitive proxy statement to be used in connection with the 2018 Annual Meeting of Shareholders under the captions:

- “Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Auditors”
- “Audit Fees, Audit Related Fees, Tax Fees, and All Other Fees”

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) 1. Financial Statements

The following financial statements are included by reference in Part II, Item 8 hereof.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income (Loss)

Consolidated Statements of Shareholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

2. Financial Statement Schedules

The financial statement schedules required by this Item are omitted because the information is either inapplicable, not required or is in the consolidated financial statements as a part of this Report.

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3. The following exhibits are incorporated by reference herein or filed with this Form 10-K:

- 3(i)- Articles of Incorporation of Registrant, as amended. (Incorporated by reference to Exhibit 3(i) of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 10, 2015)
- 3(ii)- By-laws 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 10, 2015)
- 10.1- QNB Corp. 1998 Stock Incentive Plan. (Incorporated by reference to Exhibit 4.3 to Registration Statement No. 333-91201 on Form S-8, filed with the Commission on November 18, 1999)
- 10.2- QNB Corp. 2005 Stock Incentive Plan. (Incorporated by reference to Exhibit 99.1 to Registration Statement No. 333-125998 on Form S-8, filed with the Commission on June 21, 2005)
- 10.3- QNB Corp. 2011 Employee Stock Purchase Plan. (Incorporated by reference to Exhibit 99.1 to Registration Statement No. 333-175788 on Form S-8, filed with the Commission on July 26, 2011)
- 10.4- Employment Agreement between Registrant and David W. Freeman. (Incorporated by reference to Exhibit 10.1 of Registrant's Current Report on Form 8-K, SEC File No. 0-17706, filed with the Commission on December 28, 2012)
- 10.5- Change of Control Agreement between Registrant and Scott G. Orzechoski. (Incorporated by reference to Exhibit 10.1 of Registrant's Quarterly Report on Form 8-K, SEC File No. 0-17706, filed with the Commission on November 9, 2011)
- 10.6- Change of Control Agreement between Registrant and Dale A. Westwood (fka Wentz). (Incorporated by reference to Exhibit 10.9 of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 29, 2013)
- 10.7- Change of Control Agreement between Registrant and Janice McCracken Erkes. (Incorporated by reference to Exhibit 10.1 of Registrant's Current Report on Form 8-K, SEC File No. 0-17706, filed with the Commission on September 8, 2014)
- 10.8- Change of Control Agreement between Registrant and Christopher T. Cattie. (Incorporated by reference to Exhibit 10.9 of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 14, 2016)
- 10.9- QNB Corp 2015 Stock Incentive Plan (Incorporated by reference to Exhibit A to QNB Corp.'s proxy statement, filed April 15, 2015)
- 10.10- QNB Corp. 2016 Employee Stock Purchase Plan. (Incorporated by reference to Exhibit A to QNB Corp.'s proxy statement, filed with the Commission on April 12, 2016)
- 21- Subsidiaries of the Registrant
- 23.1- Consent of Independent Registered Public Accounting Firm
- 31.1- Section 302 Certification of the Chief Executive Officer

31.2- Section 302 Certification of the Chief Financial Officer

32.1- Section 906 Certification of the Chief Executive Officer

32.2- Section 906 Certification of the Chief Financial Officer

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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 Annual 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 Section 13 or 15(d) 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.  
 March 16, 2018  
 BY: /s/ David W. Freeman  
 David W. Freeman  
 Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report is signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated

|  |   |                |
|--|---|----------------|
| /s/ Dennis Helf<br>Dennis Helf                     | Director, Chairman  | March 16, 2018 |
| /s/ David W. Freeman<br>David W. Freeman           | Chief Executive Officer,<br>Principal Executive<br>Officer and Director | March 16, 2018 |
| /s/ Autumn R. Bayles<br>Autumn R. Bayles           | Director  | March 16, 2018 |
| /s/ Thomas J. Bisko<br>Thomas J. Bisko             | Director  | March 16, 2018 |
| /s/ Kenneth F. Brown, Jr.<br>Kenneth F. Brown, Jr. | Director  | March 16, 2018 |
| /s/ Jennifer L. Mann<br>Jennifer L. Mann           | Director  | March 16, 2018 |
| /s/ Anna Mae Papso<br>Anna Mae Papso               | Director  | March 16, 2018 |
| /s/ Gary S. Parzych<br>Gary S. Parzych             | Director  | March 16, 2018 |
| /s/ W. Randall Stauffer<br>W. Randall Stauffer     | Director  | March 16, 2018 |

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/s/ Scott R. Stevenson      Director      March 16, 2018  
Scott R. Stevenson

/s/ Janice McCracken Erkes      Chief Financial Officer      March 16, 2018  
Janice McCracken Erkes      (Principal Financial Officer)

/s/ Mary E. Liddle      Chief Accounting Officer      March 16, 2018  
Mary E. Liddle      (Principal Accounting Officer)