QNB CORP
Form 10-Q
August 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 0-17706

QNB Corp.

(Exact Name of Registrant as Specified in Its Charter)

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

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

(215) 538-5600

Registrant's Telephone Number, Including Area Code

Not Applicable

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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	Smaller Reporting Company
Emerging growth company	

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

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

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

Class	Outstanding at August 2, 2018
Common Stock, par value $0.625	3,466,504

QNB CORP. AND SUBSIDIARY

FORM 10-Q

QUARTER ENDED JUNE 30, 2018

INDEX

QNB Corp. and Subsidiary

CONSOLIDATED BALANCE SHEETS

	(in thousands, except share data) (current period unaudited) June 30, 2018	December 31, 2017
Assets		
Cash and due from banks	$10,787	$10,793
Interest-bearing deposits in banks	939	5,538
Total cash and cash equivalents	11,726	16,331
Investment debt securities		
Available-for-sale (amortized cost $356,329 and $380,440)	344,194	374,570
Investment equity securities (cost of $10,127 and $5,296)	9,600	4,975
Restricted investment in stocks	2,668	1,501
Loans held-for-sale	404	—
Loans receivable	779,886	733,283
Allowance for loan losses	(8,192)	(7,841)
Net loans	771,694	725,442
Bank-owned life insurance	11,032	10,894
Premises and equipment, net	9,648	8,495
Accrued interest receivable	3,573	3,545
Net deferred tax assets	4,523	3,319
Other assets	3,812	3,265
Total assets	$1,172,874	$1,152,337
Liabilities		
Deposits		
Demand, non-interest bearing	$135,482	$129,212
Interest-bearing demand	286,248	297,470
Money market	80,053	84,562
Savings	261,224	257,522
Time	120,303	124,485
Time of $100 or more	102,416	100,697
Total deposits	985,726	993,948
Short-term borrowings	85,646	55,756
Accrued interest payable	371	384
Other liabilities	3,313	3,679
Total liabilities	1,075,056	1,053,767

Shareholders' Equity		
Common stock, par value $0.625 per share; authorized 10,000,000 shares; 3,630,037 shares and 3,612,677 shares issued; 3,465,468 and 3,448,108 shares outstanding	2,269	2,258
Surplus	19,293	18,691
Retained earnings	88,319	84,183
Accumulated other comprehensive loss, net of tax	(9,587)	(4,086)
Treasury stock, at cost; 164,569 shares	(2,476)	(2,476)
Total shareholders' equity	97,818	98,570
Total liabilities and shareholders' equity	$1,172,874	$1,152,337

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

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share data) (unaudited)	Three months ended June 30, 2018	2017	Six months ended June 30, 2018	2017
Interest income				
Interest and fees on loans	$8,512	$7,115	$16,939	$14,187
Interest and dividends on investment securities (AFS & Equity):				
Taxable	1,551	1,551	3,128	3,114
Tax-exempt	461	484	944	949
Interest on trading securities	—	16	—	45
Interest on interest-bearing balances and other interest income	38	26	60	33
Total interest income	10,562	9,192	21,071	18,328
Interest expense				
Interest on deposits				
Interest-bearing demand	436	228	810	402
Money market	62	76	120	128
Savings	369	278	699	537
Time	379	372	757	740
Time of $100,000 or more	415	328	814	651
Interest on short-term borrowings	201	52	380	132
Total interest expense	1,862	1,334	3,580	2,590
Net interest income	8,700	7,858	17,491	15,738
Provision for loan losses	187	300	375	600
Net interest income after provision for loan losses	8,513	7,558	17,116	15,138
Non-interest income				
Net gain on sales of investment debt and equity securities	48	115	133	864
Unrealized gain (loss) on investment equity securities	41	—	(205)	—
Net gain on trading activities	—	10	—	27
Fees for services to customers	408	421	829	813
ATM and debit card	487	449	917	866
Retail brokerage and advisory	105	104	208	207
Bank-owned life insurance	69	120	137	191
Merchant	82	92	156	172
Net gain on sale of loans	37	201	44	251
Other	177	103	302	214
Total non-interest income	1,454	1,615	2,521	3,605
Non-interest expense				
Salaries and employee benefits	3,627	3,237	6,972	6,323
Net occupancy	448	425	919	876
Furniture and equipment	563	456	1,050	885

Marketing	221	307	531	536
Third party services	506	407	916	801
Telephone, postage and supplies	173	199	354	399
State taxes	164	155	335	348
FDIC insurance premiums	146	134	321	275
Other	685	622	1,313	1,087
Total non-interest expense	6,533	5,942	12,711	11,530
Income before income taxes	3,434	3,231	6,926	7,213
Provision for income taxes	572	845	1,129	1,967
Net income	$2,862	$2,386	$5,797	$5,246
Earnings per share - basic	$0.83	$0.70	$1.68	$1.53
Earnings per share - diluted	$0.82	$0.69	$1.67	$1.53
Cash dividends per share	$0.32	$0.31	$0.64	$0.62

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

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	(in thousands - unaudited)					
	2018			2017		
Three months ended June 30,	Before tax amount	Tax expense (benefit)	Net of tax amount	Before tax amount	Tax expense (benefit)	Net of tax amount
Net income	$3,434	$572	$2,862	$3,231	$845	$2,386
Other comprehensive (loss) income:						
Net unrealized holding (losses) gains on securities:						
Unrealized holding (losses) gains arising during the period	(1,217)	(255)	(962)	1,682	572	1,110
Reclassification adjustment for gains included in net income	(2)	(1)	(1)	(115)	(40)	(75)
Other comprehensive (loss) income	(1,219)	(256)	(963)	1,567	532	1,035
Total comprehensive income	$2,215	$316	$1,899	$4,798	$1,377	$3,421

Six months ended June 30,	2018			2017		
	Before tax amount	Tax expense (benefit)	Net of tax amount	Before tax amount	Tax expense (benefit)	Net of tax amount
Net income	$6,926	$1,129	$5,797	$7,213	$1,967	$5,246
Other comprehensive (loss) income:						
Net unrealized holding (losses) gains on securities:						
Unrealized holding (losses) gains arising during the period	(6,263)	(1,315)	(4,948)	2,931	997	1,934
Reclassification adjustment for gains included in net income	(3)	(1)	(2)	(864)	(294)	(570)
Other comprehensive income	(6,266)	(1,316)	(4,950)	2,067	703	1,364
Total comprehensive (loss) income	$660	$(187)	$847	$9,280	$2,670	$6,610

Tax rate of 21% for 2018 and 34% for 2017

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

5

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

Six months ended June 30, 2018 and 2017

(unaudited) (in thousands, except share and per share data)	Number of Shares Outstanding	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance, December 31, 2017	3,448,108	$ 2,258	$ 18,691	$ 84,183	$ (4,086)	$ (2,476)	$ 98,570
Net income		—	—	5,797	—	—	5,797
Other comprehensive loss, net of tax		—	—	—	(4,950)	—	(4,950)
Cash dividends declared ($0.64 per share)		—	—	(2,212)	—	—	(2,212)
Equity securities fair value reclassification [1]				(254)	254		—
ASU 2018-02 stranded tax reclassification [2]				805	(805)		—
Stock issued in connection with dividend reinvestment and stock purchase plan	9,934	6	423	—	—	—	429
Stock issued for employee stock purchase plan	1,426	1	56	—	—	—	57
Stock issued for options exercised	6,000	4	65	—	—	—	69
Stock-based compensation expense		—	58	—	—	—	58
Balance, June 30, 2018	3,465,468	$ 2,269	$ 19,293	$ 88,319	$ (9,587)	$ (2,476)	$ 97,818

[1] Refer to Note 2, ASU 2016-01

[2] Refer to Note 2, ASU 2018-02

(unaudited) (in thousands, except share and per share data)	Number of Shares Outstanding	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance, December 31, 2016	3,411,701	$ 2,235	$ 17,418	$ 80,147	$ (3,757)	$ (2,476)	$ 93,567
Net income		—	—	5,246	—	—	5,246
Other comprehensive income, net of tax		—	—	—	1,364	—	1,364

Cash dividends declared ($0.62 per share)		—	—	(2,122)	—	—	(2,122)
Stock issued in connection with dividend reinvestment and stock purchase plan	13,579	9	503	—	—	—	512
Stock issued for employee stock purchase plan	1,318	1	41	—	—	—	42
Stock issued for options exercised	6,642	4	86	—	—	—	90
Stock-based compensation expense		—	51	—	—	—	51
Balance, June 30, 2017	3,433,240	$ 2,249	$ 18,099	$ 83,271	$ (2,393)	$ (2,476)	$ 98,750

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

QNB Corp. and Subsidiary

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(in thousands, unaudited)	
Six months ended June 30,	2018	2017
Operating Activities		
Net income	$5,797	$5,246
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	436	403
Provision for loan losses	375	600
Net gain on sales of debt and equity securities	(133)	(864)
Net unrealized loss on equity securities	205	—
Net gain on sale of other real estate owned, repossessed assets and premises and equipment	(1)	(1)
Net gain on sale of loan held for investment	—	(99)
Net gain on sale of loans	(44)	(152)
Proceeds from sales of residential mortgages held-for-sale	1,949	4,675
Origination of residential mortgages held-for-sale	(2,309)	(4,264)
Income on bank-owned life insurance	(137)	(191)
Stock-based compensation expense	58	51
Net decrease in trading securities	—	3,596
Deferred income tax provision	110	130
Net increase in income taxes payable	(294)	(601)
Net (increase) decrease in accrued interest receivable	(28)	622
Amortization of mortgage servicing rights and change in valuation allowance	31	47
Net amortization of premiums and discounts on investment securities	740	839
Net decrease in accrued interest payable	(13)	(37)
Increase in other assets	(388)	(1,203)
(Decrease) increase in other liabilities	(260)	36
Net cash provided by operating activities	6,094	8,833
Investing Activities		
Proceeds from payments, maturities and calls of debt securities available-for-sale	22,380	27,255
Proceeds from the sale of debt securities available-for-sale	4,159	19,358
Proceeds from the sale of equity securities	1,390	5,262
Purchases of debt securities available-for-sale	(3,166)	(40,602)
Purchases of equity securities	(6,090)	(3,868)
Proceeds from redemption of investment in restricted bank stock	4,505	2,977
Purchase of restricted stock	(5,672)	(3,934)
Proceeds from sale of loan held for investment	—	99
Net increase in loans	(46,627)	(62,093)
Net purchases of premises and equipment	(1,590)	(241)
Redemption of bank-owned life insurance	—	752
Proceeds from sales of other real estate owned and repossessed assets	1	1
Net cash used in investing activities	(30,710)	(55,034)

Financing Activities		
Net increase in non-interest bearing deposits	6,270	1,359
Net (decrease) increase in interest-bearing deposits	(14,492)	36,600
Net increase in short-term borrowings	29,890	14,247
Cash dividends paid, net of reinvestment	(1,927)	(1,858)
Proceeds from issuance of common stock	270	380
Net cash provided by financing activities	20,011	50,728
(Decrease) increase in cash and cash equivalents	(4,605)	4,527
Cash and cash equivalents at beginning of year	16,331	10,721
Cash and cash equivalents at end of period	$11,726	$15,248
Supplemental Cash Flow Disclosures		
Interest paid	$3,593	$2,627
Income taxes paid	1,313	2,434
Non-cash transactions:		
Unsettled trades to purchase securities	—	(2,598)

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

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

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in QNB's 2017 Annual Report incorporated in the Form 10-K. Operating results for the six-month period ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

The unaudited consolidated financial statements reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the results of operations for the period and are of a normal and recurring nature.

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

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

QNB has evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2018, for items that should potentially be recognized or disclosed in these consolidated financial statements.

2. RECENT ACCOUNTING PRONOUNCEMENTS

QNB adopted ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, effective January 1, 2018. This ASU was issued by the Financial Accounting Standards Board (FASB) on January 5, 2016 to enhance the reporting model for financial instruments to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The FASB issued ASU 2018-03 in February 2018 which provides technical corrections and Improvements to ASU 2016-01. QNB adopted the applicable requirements under these ASUs as follows:

- Equity investments with readily determinable fair values are 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. The Company chose to continue to measure equity investments without readily

determinable fair value at cost adjusted for changes in observable prices minus impairment. The Company will reassess at each reporting period whether these equity investments without readily determinable fair values qualify to be measured in accordance with the practical expedient to estimate fair value. The Company can subsequently elect to measure these equity investments, if they qualify, at the estimated fair value under the practical expedient; but the election would be irrevocable. Any gains or losses resulting from changes in the fair value would be recognized in net income.

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

QNB used 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 reclassified 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.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (2017 Tax Reform Act) was enacted into law. The 2017 Tax Reform Act made 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. The Company recorded less tax expense for the three and six months periods of 2018 than in the

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

comparable periods of 2017, with effective tax rates of 16.7% in 2018 compared to 26.2% in 2017 for the three months and 16.3% in 2018 compared to 27.3% in 2017 for the six months, primarily a result of the 2017 Tax Reform Act.

QNB adopted ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 202) during the first quarter of 2018. The amendments in this ASU, issued by the FASB on February 2, 2018, 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 and eliminates the stranded tax effects resulting from the 2017 Tax Reform Act. The Company chose to early adopt the amendments in this update as permitted. QNB reclassified $805,000 from accumulated other comprehensive loss to retained earnings in the consolidated statement of shareholders' equity during the first quarter of 2018.

QNB adopted Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606) (ASC 606), effective January 1, 2018. Under ASU 2014-09, revenue is recognized when a customer obtains control of promised services in an amount that reflects the consideration the entity expects to receive in exchange for those services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. QNB applied the five-step method outlined in ASU 2014-09 to all revenue streams scoped-in by the ASU and elected the modified retrospective implementation method. Substantially all of QNB's interest income and non-interest income were not impacted by the adoption of this ASU because either the revenue from those contracts with customers is covered by other guidance in U.S. GAAP or the revenue recognition outcomes were similar to our current revenue recognition practices. We reviewed non-interest sources of income and related contracts to document the impact of the new standard on our service offerings that are in the scope of the ASU including: service charges on deposits; ATM and debit card income; retail brokerage and advisory fees; merchant income; credit card income; sale of checks to depositors; miscellaneous fees; and sale of OREOs. Upon our analysis we concluded that the adoption of ASC 606 did not change the timing and pattern of revenue recognition related to scoped in non-interest income sources and only required additional disclosures. In addition, we reviewed, and where necessary, enhanced our business processes, systems and controls to support recognition and disclosures under the new standard.

The implementation of the guidance had no material impact on the measurement or recognition of revenue of prior periods, however, additional disclosures have been added in accordance with the ASU which can be found in Note 12 – Revenue Recognition from Contracts with Customers.

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 does not expect the adoption of ASU 2016-02 to have a material impact on the consolidated 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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

- Increases users' understanding of underwriting standards and credit quality trends by requiring additional information about credit quality indicators by year of origination (vintage)
- For available-for-sale debt securities, aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses (and subsequent changes in credit losses) through an allowance rather than a write down

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

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

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

3. STOCK-BASED COMPENSATION AND SHAREHOLDERS' EQUITY

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

Stock-based compensation expense was $36,000 and $33,000 for the three months ended June 30, 2018 and 2017, respectively. Stock-based compensation expense was $58,000 and $51,000 for the six months ended June 30, 2018 and 2017, respectively. As of June 30, 2018, there was approximately $161,000 of unrecognized compensation cost related to unvested share-based compensation award grants that is expected to be recognized over the next 32 months.

Options are granted to certain employees at prices equal to the market value of the stock on the date the options are granted. The 2005 Plan authorized the issuance of 200,000 shares. The time period during which any option is exercisable under the Plan is determined by the Committee but shall not commence before the expiration of six months after the date of grant or continue beyond the expiration of five years after the date the option is awarded. The granted options vest after a three-year period. As of June 30, 2018, there were 184,200 options granted, 65,850 options forfeited, 91,825 options exercised, and 26,525 options outstanding under this Plan. The 2005 Plan expired on March 15, 2015.

The 2015 Plan authorizes the issuance of 300,000 shares. The terms of the 2015 Plan are identical to the 2005 Plan. There were 73,500 options granted and outstanding under this Plan as of June 30, 2018. There were 1,100 options forfeited and no options exercised as of June 30, 2018. The 2015 Plan expires on February 24, 2025.

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following assumptions were used in the option pricing model in determining the fair value of options granted during the period:

Six months ended June 30,	2018	2017
Risk free interest rate	2.15 %	1.48 %
Dividend yield	1.24 %	3.19 %
Volatility	18.12 %	17.89 %
Expected life (years)	4.20	4.20

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

The fair market value of options granted in the first six months of 2018 and 2017 was $5.29 and $3.88, respectively.

Stock option activity during the six months ended June 30, 2018 and 2017 is as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2017	85,525	$ 30.94		
Granted	25,000	43.60		
Exercised	(10,000)	24.86		
Forfeited	(1,600)	32.52		
Outstanding at June 30, 2018	98,925	$ 34.73	2.99	$ 1,180
Exercisable at June 30, 2018	26,525	$ 27.46	1.14	$ 509

	Number	Weighted	Weighted	Aggregate

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. EARNINGS PER SHARE & SHARE REPURCHASE PLAN

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

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Numerator for basic and diluted earnings per share - net income	$2,862	$2,386	$5,797	$5,246
Denominator for basic earnings per share - weighted average shares outstanding	3,460,360	3,425,356	3,456,467	3,420,239
Effect of dilutive securities - employee stock options	20,952	17,852	20,407	16,027
Denominator for diluted earnings per share - adjusted weighted average shares outstanding	3,481,312	3,443,208	3,476,874	3,436,266
Earnings per share - basic	$0.83	$0.70	$1.68	$1.53
Earnings per share - diluted	0.82	0.69	1.67	1.53

There were 25,000 stock options that were anti-dilutive for both three- and six-month periods ended June 30, 2018 and 2017. These stock options were not included in the above calculation.

The Board of Directors has authorized the repurchase of up to 100,000 shares of its common stock in open market or privately negotiated transactions. The repurchase authorization does not bear a termination date. There were no shares repurchased during the three and six months ended June 30, 2018 and 2017. As of June 30, 2018, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000.

5. COMPREHENSIVE INCOME (LOSS)

The following shows the components of accumulated other comprehensive income (loss) at June 30, 2018 and December 31, 2017:

	June 30, 2018	December 31, 2017
Unrealized net holding losses on available-for-sale securities	$(12,130)	$(6,165)
Unrealized losses on available-for-sale securities for which a portion of an other-than-temporary impairment loss has been recognized in earnings	(5)	(26)
Accumulated other comprehensive loss	(12,135)	(6,191)
Tax effect	2,548	1,300
Stranded tax effect (1)	—	805
Accumulated other comprehensive loss, net of tax	$(9,587)	$(4,086)

(1) Refer to Note 2, ASU 2018-02

12

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following tables present amounts reclassified out of accumulated other comprehensive income (loss) for the three and six months ended June 30, 2018 and 2017:

Three months ended June 30,	Amount reclassified from accumulated other comprehensive loss		
Details about accumulated other comprehensive loss	2018	2017	Affected line item in statement of income
Unrealized net holding gains on available-for-sale securities	$ 2	$ 115	Net gain on sale of investment securities
Other-than-temporary impairment losses on investment securities	—	—	Net other-than-temporary impairment losses on investment securities
	2	115	
Tax effect	(1)	(40)	Provision for income taxes
Total reclass out of accumulated other comprehensive income, net of tax	$ 1	$ 75	Net of tax

Six months ended June 30,	Amount reclassified from accumulated other comprehensive loss		
Details about accumulated other comprehensive loss	2018	2017	Affected line item in statement of income
Unrealized net holding gains on available-for-sale securities	$ 3	$ 864	Net gain on sale of investment securities
Other-than-temporary impairment losses on investment securities	—	—	Net other-than-temporary impairment losses on investment securities
	3	864	

Tax effect	(1)	(294)	Provision for income taxes
Total reclass out of accumulated other comprehensive income, net of tax	$ 2	$ 570	Net of tax

6. INVESTMENT SECURITIES

QNB engaged in trading activities for its own account. Municipal securities that were held principally for resale in the near term were recorded in the trading account at fair value with changes in fair value recorded in non-interest income. During the second quarter of 2017, QNB Bank redeemed the trading securities portfolio, as lack of volatility and the interest rate environment resulted in the declined performance of the portfolio. The net realized gains were $27,000 for the six months ended June 30, 2017. Interest and dividends were included in interest income.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The amortized cost and estimated fair values of investment debt securities available-for-sale and equity securities at June 30, 2018 and December 31, 2017 were as follows:

June 30, 2018	Fair value	Gross unrealized holding gains	Gross unrealized holding losses	Amortized cost
U.S. Government agency	$69,495	$ —	$ (2,982)	$ 72,477
State and municipal	70,952	236	(662)	71,378
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed	127,426	95	(5,214)	132,545
Collateralized mortgage obligations (CMOs)	71,257	11	(3,525)	74,771
Pooled trust preferred	118	—	(5)	123
Corporate debt	4,946	14	(103)	5,035
Equity	9,600	360	(887)	10,127
Total investment debt securities available-for-sale and equity securities	$353,794	$ 716	$ (13,378)	$ 366,456

December 31, 2017	Fair value	Gross unrealized holding gains	Gross unrealized holding losses	Amortized cost
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
Equity	4,975	28	(349)	5,296
Total investment debt securities available-for-sale and equity securities	$379,545	$ 975	$ (7,166)	$ 385,736

The amortized cost and estimated fair value of debt securities available-for-sale by contractual maturity at June 30, 2018 are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities are assigned to categories based on contractual maturity except for mortgage-backed securities and CMOs which are based on the estimated average life of these securities and municipal securities that have been pre-refunded.

June 30, 2018	Fair value	Amortized cost
Due in one year or less	$6,938	$ 6,922
Due after one year through five years	185,003	191,920
Due after five years through ten years	131,117	135,913
Due after ten years	21,136	21,574
Total investment debt securities available-for-sale	$344,194	$ 356,329

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Proceeds from sales of investment debt securities available-for-sale were approximately $1,756,000 and $9,872,000 for the three months ended June 30, 2018 and 2017, respectively. Proceeds from sales of investment equity securities were approximately $678,000 and $752,000 for the three months ended June 30, 2018 and 2017, respectively. Proceeds from sales of investment debt securities available-for-sale were approximately $4,159,000 and $19,358,000 for the six months ended June 30, 2018 and 2017, respectively. Proceeds from sales of investment equity securities were approximately $1,390,000 and $5,262,000 for the six months ended June 30, 2018 and 2017, respectively.

At June 30, 2018 and December 31, 2017, investment debt securities available-for-sale totaling approximately $187,915,000 and $202,887,000, respectively, were pledged as collateral for repurchase agreements and deposits of public funds.

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

	Three months ended June 30, 2018						Three months ended June 30, 2017			
	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Gross unrealized gains	Gross unrealized losses	Net gains	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Net gains/(losses)
Equity securities	$44	$ —	$ —	$ 375	$ (334)	$ 85	$131	$ —	$ —	$ 131
Debt securities available-for-sale	4	—	—	—	—	4	431	(447)	—	(16)
Total	$48	$ —	$ —	$ 375	$ (334)	$ 89	$562	$ (447)	$ —	$ 115

	Six months ended June 30, 2018						Six months ended June 30, 2017			
	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Gross unrealized gains	Gross unrealized losses	Net gains/(losses)	Gross realized gains	Gross realized losses	Other-than-temporary impairment losses	Net gains
Equity securities	$130	$ —	$ —	$ 349	$ (554)	$ (75)	$856	$ —	$ —	$856
Debt securities available-for-sale	25	(22)	—	—	—	3	509	(501)	—	8
Total	$155	$ (22)	$ —	$ 349	$ (554)	$ (72)	$1,365	$ (501)	$ —	$864

Tax expense applicable to the net realized gains for the three-month periods ended June 30, 2018 and 2017 were a credit of $14,000 and $48,000, respectively. Tax expense applicable to the net realized gains for the six-month periods ended June 30, 2018 and 2017 were $38,000 and $350,000, respectively.

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

The following table presents a roll forward of the credit loss component recognized in earnings. The credit loss component of the amortized cost represents the difference between the present value of expected future cash flows and the amortized cost basis of the

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

security prior to considering credit losses. The beginning balance represents the credit loss component for debt securities for which OTTI occurred prior to the beginning of the year. Credit-impaired debt securities must be presented in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). No credit impairments were recognized on debt securities during first six months of 2018 or 2017. The table presents a summary of the cumulative credit-related other-than-temporary impairment charges recognized as components of earnings for debt securities still held by QNB:

Six months ended June 30,	2018	2017
Balance, beginning of period	$ 1	$ 1,153
Reductions: sale, collaterized debt obligation	—	(1,152)
Additions:		
Initial credit impairments	—	—
Subsequent credit impairments	—	—
Balance, end of period	$ 1	$ 1

The following table indicates the length of time individual securities have been in a continuous unrealized loss position at June 30, 2018 and December 31, 2017:

		Less than 12 months		12 months or longer		Total	
June 30, 2018	No. of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government agency	53	$ 8,731	$ (258)	$ 60,764	$ (2,724)	$ 69,495	$ (2,982)
State and municipal	99	35,507	(492)	5,604	(170)	41,111	(662)
U.S. Government agencies and sponsored enterprises (GSEs):							
Mortgage-backed	108	53,757	(1,795)	71,300	(3,419)	125,057	(5,214)
Collateralized mortgage obligations (CMOs)	77	21,839	(712)	48,757	(2,813)	70,596	(3,525)
Pooled trust preferred	1	—	—	118	(5)	118	(5)

Corporate debt	4	2,963	(68)	969	(35)	3,932	(103)
Equity	19	4,128	(550)	832	(337)	4,960	(887)
Total	361	$126,925	$ (3,875)	$188,344	$ (9,503)	$315,269	$ (13,378)

		Less than 12 months		12 months or longer		Total	
December 31, 2017	No. of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	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 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)

Management evaluates debt securities, which are comprised of U.S. Government agencies, state and municipalities, mortgage-backed securities, CMOs and corporate debt securities, for other-than-temporary impairment and considers the current economic conditions, the length of time and the extent to which the fair value has been less than cost, interest rates and the bond rating of each security. The unrealized losses at June 30, 2018 in U.S. Government agency securities, state and municipal securities, mortgage-backed securities,

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

CMOs and corporate debt securities are primarily the result of interest rate fluctuations. If held to maturity, these bonds will mature at par, and QNB will not realize a loss. The Company has the intent to hold the securities and does not believe it will be required to sell the securities before recovery occurs.

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

QNB holds one pooled trust preferred security as of June 30, 2018. This security has a total amortized cost of approximately $123,000 and a fair value of $118,000. The pooled trust preferred security is available-for-sale securities and is carried at fair value.

The following table provides additional information related to the pooled trust preferred security (PreTSL) as of June 30, 2018:

Deal	Class	Book value	Fair value	Unrealized gains (losses)	Realized OTTI credit loss (YTD 2018)	Total recognized OTTI credit loss	Moody's /Fitch ratings	Current number of performing banks	Current number of performing insurance companies	Actual deferrals and defaults as a % of total collateral	Total performing collateral as a % of outstanding bonds
PreTSL IV	Mezzanine*	$123	$118	$ (5)	$ —	$ (1)	Ba1/BB	4	—	0.00 %	185.4 %

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 quarter ended June 30, 2017 consolidated statement of income. Several years ago, QNB had recorded $1,152,000 in OTTI for four of these five 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 OTTI, which involves the use of a third-party valuation firm to assist management with the valuation. When evaluating these investments, a credit-related portion and a non-credit related portion of impairment are determined. The credit-related portion is recognized in earnings and represents the expected shortfall in future cash flows. The non-credit related portion is recognized in other comprehensive income and represents the difference between the book value and the fair value of the security less any current quarter credit related impairment. For the quarter and six months ended June 30, 2018 and 2017, no other-than-temporary impairment charges representing credit impairment were recognized on our pooled trust preferred collateralized debt obligations. A discounted cash flow analysis provides the best estimate of credit related OTTI for these securities. Additional information related to this analysis follows.

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. RESTRICTED INVESTMENT IN STOCK

Restricted investment in stock includes Federal Home Loan Bank of Pittsburgh (FHLB) with a carrying cost of $2,656,000, Atlantic Community Bankers Bank (ACBB) stock with a carrying cost of $12,000 and VISA Class B stock with a carrying cost of $0 at June 30, 2018. FHLB and ACBB stock was issued to the Bank as a requirement to facilitate the Bank's participation in borrowing and other banking services. The Bank's investment in FHLB stock may fluctuate, as it is based on the member banks' use of FHLB's services.

The Bank owns 6,502 shares of Visa Class B stock, which was necessary to participate in Visa services in support of the Bank's credit card, debit card, and related payment programs (permissible activities under banking regulations) as a member institution. Following the resolution of Visa's covered litigation, shares of Visa's Class B stock will be converted to Visa Class A shares using a conversion factor (1.6298 as of June 30, 2018), which is periodically adjusted to reflect VISA's ongoing litigation costs. There is a very limited market for this stock, as only current owners of Class B shares are permitted to transact in Class B. Due to the lack of orderly trades and public information of such trades, Visa Class B does not have a readily determinable fair value.

These restricted investments are carried at cost and evaluated for OTTI periodically. As of June 30, 2018, there was no OTTI associated with these shares.

8. LOANS & ALLOWANCE FOR LOAN LOSSES

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

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

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

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

Major classes of loans are as follows:

	June 30, 2018	December 31, 2017
Commercial:		
Commercial and industrial	$160,281	$147,190
Construction	52,143	51,157
Secured by commercial real estate	304,865	286,867
Secured by residential real estate	69,995	71,703
State and political subdivisions	47,405	38,087

Retail:		
1-4 family residential mortgages	63,681	55,818
Home equity loans and lines	74,346	75,576
Consumer	6,955	6,680
Total loans	779,671	733,078
Net unearned costs	215	205
Loans receivable	$779,886	$733,283

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

Overdrafts are reclassified as loans and are included in consumer loans above and total loans on the balance sheet. At June 30, 2018 and December 31, 2017, overdrafts were approximately $122,000 and $126,000, respectively.

QNB generally lends in its trade area which is comprised of Quakertown and the surrounding communities. To a large extent, QNB makes loans collateralized at least in part by real estate. Its lending activities could be affected by changes in the general economy, the regional economy, or real estate values. Other than disclosed in the table above, at June 30, 2018, there was a concentration of loans to lessors or residential buildings and dwellings of 15.6% of total loans and to lessors of nonresidential buildings of 18.6% of total loans,

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

compared with 15.7% and of 17.3% of total loans, respectively, at December 31, 2017. These concentrations were primarily within the commercial real estate categories.

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.

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 a ten-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 - lower risk
4- Acceptable - average risk

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5- Acceptable – high risk
6- Pass watch
7- Special Mention - potential weaknesses
8- Substandard - well defined weaknesses
9- Doubtful - full collection unlikely
10- Loss - considered uncollectible

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

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of June 30, 2018 and December 31, 2017:

June 30, 2018	Pass	Special mention	Substandard	Doubtful	Total
Commercial:					
Commercial and industrial	$154,058	$ 183	$ 6,040	$ —	$160,281
Construction	52,143	—	—	—	52,143
Secured by commercial real estate	286,441	8,320	10,104	—	304,865
Secured by residential real estate	67,940	—	2,055	—	69,995
State and political subdivisions	47,405	—	—	—	47,405
Total	$607,987	$ 8,503	$ 18,199	$ —	$634,689

December 31, 2017	Pass	Special 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
Total	$566,703	$11,654	$ 16,647	$ —	$595,004

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For retail loans, the Company evaluates credit quality based on the performance of the individual credits. The following tables present the recorded investment in the retail classes of the loan portfolio based on payment activity as of June 30, 2018 and December 31, 2017:

June 30, 2018	Performing	Non-performing	Total
Retail:			
1-4 family residential mortgages	$ 62,704	$ 977	$ 63,681
Home equity loans and lines	74,200	146	74,346
Consumer	6,851	104	6,955
Total	$ 143,755	$ 1,227	$ 144,982

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
Total	$ 136,964	$ 1,110	$ 138,074

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of June 30, 2018 and December 31, 2017:

June 30, 2018	30-59 days past due	60-89 days past due	90 days or more past due	Total past due loans	Current	Total loans receivable
Commercial:						
Commercial and industrial	$ 58	$ 247	$ 1,361	$ 1,666	$ 158,615	$ 160,281
Construction	—	—	—	—	52,143	52,143
Secured by commercial real estate	736	86	647	1,469	303,396	304,865
Secured by residential real estate	372	50	199	621	69,374	69,995
State and political subdivisions	—	—	—	—	47,405	47,405
Retail:						
1-4 family residential mortgages	—	119	494	613	63,068	63,681

Home equity loans and lines	63	47	65	175	74,171	74,346
Consumer	19	28	23	70	6,885	6,955
Total	$ 1,248	$ 577	$ 2,789	$ 4,614	$775,057	$ 779,671

December 31, 2017	30-59 days past due	60-89 days past due	90 days or more past due	Total past due loans	Current	Total loans receivable
Commercial:						
Commercial and industrial	$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
Retail:						
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
Total	$1,966	$633	$1,620	$4,219	$728,859	$733,078

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following tables disclose the recorded investment in loans receivable that are either on non-accrual status or past due 90 days or more and still accruing interest as of June 30, 2018 and December 31, 2017:

June 30, 2018	90 days or more past due (still accruing)	Non-accrual
Commercial:		
Commercial and industrial	$ —	$ 2,678
Construction	—	—
Secured by commercial real estate	—	1,651
Secured by residential real estate	—	1,198
State and political subdivisions	—	—
Retail:		
1-4 family residential mortgages	—	977
Home equity loans and lines	—	146
Consumer	23	81
Total	$ 23	$ 6,731

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

Activity in the allowance for loan losses for the three and six months ended June 30, 2018 and 2017 are as follows:

Three months ended June 30, 2018	Balance, beginning of period	Provision for (credit to) loan losses	Charge-offs	Recoveries	Balance, end of period
Commercial:					
Commercial and industrial	$ 2,829	$ 4	$ —	$ 7	$ 2,840
Construction	557	16	—	—	573
Secured by commercial real estate	2,431	278	—	1	2,710
Secured by residential real estate	835	(72)	—	18	781
State and political subdivisions	121	69	—	—	190
Retail:					
1-4 family residential mortgages	512	(3)	—	—	509
Home equity loans and lines	381	(27)	(44)	1	311
Consumer	61	21	(23)	8	67
Unallocated	310	(99)	N/A	N/A	211
Total	$ 8,037	$ 187	$ (67)	$ 35	$ 8,192

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Six months ended June 30, 2018	Balance, beginning of period	Provision for (credit to) loan losses	Charge-offs	Recoveries	Balance, end of period
Commercial:					
Commercial and industrial	$ 2,711	$ 107	$ —	$ 22	$ 2,840
Construction	563	10	—	—	573
Secured by commercial real estate	2,410	298	—	2	2,710
Secured by residential real estate	816	(55)	—	20	781
State and political subdivisions	114	76	—	—	190
Retail:					
1-4 family residential mortgages	444	65	—	—	509
Home equity loans and lines	357	(7)	(44)	5	311
Consumer	57	39	(49)	20	67
Unallocated	369	(158)	N/A	N/A	211

Total	$ 7,841	$ 375	$ (93)	$ 69	$ 8,192

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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. TDR loans that are in compliance with their modified terms and that yield a market rate may be removed from the TDR status after a period of performance.

Performing TDRs (not reported as non-accrual or past due 90 days or more and still accruing) totaled $1,233,000 and $1,321,000 as of June 30, 2018 and December 31, 2017, respectively. Non-performing TDRs totaled $2,444,000 and $2,994,000 as of June 30, 2018 and December 31, 2017, respectively. All TDRs are included in impaired loans.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

	June 30, 2018		December 31, 2017	
	Unpaid principal balance	Related allowance	Unpaid principal balance	Related allowance
TDRs with no specific allowance recorded	$3,398	$ —	$3,448	$ —
TDRs with an allowance recorded	279	190	867	235
Total	$3,677	$ 190	$4,315	$ 235

There was one newly identified TDR during the six months ended June 30, 2018. The TDR concession involved extension of a maturity date and lower monthly payments. As of June 30, 2018 and December 31, 2017, QNB had no commitments to lend additional funds to customers with loans whose terms have been modified in troubled debt restructurings. There were net charge-offs of $0 and $3,000 during the six months ended June 30, 2018 and 2017, respectively, resulting from loans previously modified as TDRs.

The following tables present loans, by loan class, modified as TDRs during the three and six months ended June 30, 2018 and 2017. The pre-modification and post-modification outstanding recorded investments disclosed in the tables below, represent carrying amounts immediately prior to the modification and as of the period end indicated.

Three months ended June 30,	2018			2017		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Retail:						
Home equity loans and lines	—	$ —	$ —	—	$ —	$ —
Total	—	$ —	$ —	—	$ —	$ —

Six months ended June 30,	2018			2017		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Retail:						
Home equity loans and lines	1	$ 47	$ 57	—	$ —	$ —
Total	1	$ 47	$ 57	—	$ —	$ —

There were no loans modified as TDRs within 12 months prior to June 30, 2018 for which there was a payment default (60 days or more past due) during the six months ended June 30, 2018. There was one loan with an outstanding balance of $21,000 that was modified as TDRs within 12 months prior to June 30, 2017 for which there was a payment default (60 days or more past due) during the six months ended June 30, 2017.

The Company has four consumer mortgage loans secured by residential real estate for which foreclosure proceedings are in process at June 30, 2018. The recorded investment is $559,000.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following tables present the balance in the allowance for loan losses at June 30, 2018 and December 31, 2017 disaggregated on the basis of the Company's impairment method by class of loans receivable along with the balance of loans receivable by class, excluding unearned fees and costs, disaggregated on the basis of the Company's impairment methodology:

	Allowance for Loan Losses			Loans Receivable		
June 30, 2018	Balance	Balance related to loans individually evaluated for impairment	Balance related to loans collectively evaluated for impairment	Balance	Balance individually evaluated for impairment	Balance collectively evaluated for impairment
Commercial:						
Commercial and industrial	$2,840	$ 1,125	$ 1,715	$160,281	$ 5,079	$ 155,202
Construction	573	—	573	52,143	—	52,143
Secured by commercial real estate	2,710	—	2,710	304,865	3,781	301,084
Secured by residential real estate	781	61	720	69,995	1,573	68,422
State and political subdivisions	190	—	190	47,405	—	47,405
Retail:						
1-4 family residential mortgages	509	9	500	63,681	1,309	62,372
Home equity loans and lines	311	13	298	74,346	166	74,180
Consumer	67	—	67	6,955	81	6,874
Unallocated	211	N/A	N/A	N/A	N/A	N/A
Total	$8,192	$ 1,208	$ 6,773	$779,671	$ 11,989	$ 767,682

	Allowance for Loan Losses			Loans Receivable		
December 31, 2017	Balance	Balance related to loans individually evaluated for	Balance related to loans collectively evaluated for	Balance	Balance individually evaluated for impairment	Balance collectively evaluated for impairment

		impairment	impairment			
Commercial:						
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
Retail:						
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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table summarizes additional information, in regards to impaired loans by loan portfolio class, as of June 30, 2018 and December 31, 2017:

	June 30, 2018			December 31, 2017		
	Recorded investment (after charge-offs)	Unpaid principal balance	Related allowance	Recorded investment (after charge-offs)	Unpaid principal balance	Related allowance
With no specific allowance recorded:						
Commercial:						
Commercial and industrial	$3,789	$3,998		$5,070	$5,461	
Construction	—	—		1	1	
Secured by commercial real estate	3,781	4,336		3,874	4,464	
Secured by residential real estate	1,408	1,712		914	1,239	
State and political subdivisions	—	—		—	—	
Retail:						
1-4 family residential mortgages	1,150	1,191		1,057	1,108	
Home equity loans and lines	126	177		124	168	
Consumer	81	87		85	90	
Total	$10,335	$11,501		$11,125	$12,531	
With an allowance recorded:						
Commercial:						
Commercial and industrial	$1,290	$2,535	$ 1,125	$1,428	$2,593	$ 1,260
Construction	—	—	—	—	—	—
Secured by commercial real estate	—	—	—	—	—	—
Secured by residential real estate	165	185	61	830	879	84
State and political subdivisions	—	—	—	—	—	—
Retail:						
1-4 family residential mortgages	159	185	9	161	163	8
Home equity loans and lines	40	41	13	40	41	40
Consumer	—	—	—	—	—	—
Total	$1,654	$2,946	$ 1,208	$2,459	$3,676	$ 1,392
Total:						
Commercial:						

Commercial and industrial	$5,079	$6,533	$ 1,125	$6,498	$8,054	$ 1,260
Construction	—	—	—	1	1	—
Secured by commercial real estate	3,781	4,336	—	3,874	4,464	—
Secured by residential real estate	1,573	1,897	61	1,744	2,118	84
State and political subdivisions	—	—	—	—	—	—
Retail:						
1-4 family residential mortgages	1,309	1,376	9	1,218	1,271	8
Home equity loans and lines	166	218	13	164	209	40
Consumer	81	87	—	85	90	—
Total	$11,989	$14,447	$ 1,208	$13,584	$16,207	$ 1,392

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table presents additional information regarding the average recorded investment and interest income recognized on impaired loans:

Six Months Ended June 30,	2018 Average recorded investment	Interest income recognized	2017 Average recorded investment	Interest income recognized
Commercial:				
Commercial and industrial	$6,208	$ 121	$4,879	$ 8
Construction	—	—	86	2
Secured by commercial real estate	3,752	49	5,838	78
Secured by residential real estate	1,696	9	2,252	13
State and political subdivisions	—	—	—	—
Retail:				
1-4 family residential mortgages	1,222	6	955	7
Home equity loans and lines	186	1	102	1
Consumer	83	—	91	—
Total	$13,147	$ 186	$14,203	$ 109

9. FAIR VALUE MEASUREMENTS AND DISCLOSURES

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.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table sets forth QNB's financial assets measured at fair value on a recurring and nonrecurring basis and the fair value measurements by level within the fair value hierarchy as of June 30, 2018:

	Quoted prices in active markets for identical assets (Level 1)	Significant other observable input (Level 2)	Significant unobservable inputs (Level 3)	Balance at end of period
Recurring fair value measurements				
Equity securities	$ 9,600	$ —	$ —	$ 9,600
Debt securities available-for-sale				
U.S. Government agency securities	—	69,495	—	69,495
State and municipal securities	—	70,952	—	70,952
U.S. Government agencies and sponsored enterprises (GSEs):				
Mortgage-backed securities	—	127,426	—	127,426
Collateralized mortgage obligations (CMOs)	—	71,257	—	71,257
Pooled trust preferred securities	—	—	118	118
Corporate debt securities	—	4,946	—	4,946
Total debt securities available-for-sale	—	344,076	118	344,194
Total recurring fair value measurements	$ 9,600	$ 344,076	$ 118	$ 353,794
Nonrecurring fair value measurements				
Impaired loans	$ —	$ —	$ 446	$ 446
Mortgage servicing rights	—	—	6	6
Total nonrecurring fair value measurements	$ —	$ —	$ 452	$ 452

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three or six months ended June 30, 2018. There were also no transfers in or out of level 3 for the same periods. There were no losses included in earnings attributable to the change in unrealized gains or losses relating to the available-for-sale securities above with fair value measurements utilizing significant unobservable inputs for the three- or six-month periods ended

June 30, 2018.

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table sets forth QNB's financial assets measured at fair value on a recurring and nonrecurring basis, the fair value measurements by level within the fair value hierarchy as of December 31, 2017:

December 31, 2017	Quoted prices in active markets for identical assets (Level 1)	Significant other observable input (Level 2)	Significant unobservable inputs (Level 3)	Balance at end of period
Recurring fair value measurements				
Equity securities	$ 4,975	$ —	$ —	$ 4,975
Debt securities available-for-sale				
U.S. Government agency securities	—	70,524	—	70,524
State and municipal securities	—	76,804	—	76,804
U.S. Government agencies and sponsored enterprises (GSEs):				
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
Total debt securities available-for-sale	—	374,355	215	374,570
Total recurring fair value measurements	$ 4,975	$ 374,355	$ 215	$ 379,545
Nonrecurring fair value measurements				
Impaired loans	$ —	$ —	$ 1,067	$ 1,067
Mortgage servicing rights	—	—	34	34
Total nonrecurring fair value measurements	$ —	$ —	$ 1,101	$ 1,101

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	
June 30, 2018	Fair value	techniques		input		of values	
Impaired loans	$299	Appraisal of collateral	(1)	Appraisal adjustments	(2)	-20% to -80%	
				Liquidation expenses	(3)	-10%	
Impaired loans	147	Financial statement values for UCC collateral		Financial statement value discounts	(4)	-20% to -50%	
Mortgage servicing rights	6	Discounted cash flow		Remaining term		2 to 27 years	
				Discount rate		12.50	%

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	(4)	-25% to -50%
Mortgage servicing rights	34	Discounted cash flow		Remaining term		2 to 26 years
				Discount rate		13% to 15%

(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.

31

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

The following table presents additional information about the securities available-for-sale measured at fair value on a recurring basis and for which QNB utilized significant unobservable inputs (Level 3 inputs) to determine fair value for the six months ended June 30, 2018 and 2017:

	Fair value measurements using significant unobservable inputs (Level 3)	
	2018	2017
Balance, January 1,	$215	$2,281
Payments received	(119)	(55)
Sale of securities	—	(2,026)
Total gains or losses (realized/unrealized)		
Included in earnings	—	(15)
Included in other comprehensive income	22	27
Transfers in and/or out of Level 3	—	—
Balance, June 30,	$118	$212

The Level 3 securities consist of one collateralized debt obligation security, PreTSL security, which is backed by trust preferred securities issued by banks, thrifts, and insurance companies. As discussed in Note 6, the market for these securities at June 30, 2018 was not active and markets for similar securities also are not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which the PreTSLs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive and there are currently very few market participants who are willing and or able to transact for these securities.

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

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at June 30, 2018;
- 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 and 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 5.74% 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 June 30, 2018 and December 31, 2017:

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 - available for sale (carried at fair value): 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 stocks (carried at cost): The fair value of stock in Atlantic Community Bankers Bank, the Federal Home Loan Bank and VISA Class B is the carrying amount, based on redemption provisions, and considers the limited marketability of and restrictions on 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 liquidity, credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

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

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

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

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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

			Fair value measurements		
June 30, 2018	Carrying amount	Fair value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets					
Cash and cash equivalents	$11,726	$11,726	$11,726	$—	$—
Investment securities:					
Equities	9,600	9,600	9,600	—	—
Available-for-sale	344,194	344,194	—	344,076	118
Restricted investment in stocks	2,668	2,668	—	2,668	—
Loans held-for-sale	404	415	—	415	—
Net loans	771,694	774,814	—	—	774,814
Mortgage servicing rights	466	609	—	—	609

Accrued interest receivable	3,573	3,573	—	3,573	—
Financial liabilities					
Deposits with no stated maturities	$763,007	$763,007	$763,007	$—	$—
Deposits with stated maturities	222,719	218,800	—	218,800	—
Short-term borrowings	85,646	85,646	85,646	—	—
Accrued interest payable	371	371	—	371	—
Off-balance sheet instruments					
Commitments to extend credit	$—	$—	$—	$—	$—
Standby letters of credit	—	—	—	65	—

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

			Fair value measurements		
December 31, 2017	Carrying amount	Fair value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets					
Cash and cash equivalents	$16,331	$16,331	$16,331	$—	$—
Investment securities:					
Equities	4,975	4,975	4,975	—	—
Available-for-sale	374,570	374,570	—	374,355	215
Restricted investment in 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	—
Financial liabilities					
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	—
Off-balance sheet instruments					
Commitments to extend credit	$—	$—	$—	$—	$—
Standby letters of credit	—	—	—	—	—

10. OFF-BALANCE-SHEET FINANCIAL INSTRUMENTS AND GUARANTEES

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

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

	June 30, 2018	December 31, 2017
Commitments to extend credit and unused lines of credit	$293,857	$313,541
Standby letters of credit	18,774	15,211
Total financial instrument commitments	$312,631	$328,752

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 of $17,708,000 will expire within

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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. Management believes that the proceeds obtained through a liquidation of such collateral and the enforcement of personal guarantees would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The amount of the liability as of June 30, 2018 and December 31, 2017 for guarantees under standby letters of credit issued is not material.

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

11. REGULATORY RESTRICTIONS

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) was enacted into law, which provides certain modifications to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which will provide regulatory relief for smaller and certain regional banking organizations. In addition, the legislation establishes new consumer protections and amends various securities- and investment company-related requirements. In addition to the sections that reduce the regulator burden on the Bank, the following sections of EGRRCPA will impact or potentially impact QNB's financial statements:

- Section 201 requires the Federal banking agencies to promulgate a rule establishing a new "Community Bank Leverage Ratio" of 8%-10% for depository institutions and depository institution holding companies, including banks and bank holding companies, with less than $10 billion in total consolidated assets. If such a depository institution or holding company maintains tangible equity in excess of this leverage ratio, it would be deemed to be in compliance with (1) the leverage and risk-based capital requirements promulgated by the Federal banking agencies; (2) in the case of a depository institution, the capital ratio requirements to be considered "well capitalized" under the Federal banking agencies' "prompt corrective action" regime; and (3) "any other capital or leverage requirements" to which the depository institution or holding company is subject, in each case unless the appropriate Federal banking agency determines otherwise based on the particular institution's risk profile. In carrying out these requirements, the Federal banking agencies are required to consult with State banking regulators and notify the applicable State banking regulator of any qualifying community bank that exceeds or no longer exceeds the Community Bank Leverage Ratio.

- Section 214 statutorily prescribes that the Federal banking agencies may only require depository institutions to apply a heightened risk-weight to exposures that are "high volatility commercial real estate" (HVCRE) if the exposures meet the definition of a HVCRE Acquisition, Development or Construction (ADC) loan as set forth in that section. The new definition applies to a narrower scope of exposures. The new definition of HVCRE ADC loan excludes loans made prior to January 1, 2015, amends the loan-to-value/capital contribution exemption, specifies the loan must primarily finance the property, has the purpose of providing financing to acquire, develop or improve such real property in income-producing property and is dependent upon future income or sales proceeds or refinancing of such property to repay the loan. Once the property sufficiently produces cash-flows to support the debt service and expenses in accordance with the bank's underwriting criteria for permanent financing, the loan meets the exemption as a HVCRE ADC loan. The new definition is applicable for QNB's reporting of its Regulatory Capital Ratios in Note 11 and had a positive impact of approximately five basis points to the ratios.

- Section 217 requires a reduction of the Federal Reserve Bank's combined surplus fund from $7.5 billion to $6.825 billion. This surplus fund was decreased earlier this year from $10 billion to $7.5 billion as part of the Bipartisan Budget Act of 2018. This will impact the calculation of QNB's Deposit Insurance.

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

Both the Company and the Bank are subject to regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can initiate actions by regulators that could have an effect on the financial statements. Under the

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

framework for prompt corrective action, both the Company and the Bank must meet capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items.

The capital amounts and classification are also subject to qualitative judgments by the regulators. Management believes, as of June 30, 2018, that the Company and the Bank met capital adequacy requirements to which they were subject.

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

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

	Capital levels					
			Adequately			
	Actual		capitalized		Well capitalized	
As of June 30, 2018	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital (to risk-weighted assets):						
Consolidated	$115,662	12.70%	$72,861	8.00%	$91,077	10.00%
Bank	106,129	12.03	70,572	8.00	88,215	10.00
Tier I capital (to risk-weighted assets):						
Consolidated	107,397	11.79	54,646	6.00	54,646	6.00
Bank	97,864	11.09	52,929	6.00	70,572	8.00
Common equity tier 1 capital (to risk-weighted assets):						
Consolidated	107,397	11.79	40,985	4.50	N/A	N/A
Bank	97,864	11.09	39,697	4.50	57,339	6.50
Tier I capital (to average assets):						
Consolidated	107,397	9.20	46,655	4.00	N/A	N/A
Bank	97,864	8.46	46,262	4.00	57,827	5.00

	Capital levels			
	Actual		Well capitalized	

As of December 31, 2017	Amount	Ratio	Adequately capitalized Amount	Ratio	Amount	Ratio
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

QNB CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REVENUE RECOGNITION FROM CONTRACTS WITH CUSTOMERS

The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers. The main types of revenue contracts included in non-interest income within the consolidated statements of operations are as follows:

- Fees for services to customers—fees include service charges on deposits which are included as liabilities in the consolidated statement of financial position and consist of transaction-based fees, stop payment fees, Automated Clearing House (ACH) fees, account maintenance fees, and overdraft services fees for various retail and business checking customers. These fees are charged as earned on the day of the transaction or within the month of the service, with the exception of Enhanced Account Analysis Fees, which are calculated on the previous month's activity and assessed on the following month. The Enhanced Account Analysis Fees are currently being accrued; the revenue is currently being recorded in the month it is earned. Service charges on deposits are withdrawn directly from the customer's account balance.
- ATM and debit card – fees are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request.
- Retail brokerage and advisory—fee income and related expenses are accrued monthly to properly record the revenues in the month they are earned. Advisory fees are collected in advance on a quarterly basis. These advisory fees and recorded in the first month of the quarter for which the service is being performed. Fees that are transaction based are recognized at the point in time that the transaction is executed (i.e. trade date).
- Merchant – QNB earns interchange fees from credit/debit cardholder transactions conducted through VISA/MasterCard payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized monthly, concurrently with the transaction processing services provided to the cardholder within the month.
- Other—includes credit card fees, sales of checks to depositors, miscellaneous fees and gain/losses on sale of OREO.
- Credit card fees are recognized monthly, concurrently with the transaction processing services provided to the cardholder within the month.
- Sales of checks to depositors are commissions earned from a third-party who provides checks to QNB's customers. There is a pre-paid incentive with the third party which is recognized over the term of the contact. Other commissions on the sales of checks are recorded weekly.
- Miscellaneous fees, such as wire, cashier check and garnishment fees, are charged as earned on the day of the transaction.
- Gain (loss) on sales of OREO – QNB records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the QNB finances the sale of OREO to the buyer, QNB assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is

derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, QNB adjusts the transaction prices and related gain (loss) on sale if a significant financing component is present.

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

QNB Corp. is a bank holding company headquartered in Quakertown, Pennsylvania. QNB Corp., through its wholly-owned subsidiary, the Bank, has been serving the residents and businesses of upper Bucks, northern Montgomery and southern Lehigh counties in Pennsylvania since 1877. Due to its limited geographic area, growth is pursued through expansion of existing customer relationships and building new relationships by stressing a consistent high level of service at all points of contact. The Bank is a locally managed community bank that provides a full range of commercial and retail banking and retail brokerage services.

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

FORWARD-LOOKING STATEMENTS

In addition to historical information, this document contains forward-looking statements. Forward-looking statements are typically identified by words or phrases such as “believe,” “expect,” “anticipate,” “intend,” “estimate,” “project” and variat of such words and similar expressions, or future or conditional verbs such as “will,” “would,” “should,” “could,” “may” or similar expressions. The U.S. Private Securities Litigation Reform Act of 1995 provides safe harbor in regard to the inclusion of forward-looking statements in this document and documents incorporated by reference.

Shareholders should note that many factors, some of which are discussed elsewhere in this document and in the documents that are incorporated by reference, and including the risk factors identified in Item 1A of QNB’s 2017 Form 10-K, could affect the future financial results of the Company and its subsidiary and could cause those results to differ materially from those expressed in the forward-looking statements contained or incorporated by reference in this document. These factors include, but are not limited, to the following:

- Volatility in interest rates and shape of the yield curve;
- Credit risk;
- Liquidity risk;
- Operating, legal and regulatory risks;
- Economic, political and competitive forces affecting QNB’s business; and
- The risk that the analysis of these risks and forces could be incorrect, and/or that the strategies developed to address them could be unsuccessful.

QNB cautions that these forward-looking statements are subject to numerous assumptions, risks and uncertainties, all of which change over time, and QNB assumes no duty to update forward-looking statements. Management cautions readers not to place undue reliance on any forward-looking statements. These statements speak only as of the date of this report on Form 10-Q, even if subsequently made available by QNB on its website or otherwise, and they advise readers that various factors, including those described above, could affect QNB’s financial performance and could cause actual results or circumstances for future periods to differ materially from those anticipated or projected. Except as required by law, QNB does not undertake, and specifically disclaims any obligation, to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Other-Than-Temporary Investment Security Impairment

Securities are evaluated periodically to determine whether a decline in their value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term “other-than-temporary” is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. For equity securities, once a decline in value is determined to be other-than-temporary, the value of the equity security is reduced and a corresponding charge to earnings is recognized. There were no other-than-temporary impairment charges recorded during the quarter or six months ended June 30, 2018 and 2017, respectively.

The Company follows accounting guidance related to the recognition and presentation of other-than-temporary impairment that specifies (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. There were no credit-related other-than-temporary impairment charges in the quarter or six months ended June 30, 2018 or 2017, respectively.

Allowance for Loan Losses

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

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

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

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

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

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

Foreclosed Assets

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

Stock-Based Compensation

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

Income Taxes

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

RESULTS OF OPERATIONS - OVERVIEW

QNB reported net income for the second quarter of 2018 of $2,862,000, or $0.82 per share on a diluted basis, compared to net income of $2,386,000, or $0.69 per share on a diluted basis, for the same period in 2017. For the six-month period ended June 30, 2018, QNB reported net income of $5,797,000, or $1.67 per share on a diluted basis, compared to net income of $5,246,000, or $1.53 per share on a diluted basis, for the same period in 2017.

Net income expressed as an annualized rate of return on average assets and average shareholders' equity was 0.98% and 10.70%, respectively, for the quarter ended June 30, 2018 compared with 0.87% and 9.52%, respectively, for the quarter ended June 30, 2017. For the six months ended June 30, 2018, the annualized rate of return on average assets and average shareholders' equity was 1.00% and 11.02%, respectively, compared with 0.97% and 10.62%, for the same period in 2017.

Total assets as of June 30, 2018 were $1,172,874,000, compared with $1,152,337,000 at December 31, 2017. Loans receivable at June 30, 2018 were $779,886,000, compared with $733,283,000 at December 31, 2017, an increase of $46,603,000, or 6.4%, with commercial lending as the largest contributor to the growth. Total deposits of $985,726,000 at June 30, 2018 decreased $8,222,000, or 0.8%, compared with total deposits of $993,948,000 at December 31, 2017.

Results for the three and six months ended June 30, 2018 include the following significant components:

- Net interest income increased $842,000, or 10.7%, to $8,700,000 and $1,753,000, or 11.1%, to $17,491,000 for the three and six months ended June 30, 2018 respectively.
- Net interest margin on a tax-equivalent basis increased five basis points for the quarter and two basis points year-to-date, to 3.15% and 3.18%, respectively.
- QNB recorded $187,000 in provision for loan losses for the quarter and $375,000 for the six months ended June 30, 2018, compared with $300,000 and $600,000 for the same periods in 2017, respectively.

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

- Non-interest income decreased $161,000, or 10.0%, to $1,454,000 for the second quarter and $1,084,000, or 30.1%, to $2,521,000 for year-to-date 2018, compared with the same periods in 2017.
- Non-interest expense increased $591,000, or 9.9%, to $6,533,000 for the second quarter and $1,181,000, or 10.2%, to $12,711,000 for year-to-date 2018, compared to the same periods in 2017.
- Total non-performing loans were $7,987,000, or 1.02% of loans receivable at June 30, 2018, compared to $9,242,000, or 1.26% of loans receivable at December 31, 2017. Loans on non-accrual status were $6,731,000 at June 30, 2018 compared with $7,921,000 at December 31, 2017. Net charge-offs for the six months ended June 30, 2018 were $24,000, compared with net recoveries of $41,000 for the 2017 period.

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

NET INTEREST INCOME

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

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable-equivalent basis for the three- and six-month periods ended June 30, 2018 and 2017. The tax-equivalent adjustments are based on the marginal Federal corporate tax rate of 21% and 34% for three and six months ended June 30, 2018 and 2017, respectively.

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Total interest income	$10,562	$9,192	$21,071	$18,328
Total interest expense	1,862	1,334	3,580	2,590
Net interest income	8,700	7,858	17,491	15,738
Tax-equivalent adjustment	201	390	402	777
Net interest income (fully taxable-equivalent)	$8,901	$8,248	$17,893	$16,515

Net interest income is the primary source of operating income for QNB. Net interest income is interest income, dividends, and fees on earning assets, less interest expense incurred for funding sources. Earning assets primarily include loans, investment securities, interest bearing balances at the Federal Reserve Bank (Fed) and Federal funds sold. Sources used to fund these assets include deposits and borrowed funds. Net interest income is affected by changes in interest rates, the volume and mix of earning assets and interest-bearing liabilities, and the amount of earning assets funded by non-interest bearing deposits.

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

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

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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

	Three Months Ended					
	June 30, 2018			June 30, 2017		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
Assets						
Trading securities	$—	0.00 %	$—	$1,985	4.78 %	$24
Investment securities (AFS & Equity):						
U.S. Government agencies	72,476	1.79	324	73,007	1.78	325
State and municipal	71,528	3.26	584	75,620	3.88	733
Mortgage-backed and CMOs	212,076	2.12	1,124	221,045	2.04	1,130
Pooled trust preferred securities	123	4.53	2	2,846	2.27	16
Corporate debt securities	6,538	2.39	39	8,064	1.98	40
Equities	10,109	2.87	72	6,923	3.18	55
Total investment securities	372,850	2.30	2,145	387,505	2.37	2,299
Loans:						
Commercial real estate	427,120	4.61	4,904	387,959	4.41	4,270
Residential real estate	60,830	3.82	580	49,196	3.84	472
Home equity loans	66,298	4.46	736	65,822	3.78	621
Commercial and industrial	155,505	4.98	1,930	124,363	4.63	1,437
Consumer loans	7,105	5.95	106	6,494	5.38	87
Tax-exempt loans	40,686	3.21	325	34,927	3.97	346
Total loans, net of unearned income*	757,544	4.54	8,581	668,761	4.34	7,233
Other earning assets	2,890	5.12	37	9,018	1.18	26
Total earning assets	1,133,284	3.81	10,763	1,067,269	3.60	9,582
Cash and due from banks	11,657			13,213		
Allowance for loan losses	(8,103)			(7,766)		
Other assets	29,545			29,228		
Total assets	$1,166,383			$1,101,944		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing demand	$186,532	0.23 %	108	$171,584	0.21 %	88
Municipals	99,001	1.33	328	92,188	0.61	140
Money market	77,903	0.32	62	92,866	0.33	76
Savings	263,365	0.56	369	253,524	0.44	278
Time	121,392	1.25	379	128,394	1.16	372
Time of $100,000 or more	105,353	1.58	415	94,741	1.39	328

Total interest-bearing deposits	853,546	0.78	1,661	833,297	0.62	1,282
Short-term borrowings	67,841	1.19	201	44,365	0.46	52
Total interest-bearing liabilities	921,387	0.81	1,862	877,662	0.61	1,334
Non-interest-bearing deposits	133,454			118,895		
Other liabilities	4,241			4,846		
Shareholders' equity	107,301			100,541		
Total liabilities and shareholders' equity	$1,166,383			$1,101,944		
Net interest rate spread		3.00 %			2.99 %	
Margin/net interest income		3.15 %	$8,901		3.10 %	$8,248

43

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

	Six Months Ended					
	June 30, 2018			June 30, 2017		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
Assets						
Trading securities	$-	0.00 %	$-	$2,393	5.69 %	$68
Investment securities (AFS & Equity):						
U.S. Government agencies	72,475	1.79	649	74,540	1.76	657
State and municipal	73,127	3.27	1,196	73,823	3.89	1,438
Mortgage-backed and CMOs	215,753	2.11	2,274	222,497	2.05	2,278
Pooled trust preferred securities	179	4.07	4	2,876	1.26	18
Corporate debt securities	7,290	2.30	84	8,067	1.94	78
Equities	9,231	2.91	133	6,881	3.27	112
Total investment securities	378,055	2.30	4,340	388,684	2.36	4,581
Loans:						
Commercial real estate	424,032	4.65	9,768	381,609	4.57	8,650
Residential real estate	58,958	3.84	1,132	48,370	3.85	930
Home equity loans	66,253	4.35	1,430	66,104	3.82	1,251
Commercial and industrial	155,068	5.08	3,904	118,717	4.65	2,736
Consumer loans	7,010	5.89	205	6,377	5.25	166
Tax-exempt loans	39,567	3.23	634	35,117	3.95	689
Total loans, net of unearned income*	750,888	4.59	17,073	656,294	4.43	14,422
Other earning assets	4,223	2.86	60	7,540	0.92	34
Total earning assets	1,133,166	3.82	21,473	1,054,911	3.65	19,105
Cash and due from banks	11,486			12,658		
Allowance for loan losses	(8,086)			(7,605)		
Other assets	28,790			29,032		
Total assets	$1,165,356			$1,088,996		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing demand	$183,323	0.22 %	203	$166,783	0.20 %	168
Municipals	100,775	1.21	607	89,764	0.53	234
Money market	79,938	0.30	120	85,469	0.30	128
Savings	261,266	0.54	699	247,317	0.44	537
Time	122,641	1.25	757	129,540	1.15	740
Time of $100,000 or more	106,555	1.54	814	95,129	1.38	651

Total interest-bearing deposits	854,498	0.76	3,200	814,002	0.61	2,458
Short-term borrowings	69,637	1.10	380	52,418	0.51	132
Total interest-bearing liabilities	924,135	0.78	3,580	866,420	0.60	2,590
Non-interest-bearing deposits	130,835			118,381		
Other liabilities	4,313			4,605		
Shareholders' equity	106,073			99,590		
Total liabilities and shareholders' equity	$1,165,356			$1,088,996		
Net interest rate spread		3.04 %			3.05 %	
Margin/net interest income		3.18 %	$17,893		3.16 %	$16,515

Tax-exempt securities and loans were adjusted to a tax-equivalent basis and are based on the marginal Federal corporate tax rate of 21 percent and 34 percent for three and six months ended June 30, 2018 and 2017, respectively. Non-accrual loans and investment securities are included in earning assets.

* Includes loans held-for-sale

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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

	Three months ended June 30, 2018 compared to June 30, 2017			Six months ended June 30, 2018 compared to June 30, 2017		
	Total Change	Due to change in: Volume	Rate	Total Change	Due to change in: Volume	Rate
Interest income:						
Trading securities	$(24)	$(24)	$—	$(68)	$(68)	$—
Investment securities (AFS & Equity):						
U.S. Government agencies	(1)	(3)	2	(8)	(18)	10
State and municipal	(149)	(39)	(110)	(242)	(13)	(229)
Mortgage-backed and CMOs	(6)	(46)	40	(4)	(69)	65
Pooled trust preferred securities	(14)	(15)	1	(14)	(17)	3
Corporate debt securities	(1)	(8)	7	6	(7)	13
Equities	17	25	(8)	21	37	(16)
Total Investment securities (AFS & Equity)	(154)	(86)	(68)	(241)	(87)	(154)
Loans:						
Commercial real estate	634	431	203	1,118	961	157
Residential real estate	108	112	(4)	202	203	(1)
Home equity loans	115	4	111	179	3	176
Commercial and industrial	493	360	133	1,168	838	330
Consumer loans	19	9	10	39	17	22
Tax-exempt loans	(21)	56	(77)	(55)	87	(142)
Total Loans	1,348	972	376	2,651	2,109	542
Other earning assets	11	(17)	28	26	(15)	41
Total interest income	1,181	845	336	2,368	1,939	429
Interest expense:						
Interest-bearing deposits:						
Interest-bearing demand	20	8	12	35	17	18
Municipals	188	11	177	373	29	344
Money market	(14)	(12)	(2)	(8)	(7)	(1)
Savings	91	11	80	162	31	131
Time	7	(20)	27	17	(40)	57
Time of $100,000 or more	87	35	52	163	78	85

Total interest-bearing deposits	379	33	346	742	108	634
Short-term borrowings	149	27	122	248	43	205
Total interest expense	528	60	468	990	151	839
Net interest income	$653	$785	$(132)	$1,378	$1,788	$(410)

Net Interest Income and Net Interest Margin – Quarterly Comparison

Average earning assets for the second quarter of 2018 were $1,133,284,000, an increase of $66,015,000, or 6.2%, from the second quarter of 2017, with average loans increasing $88,783,000, or 13.3%, and average investment securities decreasing $16,640,000, or 4.3%, over the same period. Growth in the loan portfolio supports net interest income and the net interest margin as loans generally earn a higher yield than investment securities. Average loans as a percent of average earning assets were 66.8% for the second quarter of 2018, compared with 62.7% for the second quarter of 2017. On the funding side, average deposits increased $34,808,000, or 3.7%, to $987,000,000 for the second quarter of 2018 with growth in all categories except money markets and time deposits less than $100,000. Customers continue to reinvest funds into non-time deposits, as the yield in time deposits remains low and customers prefer to keep their funds liquid to capitalize on rising rates. Average borrowed funds for the second quarter of 2018 increased $23,476,000, to $67,841,000, which consisted of average commercial repurchase agreements of $37,484,000 and average overnight borrowings of

$30,357,000. For the same period in 2017, borrowings consisted of average commercial repurchase agreements of $40,216,000 and average overnight borrowings of $4,149,000.

The net interest margin for the second quarter of 2018 increased five basis points to 3.15% compared to the same period in 2017. While competition for quality loans in our local market continues to exert pressure on the net interest margin, three increases in the prime lending rate since June 30, 2017 have provided increased interest income on variable rate loans, and moderate competitive pricing pressure on deposits.

The Rate-Volume Analysis tables, as presented on a tax-equivalent basis, highlight the impact of changing rates and volumes on interest income and interest expense. Total interest income on a tax-equivalent basis increased $1,181,000, or 12.3%, to $10,763,000 for the second quarter of 2018; total interest expense increased $528,000, or 39.6%, to $1,862,000. The increase in interest income was due to growth in loans. All categories of interest-bearing deposits, except money markets, experienced higher rates in the second quarter of 2018 compared to second quarter of 2017, due to rate increases for municipal deposits indexed to Fed Funds, and a 15-basis point rate increase to the eSavings and Rewards checking products since June 30, 2017.

The yield on earning assets on a tax-equivalent basis increased 21 basis points from 3.60% for the second quarter of 2017 to 3.81% for the second quarter of 2018. The cost of interest-bearing liabilities was 0.81% for the second quarter ended June 30, 2018, compared with 0.61% for the same period in 2017.

Interest income on investment securities (available-for-sale and equity) decreased $154,000 when comparing the quarters ended June 30, 2018 and 2017. The average yield on the investment portfolio was 2.30% for the first quarter of 2018 compared with 2.37% for the second quarter of 2017. Proceeds from sales, payments, calls and maturities, net of purchases, were utilized to grow the loan portfolio at higher yields than the investment portfolio.

Interest income on trading securities decreased $24,000, as the portfolio was sold in 2017, reducing the $1,985,000 second quarter 2017 average balance to $0 in 2018. Decreased interest income on U.S. Government agencies of $1,000 was primarily due to a decrease in volume of $531,000.

Tax-exempt municipal securities experienced a decrease in yield due to the 2017 Tax Reform Act of approximately 62 basis points and is the primary contributing factor to the $149,000 decline in interest income; also contributing was a decrease in average balances of $4,092,000. QNB had purchased many municipal securities when rates were significantly higher. Many of these bonds have either reached maturity or their call dates and are being replaced with municipal bonds with lower yields. Typically, QNB purchases municipal bonds with 10-15 year maturities with call dates between 2-5 years. The yield on this portfolio is expected to continue to decline as additional higher yielding municipal bonds are expected to be called or mature during 2018. The current yield on replacement bonds is well below the yield of the bonds being called or maturing.

Interest income on mortgage-backed securities and CMOs decreased $6,000 with an eight-basis point increase in average yield which partially offset the $8,969,000 decrease in average balances. This portfolio generally provides higher yields relative to agency bonds and also provides monthly cash flow which can be used for liquidity purposes or can be reinvested when interest rates eventually increase. Mortgage refinancing activity over the past three years was significant resulting in an increase in prepayments on these securities. Since most of these securities were purchased at a premium, prepayments result in a shorter amortization period of this premium and therefore a reduction in income.

Dividends on equity securities increased $17,000, as the average balance increased $3,186,000, or 46.0%, more than offset the decrease in yield of 31 basis points when comparing the quarters ended June 30, 2018 and 2017.

Income on loans increased $1,348,000 to $8,581,000 when comparing the second quarters of 2018 and 2017, with a 13.3% growth in average balances contributing an increase in interest income of $972,000. Despite increases in the prime rate in June and December of 2017 and March and June of 2018, competitive pressures result in new loans being originated at lower rates. Mitigating competitive pricing, variable rate loans have repriced higher.

The largest category of the loan portfolio is commercial real estate loans. This category of loans includes commercial purpose loans secured by either commercial properties such as office buildings, factories, warehouses, medical facilities and retail establishments, or residential real estate, usually the residence of the business owner. The category also includes construction and land development loans. Income on commercial real estate loans increased $634,000 primarily due to the 10.1% increase in average balances. Average balances increased $39,161,000, to $427,120,000 for the quarter ended June 30, 2018 compared with the same quarter in 2017. The yield on commercial real estate loans increased 20 basis points from 4.41% in 2017 to 4.61% in 2018.

Income on commercial and industrial loans increased $493,000. Average balances increased $31,142,000, or 25.0%, to $155,505,000 for the second quarter of 2018 resulting in a $360,000 increase in income. The average yield on these loans increased 35 basis points to 4.98% resulting in an increase in income of $133,000. Many of the loans in this category are indexed to the prime interest rate, which increased by 75 basis points since June 30, 2017.

Tax-exempt loan income was $325,000 for the second quarter of 2018, a decrease of $21,000 from the same period in 2017. As with municipal marketable securities, there was a decrease in yield due to the 2017 Tax Reform Act. The yield on municipal loans decreased 76 basis points, to 3.21% for the second quarter of 2018, compared with the same period in 2017, resulting in decrease of $77,000 in interest income. This was partially offset by an increase in average balances of $5,759,000, or 16.5%, to $40,686,000 for the second quarter of 2018, resulting in an increase of $56,000 in income.

QNB desires to become the “local consumer lender of choice” and to effect this QNB refocused its retail lending efforts, adding new product offerings and increasing marketing and promotion. The positive impact of this focus has been year-over-year growth in balances in overall retail lending: residential mortgage, home equity and consumer loans. Average residential mortgage loans secured by first lien 1-4 family residential mortgages increased by $11,634,000, or 23.6%, to $60,830,000 for the second quarter of 2018 compared to the same period in 2017. Over this same timeframe, the average yield on the portfolio decreased two basis points to 3.82% for the second quarter of 2018. The combined result was a net increase in interest income of $108,000. Average home equity loans increased slightly by $476,000, or 0.7%, to $66,298,000 while the average yield increased 68 basis points to 4.46% resulting in an increase in interest income of $115,000. Average consumer loans increased $611,000, or 9.4%, to $7,105,000 and the yield on the portfolio increased 57 basis points to 5.95% for the second quarter of 2018 resulting in a combined $19,000 increase in interest income.

Earning assets are funded by deposits and borrowed funds. Interest expense increased $528,000, when comparing the second quarter of 2018 to the same period in 2017. The growth in average deposits continues to be centered in accounts with greater liquidity, such as non-interest and interest-bearing demand and savings deposits. Average non-interest-bearing demand accounts increased $14,559,000, or 12.2%, to $133,454,000 for the second quarter of 2018. QNB has been successful in increasing both personal and business checking accounts. Average interest-bearing demand accounts increased $14,948,000, or 8.7%, to $186,532,000 for the second quarter of 2018. Interest expense on interest-bearing demand accounts increased $20,000 to $108,000 for the same period, as the average rate paid increased two basis points to 0.23% for the second quarter of 2018. Included in this category is QNB-Rewards checking, a higher-rate checking account product that pays 1.25% on balances up to $25,000 and 0.40% for balances over $25,000. In order to receive the high rate a customer must receive an electronic statement, have one direct deposit or other ACH transaction and have at least 12 check card purchase transactions post and clear per statement cycle. For the second quarter of 2018, the average balance in this product was $56,627,000 and the related interest expense was $85,000 for an average yield of 0.60%. In comparison, the average balance of the QNB-Rewards accounts for the second quarter of 2017 was $51,815,000 with a related interest expense of $70,000 and an average rate paid of 0.54%. 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 $119,769,000 for the second quarter of 2017 to $129,905,000 for the second quarter of 2018. The average rate paid on these balances was 0.07% for the 2018 quarter compared to 0.06% for the same period in 2017.

Interest expense on municipal interest-bearing demand accounts increased $188,000 to $328,000 for the second quarter of 2018. The average balance of municipal interest-bearing demand accounts increased $6,813,000, or 7.4%, to $99,001,000, with the average interest rate paid on these accounts increasing 72 basis points to 1.33% for the second quarter of 2018. Many of these accounts are indexed to the Federal funds rate with rate floors between 0.25% and 0.50%; therefore, the increases in the Federal funds rate affected the yield of these deposits. Municipal deposits are seasonal in nature and are received during the third quarter as tax receipts are collected and are withdrawn over the course of the next year.

Average money market accounts decreased $14,963,000, or 16.1%, to $77,903,000 for the second quarter of 2018 compared with the same period in 2017. Interest expense on money market accounts decreased $14,000 to $62,000, while the average interest rate paid on money market accounts decreased one basis point to 0.32% for the second quarter of 2018. Most of balances in this category are in a product that pays a tiered rate based on account balances.

Interest expense on savings accounts increased $91,000 when comparing the second quarter of 2018 to the second quarter of 2017, and the average rate increased 12 basis points to 0.56% when comparing both periods. When comparing these same periods, average savings accounts increased $9,841,000, or 3.9%, to $263,365,000 for the second quarter of 2018 with both the statement savings and e-Savings products accounting for the growth in savings balances. QNB's online e-Savings product is the largest category of savings deposits, with average balances for the second quarter of 2018 of $190,063,000. This product has grown successfully since its introduction in the third quarter of 2009. The average yield paid on these accounts was 0.71% for the first quarter of 2018 and 0.55% for the same period in 2017. Traditional statement savings accounts, passbook savings and club accounts are also included in the savings category and average balances in these types of savings accounts increased $4,439,000, or 6.4%, when comparing the first quarter of 2018 average to the same period in 2017.

Total interest expense on total time deposits totaled $794,000 for the second quarter of 2018 compared to $700,000 in 2017. Average total time deposits increased by $3,610,000 to $226,745,000 for the second quarter of 2018. As with fixed-rate loans and investment securities, time deposits reprice over time and, therefore, have less of an immediate impact on costs in either a rising or falling rate environment, however, the maturity and repricing characteristics of time deposits tend to be shorter. The average rate paid on total time deposits increased 14 basis points from 1.26% to 1.40% when comparing the second quarter of 2017 to the same period in 2018.

Approximately $92,217,000, or 41%, of time deposits at June 30, 2018 will mature over the next 12 months. The average rate paid on these time deposits is approximately 0.92%. The yield on the time deposit portfolio may change slightly in the next quarter as short-term time deposits reprice. However, given the short-term nature of these deposits, interest expense may increase if short-term time deposit rates were to increase suddenly or if customers select higher paying longer-term time deposits.

Short-term borrowings are primarily comprised of sweep accounts structured as repurchase agreements with our commercial customers and overnight FHLB borrowings. Interest expense on short-term borrowings increased $149,000 for the second quarter of 2018 to $201,000 when compared to the same period in 2017. When comparing these same periods, average balances increased from $23,476,000 to $67,841,000, primarily due to an increase in average FHLB borrowings of $26,199,000, while the average rate paid increased 73 basis points to 1.19% for the second quarter of 2018.

Net Interest Income and Net Interest Margin – Six-Month Comparison

For the six-month period ending June 30, 2018 average earning assets increased $78,255,000, or 7.4%, to $1,133,166,000, with average loans increasing 14.4% and average investment securities decreasing 3.3%. Average total deposits increased $52,950,000, or 5.7%, to $985,333,000 for the six-month period ended June 30, 2018 compared to the same period in 2017. The net interest margin on a tax-equivalent basis was 3.18% for the six-month period ended June 30, 2018, a two-basis point increase from the same period in 2017.

Total interest income on a tax-equivalent basis increased $2,368,000, or 12.4%, from $19,105,000 to $21,473,000, when comparing the six-month periods ended June 30, 2017 and June 30, 2018 due to the additional interest income generated from the growth in earning assets combined with the impact of improved yields on some of those assets. Interest income increased $1,939,000 as a result of volume increases, and $429,000 as a result of better yields. The analysis of the six-month comparison periods is similar to what was described in the quarterly analysis.

The yield on earning assets increased from 3.65% to 3.82% for the six-month periods with the yield on loans up 16 basis points to 4.59%. QNB continues to experience pressure on yields due to historically low levels of interest rates over the past several years and competitive pressures on loan pricing. The yield on investments, including trading securities, decreased eight basis points from 2.38% to 2.30% when comparing the six-month periods.

Total interest expense increased $990,000 for the six-month period ended June 30, 2018 compared with the same period in 2017, attributable to the increase in deposits into higher-earning interest-bearing DDA, as well as rate increases in the eSavings, Rewards checking, and municipal deposits, which are correlated to changes in the Fed Funds target rate. The average rate paid on interest bearing deposits increased 15 basis point to 0.76% for the six-month period ended June 30, 2018 versus the first half of 2017. QNB Bank funded short-term cash needs with increased Federal Home Loan Bank borrowings in the first half of 2018 compared with the same period in 2017; the total short-term borrowing rate increased 59 basis points, which also contributed to the increase in interest expense. The yield on interest-bearing liabilities rose 18 basis points to 0.78% for the first half of 2018.

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES

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

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

Based on this analysis, QNB recorded $187,000 and $375,000 in provision for loan losses in the second quarter and first six months of 2018, compared with $300,000 and $600,000 for the same periods in 2017, respectively. QNB's allowance for loan losses of $8,192,000 represents 1.05% of loans receivable at June 30, 2018 compared with an allowance for loan losses of $7,841,000, or 1.07% of loans receivable, at December 31, 2017, and $8,035,000, or 1.16% of loans receivable at June 30, 2017. Management believes the allowance for loan losses at June 30, 2018 is adequate as of that date based on its analysis of known and inherent losses in the portfolio.

Net charge-offs were $32,000 and $24,000 for the three and six months ended June 30, 2018, respectively, compared with net recoveries of $16,000 and $41,000, respectively, for the same periods in 2017. Annualized net charge-offs as a percentage of average loans receivable were 0.02% and 0.01% for the three and six months ended June 30, 2018, respectively, compared with annualized recoveries as a percentage of loans receivable of 0.01% for the same periods in 2017.

Non-performing assets of $7,987,000 at June 30, 2018 compares favorably with $9,242,000 as of December 31, 2017 and $10,846,000 as of June 30, 2017. 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 1.02% of loans receivable at June 30, 2018 compared with 1.26% of loans receivable at December 31, 2017. At June 30, 2017, non-performing loans totaled $10,846,000, or 1.56% of loans receivable. In cases where there is a collateral shortfall on non-accrual loans, specific impairment reserves have been established based on updated collateral values even if the borrower continues to pay in accordance with the terms of the agreement. At June 30, 2018, $3,512,000, or approximately 52%, of the loans classified as non-accrual are current or past due less than 30 days. Loans classified as substandard or doubtful totaled $18,199,000, an increase of $1,552,000, or 9.3%, from the $16,647,000 reported at December 31, 2017 and a increase of $643,000, or 3.7%, from the $17,556,000 reported at June 30, 2017.

QNB had $23,000 in loans past due 90 days or more and still accruing interest at June 30, 2018, compared to $0 at December 31, 2017 and June 30, 2017. Total loans 30 days or more past due, which includes non-accrual loans by actual number of days delinquent, represented 0.59% of loans receivable at June 30, 2018 compared with 0.58% at December 31, 2017 and 0.30% at June 30, 2017. The majority of the increase in the ratio of delinquent to total loans is due to one commercial relationship.

Troubled debt restructured loans, not classified as non-accrual loans or loans past due 90 days or more and accruing, were $1,233,000 at June 30, 2018, compared with $1,321,000 at December 31, 2017, and $1,393,000 at June 30, 2017. There was one newly identified troubled debt restructuring in the six months ended June 30, 2018, a non-accruing home equity loan. QNB had no other real estate owned or repossessed assets as of June 30, 2018, December 31, 2017, or June 30, 2017.

A loan is considered impaired, based on current information and events, if it is probable that QNB will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration all the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral, if the loan is collateral dependent.

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

	June 30, 2018	December 31, 2017	June 30, 2017
Non-accrual loans	$6,731	$7,921	$9,453
Loans past due 90 days or more and still accruing interest	23	—	—
Troubled debt restructured loans (not already included above)	1,233	1,321	1,393
Total non-performing loans	7,987	9,242	10,846
Total loans (excluding loans held-for-sale):			
Average total loans (YTD)	$750,828	$682,292	$656,026
Total loans	779,886	733,283	695,213
Allowance for loan losses	8,192	7,841	8,035
Allowance for loan losses to:			
Non-performing loans	102.57 %	84.84 %	74.09 %
Total loans (excluding held-for-sale)	1.05 %	1.07 %	1.16 %
Average total loans	1.09 %	1.15 %	1.22 %
Non-performing loans / total loans (excluding held-for-sale)	1.02 %	1.26 %	1.56 %
Non-performing assets / total assets	0.68 %	0.80 %	0.97 %

An analysis of net loan recoveries for the three and six months ended June 30, 2018 compared to 2017 is as follows:

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

	2018	2017	2018	2017
Net recoveries	$32	$(16)	$24	$(41)
Net annualized recoveries charge-offs to:				
Total loans	0.02%	(0.01%)	0.01%	(0.01%)
Average total loans excluding held-for-sale	0.02%	(0.01%)	0.01%	(0.01%)
Allowance for loan losses	1.57%	(0.81%)	0.59%	(1.03%)

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

At June 30, 2018 and December 31, 2017, the recorded investment in loans for which impairment has been identified totaled $11,989,000 and $13,584,000 of which $10,335,000 and $11,125,000, respectively, required no specific allowance for loan loss. The recorded investment in impaired loans requiring an allowance for loan losses was $1,654,000 and $2,459,000 at June 30, 2018 and December 31, 2017, respectively, and the related allowance for loan losses associated with these loans was $1,208,000 and $1,392,000, respectively. Most of the loans that have been identified as impaired are collateral-dependent. See Note 8 to the Notes to Consolidated Financial Statements for additional detail of impaired loans.

NON-INTEREST INCOME

Non-Interest Income Comparison

	Three months ended June 30,		Change from prior year		Six months ended June 30,		Change from prior year	
	2018	2017	Amount	Percent	2018	2017	Amount	Percent
Net gain on sales of investment securities	$48	$115	$(67)	-58.3 %	$133	$864	$(731)	-84.6 %
Unrealized gain (loss) on investment equity securities	41	—	41	N/M	(205)	—	(205)	N/M
Net gain on trading activity	—	10	(10)	N/M	—	27	(27)	N/M
Fees for services to customers	408	421	(13)	(3.1)	829	813	16	2.0
ATM and debit card	487	449	38	8.5	917	866	51	5.9
Retail brokerage and advisory	105	104	1	1.0	208	207	1	0.5
Bank-owned life insurance	69	120	(51)	(42.5)	137	191	(54)	(28.3)
Merchant	82	92	(10)	(10.9)	156	172	(16)	(9.3)
Net gain on sale of loans	37	201	(164)	(81.6)	44	251	(207)	(82.5)
Other	177	103	74	71.8	302	214	88	41.1
Total	$1,454	$1,615	$(161)	-10.0 %	$2,521	$3,605	$(1,084)	-30.1 %

Quarter to Quarter Comparison

Total non-interest income for the second quarter of 2018 was $1,454,000, a decrease of $161,000, compared to $1,615,000 for the second quarter of 2017. Excluding net gains on investment securities, trading activities and sale of loans for both periods, total non-interest income increased 3.0% to $1,328,000 for the second quarter of 2018 compared to $1,289,000 for the second quarter of 2017.

Net gains on investment securities decreased $67,000 from $115,000 in second quarter of 2017 to $48,000 in second quarter of 2018. Gain on investments are primarily derived from sale of equity securities. Market conditions in the equities market for the quarter ended June 30, 2018 versus the same period in 2017 resulted in fewer opportunities for profitable sales. The adoption of Accounting Standard Update 2016-01 (ASU 2016-01) effective January 1, 2018 requires the Company to record unrealized gains or losses on equity securities through earnings, rather than in other comprehensive income (loss), a component of shareholders' equity. Unrealized gains on equity securities were

$41,000 for the second quarter of 2018. The Bank redeemed the trading investment portfolio in its entirety during the second quarter of 2017, therefore no income in 2018 compared with the same period in 2017.

QNB originates residential mortgage loans for sale in the secondary market. Net gain on sale of residential mortgage loans decreased $65,000 when comparing the two periods. The net gain on residential mortgage sales is directly related to the volume of mortgages sold and the timing of the sales relative to the interest rate environment. Residential mortgage loans to be sold are identified at origination. Proceeds from the sale of residential mortgages were $1,344,000 and $2,652,000 for the second quarters of 2018 and 2017, respectively. QNB recognized a $99,000 gain on sale of a non-performing loan during the second quarter of 2017.

Fees for services to customers decreased $13,000, or 3.1%, to $408,000 at June 30, 2018, due primarily to an decrease in net overdraft income. ATM and debit card income increased $38,000, or 8.5%, to $487,000 for the second quarter of 2018, compared to the same period in 2017, due to increases in card-based transactions and expansion of checking account households.

Bank-owned life insurance included a life insurance benefit of $51,000 in the second quarter of 2017. Other non-interest income increased $74,000, or 71.8%, due to a sales tax refund of $57,000 in 2018, increased letter of credit income and mortgage servicing fees.

Six-Month Comparison

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

Total non-interest income for the six-month periods ended June 30, 2018 and 2017 was $2,521,000 and $3,605,000, respectively, a decrease of $1,084,000, or 30.1%. Excluding net gains on investment securities, trading activities and loans for both periods total non-interest income was $2,549,000 and $2,463,000, an increase of $86,000.

Net investment securities gains decreased $731,000 to $133,000 for the six months ended June 30, 2018 compared to $864,000 for the comparable six months in 2017. Market conditions in the equities market for the six months ended June 30, 2018 versus the same period in 2017 resulted in fewer opportunities for profitable sales. Under ASU 2016-01, QNB recorded unrealized losses on equity securities of $205,000 for the six months ended June 30, 2018.

Excluding the $99,000 gain on note sale during 2017, net gains on the sale of loans decreased $108,000 to $44,000, when comparing the six months ended June 30, 2018 to the same period in 2017. Proceeds from the sale of residential mortgages were $1,949,000 and $4,675,000 for the six-month periods ended June 30, 2018 and 2017, respectively.

ATM and debit card income, and fees for services to customers increased for the first six months of 2018 compared to 2017, for reasons detailed in the quarterly comparison.

NON-INTEREST EXPENSE

Non-Interest Expense Comparison

	Three months ended June 30,		Change from prior year		Six months ended June 30,		Change from prior year	
	2018	2017	Amount	Percent	2018	2017	Amount	Percent
Salaries and employee benefits	$3,627	$3,237	$390	12.0 %	$6,972	$6,323	$649	10.3 %
Net occupancy	448	425	23	5.4	919	876	43	4.9
Furniture and equipment	563	456	107	23.5	1,050	885	165	18.6
Marketing	221	307	(86)	(28.0)	531	536	(5)	(0.9)
Third-party services	506	407	99	24.3	916	801	115	14.4
Telephone, postage and supplies	173	199	(26)	(13.1)	354	399	(45)	(11.3)
State taxes	164	155	9	5.8	335	348	(13)	(3.7)
FDIC insurance premiums	146	134	12	9.0	321	275	46	16.7
Other	685	622	63	10.1	1,313	1,087	226	20.8
Total	$6,533	$5,942	$591	9.9 %	$12,711	$11,530	$1,181	10.2 %

Quarter to Quarter Comparison

Total non-interest expense was $6,533,000 for the second quarter of 2018, an increase of $591,000, or 9.9%, compared to the second quarter of 2017.

Salaries and benefits comprise the largest component of non-interest expense. QNB monitors, through the use of various surveys, the competitive salary and benefit information in its markets and makes adjustments when appropriate. Salaries and benefits expense increased $390,000, or 12.0%, to $3,627,000 when comparing the two quarters. Salary expense and related payroll taxes increased $167,000, or 5.9%, to $2,989,000 during the second quarter 2018 compared to the same period in 2017 due to additions to staff. Benefits expense increased $223,000, or 53.7%, to $638,000, due primarily to increased medical insurance claims comparing the two quarters.

Net occupancy and furniture and equipment expense increased $130,000, or 14.8%, to $1,011,000, due to the relocation of the Warminster loan facility to a new full-service branch, as well as, the renovation of the operations center. Building and equipment maintenance expense increased $54,000, depreciation expense increased $19,000, and computer software amortization and maintenance expense increased $43,000, when comparing the two quarters. Marketing expense decreased $86,000, or 28.0%, to $221,000 for the quarter ended June 30, 2018. This was due to the timing of sponsorships and donations made in the first quarter of 2018 versus in the second quarter of 2017.

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, IT services, statement printing and mailing, investment security safekeeping and supply management services. Third party services expense increased $99,000 when comparing the two periods, due primarily to legal fees and IT services.

Telephone and postage and supplies expenses decreased $26,000, or 13.1%, due to decreased data line cost and costs related to debit card conversion in 2017. FDIC insurance premiums increased $12,000, or 9.0%, due to the change in the assessment rate for the quarter. Other non-interest expense increased $63,000, or 10.1%, due to training and check card expense.

Six-Month Comparison

Total non-interest expense was $12,711,000 for the six-month period ended June 30, 2018, an increase of $1,181,000, or 10.2%, compared to the first half of 2017.

Salaries and benefits expense increased $649,000 to $6,972,000 for the six months ended June 30, 2018 compared to the same period in 2017, for the same reasons described in the quarter comparison. Salary and related payroll tax expense increased $316,000, or 5.7%, during the period, to $5,840,000 while benefits expense increased $333,000, to $1,132,000, related to increased medical premiums and post-retirement life insurance expense.

Net occupancy and furniture and equipment expense increased $208,000, or 1.8%, to $1,969,000, and third-party services increased $115,000, or 14.4%, to $916,000 for the six months ended June 30, 2018, for the same reasons described in the quarter comparison.

Telephone, postage and supplies expenses decreased in the first six months of 2018 compared to 2017, and FDIC insurance premiums and other non-interest expense increased for the first six months ended June 30, 2017, due to the reasons described in the quarter comparison.

INCOME TAXES

QNB utilizes an asset and liability approach for financial accounting and reporting of income taxes. As of June 30, 2018, QNB's net deferred tax asset was $4,523,000. The primary components of deferred taxes are deferred tax assets of $1,720,000 relating to the allowance for loan losses, $2,548,000 related to unrealized losses on available for sale securities, and $324,000 related to non-accrual interest income. As of December 31, 2017, QNB's net deferred tax asset was $3,319,000. The primary difference in the balance of net deferred tax assets when comparing June 30, 2018 to December 31, 2017 is the increase in deferred tax asset due to increased unrealized losses on available for sale securities.

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

Applicable income tax expense was $572,000 for the quarter and $1,129,000 for the six months ended June 30, 2018, compared to $845,000 and $1,967,000 for the same periods in 2018. The effective tax rate for second quarter and year-to-date 2018 was 16.7% and 16.3%, respectively, compared with 26.2% and 27.3% for the same periods in 2017. This decrease in effective tax rate in 2018 is due primarily to a reduced corporate tax rate from 34% to 21%, resulting from the Tax Cuts and Jobs Act, effective January 1, 2018.

FINANCIAL CONDITION ANALYSIS

Financial service organizations are challenged to demonstrate they can generate sustainable and consistent earnings growth in a dynamic operating environment. Rate competition for quality loans is anticipated to continue through 2018. It is also anticipated that the rate competition for attracting and retaining deposits will continue to increase in 2018, as short-term interest rates increase, which could result in a lower net interest margin and a decline in net interest income.

QNB's primary business is accepting deposits and making loans to meet the credit needs of the communities it serves. Loans are the most significant component of earning assets and growth in loans to small businesses and residents of these communities has been a primary focus of QNB. Inherent within the lending function is the evaluation and acceptance of credit risk and interest rate risk. QNB manages credit risk associated with its lending activities through portfolio diversification, underwriting policies and procedures and loan monitoring practices. QNB is committed to make credit available to its customers.

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

Total assets at June 30, 2018 were $1,172,874,000 compared with $1,152,337,000 at December 31, 2017. Cash and cash equivalents decreased $4,605,000 from $16,331,000 at December 31, 2017 to $11,726,000 at June 30, 2018, due primarily to growth in loans.

The composition of the investment portfolio is essentially unchanged since December 31, 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 and changes in spread relationships in different sectors and for liquidity purposes. Management continually reviews strategies that will result in an increase in the yield or improvement in the structure of the investment portfolio, including monitoring credit and concentration risk in the portfolio. QNB owns one CDO in the form of a pooled trust preferred security, with a fair value of $118,000. PreTSL IV represents the senior-most obligation of the trust.

Loans receivable grew $46,603,000, or 6.4%, with commercial loans increasing $39,685,000, or 6.7%, to $634,689,000 at June 30, 2018, compared with $595,004,000 at year-end 2017. Retail loan balances grew $6,908,000, to $144,982,000, when comparing June 30, 2018 to December 31, 2017.

Deposits declined $8,222,000 to $985,726,000 at June 30, 2018. Municipal interest-bearing demand balances decreased $21,056,000, or 17.8%, to $97,108,000. Municipal deposits can be volatile depending on the timing of deposits and withdrawals, and the cash flow needs of the school districts or municipalities. Interest-bearing demand balances, excluding municipal deposits, grew $9,834,000, or 5.5%, to $189,140,000, with the Rewards checking and Select 50 products providing $8,162,000 of the growth. Savings balances increased $3,702,000 from December 31, 2017 to June 30, 2018. Non-interest-bearing demand balances increased $6,270,000 to $135,482,000 at June 30, 2018, due to both personal and business deposits. Money market balances declined $4,509,000, or 5.3%, to $80,053,000 as depositors moved to high-yielding savings accounts. Time deposits decreased $2,463,000 from December 31, 2017 to June 30, 2018. It is anticipated that total deposits will increase during the third quarter as tax money received from the local school districts flows in during September, then declines for the subsequent twelve months as the schools use the funds for operations. These deposits provide incremental income as they are invested in short-term investment securities but will further reduce the net interest margin as the spread earned is significantly less than the current net interest margin.

Short-term borrowings increased 53.6%, from $55,756,000 at December 31, 2017 to $85,646,000 at June 30, 2018. Commercial sweep accounts decreased $2,650,000, as these funds may be volatile based on businesses’ receipt and disbursement of funds. Overnight borrowings from FHLB increased $32,540,000 to $46,451,000 to support loan growth.

LIQUIDITY

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

Additional sources of liquidity are provided by the Bank’s membership in the FHLB. At June 30, 2018, the Bank had a maximum borrowing capacity with the FHLB of approximately $259,700,000, net of the $46,451,000 in overnight borrowings and a $350,000 letter of credit at June 30, 2018. The maximum borrowing depends upon qualifying collateral assets and QNB’s asset quality and capital adequacy. In addition, the Bank maintains unsecured Federal funds lines with three correspondent banks totaling $46,000,000. At June 30, 2018, there were no outstanding borrowings under these lines. During the second quarter of 2018, QNB borrowed from the FHLB to fund short-term liquidity needs. Future availability under these lines is subject to the policies of the granting banks and may be withdrawn.

Liquid sources of funds, including cash, available-for-sale and equity investment securities, and loans held-for-sale have decreased $29,952,000 since December 31, 2017, totaling $365,924,000 at June 30, 2018. Proceeds from sales, call and maturities of debt securities available-for-sale and the issuance of short-term borrowings have been used to fund loans. Management expects these liquid sources will be adequate to meet normal fluctuations in loan demand or deposit withdrawals. The investment portfolio is expected to continue to provide sufficient liquidity, even in a rising rate environment, as municipal bonds are called or mature and cash flow on mortgage-backed and CMO securities continues to be steady, although cash flow available from the investment portfolio decreased in 2018 compared to 2017, as a result of interest rates rising.

Approximately $187,915,000 and $202,887,000 of available-for-sale debt securities at June 30, 2018 and December 31, 2017, respectively, were pledged as collateral for repurchase agreements and deposits of public funds. The level of pledged securities corresponds with the municipal deposit and repurchase agreement balances.

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

CAPITAL ADEQUACY

A strong capital position is fundamental to support continued growth and profitability and to serve the needs of depositors. QNB's shareholders' equity at June 30, 2018 was $97,818,000, or 8.34% of total assets, compared with shareholders' equity of $98,570,000, or 8.55% of total assets, at December 31, 2017. Shareholders' equity at June 30, 2018 and December 31, 2017 included a negative adjustment of $9,587,000 and $4,086,000, respectively, related to unrealized holding losses, net of taxes, on investment securities available-for-sale. Without these adjustments, shareholders' equity to total assets would have been 9.08% and 8.88% at June 30, 2018 and December 31, 2017, respectively.

Average shareholders' equity and average total assets were $106,073,000 and $1,165,356,000 for the six months ended June 30, 2018, an increase of 4.5% and 4.3%, respectively, from the averages for the year ended December 31, 2017. The ratio of average total equity to average total assets was 9.1% for both the six months ended June 30, 2018 and for all 2017.

Retained earnings at June 30, 2018 were impacted by six months of net income totaling $5,797,000 partially offset by dividends declared and paid of $2,212,000 for the same period. QNB offers a Dividend Reinvestment and Stock Purchase Plan (the "Plan") to provide participants a convenient and economical method for investing cash dividends paid on the Company's common stock in additional shares at a discount. The Plan also allows participants to make additional cash purchases of stock at a discount. Stock purchases under the Plan contributed $429,000 to capital during the six months ended June 30, 2018.

The Board of Directors has authorized the repurchase of up to 100,000 shares of its common stock in open market or privately negotiated transactions. The repurchase authorization does not bear a termination date. As of June 30, 2018, 57,883 shares were repurchased under this authorization at an average price of $16.97 and a total cost of $982,000. There have been no additional shares repurchased under the plan since the first quarter of 2009.

QNB and the Bank are subject to various regulatory capital requirements as issued by Federal regulatory authorities. Regulatory capital is defined in terms of Tier 1 capital and Tier 2 capital. Risk-based capital ratios are expressed as a percentage of risk-weighted assets. Risk-weighted assets are determined by assigning various weights to all assets and off-balance sheet arrangements, such as letters of credit and loan commitments, based on associated risk. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III) became effective for QNB on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019.

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

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was enacted into law. which provides certain modifications to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which will provide

QNB CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

regulatory relief for smaller and certain regional banking organizations. Section 214 statutorily prescribes that the Federal banking agencies may only require depository institutions to apply a heightened risk-weight to exposures that are "high volatility commercial real estate" (HVCRE) if the exposures meet the definition of a HVCRE Acquisition, Development or Construction (ADC) loan as set forth in that section. The new definition applies to a narrower scope of exposures. The new definition of HVCRE ADC loan excludes loans made prior to January 1, 2015, amends the loan-to-value/capital contribution exemption, the loan must primarily finance the property, have the purpose of providing financing to acquire, develop or improve such real property in income-producing property and is dependent upon future income or sales proceeds or refinancing of such property to repay the loan. Once the property sufficiently produces cash-flows to support the debt service and expenses in accordance with the bank's underwriting criteria for permanent financing, the loan it meets the exemption as a HVCRE ADC loan. Under the new definition, QNB's was able to move certain HVCRE loans from the 150% to the 100% risk-weighted category as of June 30, 2018; resulting in a favorable increase to its regulatory capital ratios of approximately 5 basis points.

The following table sets forth consolidated information for QNB Corp.

Capital Analysis	June 30, 2018	December 31, 2017
Regulatory Capital		
Shareholders' equity	$97,818	$98,570
Net unrealized securities losses, net of tax	9,587	4,086
Net unrealized losses on available-for-sale equity securities, net of tax	—	(212)
Disallowed intangible assets	(8)	(6)
Common equity tier I capital	107,397	102,438
Tier I capital	107,397	102,438
Allowable portion: Allowance for loan losses and reserve for unfunded commitments	8,265	7,914
Unrealized gains on equity securities, net of tax	—	—
Total regulatory capital	$115,662	$110,352
Risk-weighted assets	$910,768	$881,503
Quarterly average assets for leverage capital purposes	$1,166,375	$1,153,721

	June 30,	December 31,

Capital Ratios	2018	2017
Common equity tier I capital / risk-weighted assets	11.79 %	11.62 %
Tier I capital / risk-weighted assets	11.79 %	11.62 %
Total regulatory capital / risk-weighted assets	12.70 %	12.52 %
Tier I capital / average assets (leverage ratio)	9.21 %	8.88 %

At June 30, 2018, common equity Tier I, Tier I capital, total regulatory capital and leverage ratios improved slightly from December 31, 2017. The Company remains well-capitalized by all applicable regulatory requirements as of June 30, 2018.

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 CORP. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

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 than its earning assets (loans and securities). A liability sensitive balance sheet will produce relatively less net interest income when interest rates rise and more net interest income when they decline. Based on our simulation analysis, management believes QNB's interest sensitivity position at June 30, 2018 is liability sensitive. Management expects that market interest rates will continue with gradual increases in the next 12 months, based on the economic environment and policy of the Board of Governors of the Federal Reserve System.

The following table shows the estimated impact of changes in interest rates on net interest income as of June 30, 2018 and 2017 assuming instantaneous rate shocks, and consistent levels of assets and liabilities. Net interest income for the subsequent twelve months is projected to decrease when interest rates are higher than current rates.

Estimated Change in Net Interest Income

Changes in Interest rates (in basis points)	June 30, 2018	2017
+300	(10.08%)	(8.81%)
+200	(6.60 %)	(5.77%)
+100	(3.15 %)	(2.69%)
-100	(0.02 %)	(5.78%)

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

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

QNB is not subject to foreign currency exchange or commodity price risk. At June 30, 2018, QNB did not have any hedging transactions in place such as interest rate swaps, caps or floors.

57

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.

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

ITEM 4. CONTROLS AND PROCEDURES

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

QNB CORP. AND SUBSIDIARY

PART II. OTHER INFORMATION

JUNE 30, 2018

Item 1. Legal Proceedings

No material proceedings.

Item 1A. Risk Factors

There were no material changes to the Risk Factors described in Item 1A in QNB's Annual Report on Form 10-K for the period ended December 31, 2017.

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

QNB did not repurchase any shares of its common stock during the quarter ended June 30, 2018. The following provides certain information relating to QNB's stock repurchase plan.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that may yet be Purchased Under the Plan
April 1, 2018 through April 30, 2018	—	—	—	42,117
May 1, 2018 through May 31, 2018	—	—	—	42,117
June 1, 2018 through June 30, 2018	—	—	—	42,117
Total	—	—	—	42,117

(1) Transactions are reported as of settlement dates.
(2) QNB's current stock repurchase plan was approved by its Board of Directors and announced on January 24, 2008 and subsequently increased on February 9, 2009.
(3) The total number of shares approved for repurchase under QNB's current stock repurchase plan is 100,000.
(4) QNB's current stock repurchase plan has no expiration date.
(5) QNB has no stock repurchase plan that it has determined to terminate or under which it does not intend to make further purchases.

Item 3. Default Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit 3.1	Articles of Incorporation of Registrant, as amended. (Incorporated by reference to Exhibit 3(i) of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 13, 2015).
Exhibit 3.2	Bylaws of Registrant, as amended. (Incorporated by reference to Exhibit 3(ii) of Registrant's Annual Report on Form 10-K, SEC File No. 0-17706, filed with the Commission on March 13, 2015).
Exhibit 31.1	Section 302 Certification of Chief Executive Officer
Exhibit 31.2	Section 302 Certification of Chief Financial Officer
Exhibit 32.1	Section 906 Certification of Chief Executive Officer
Exhibit 32.2	Section 906 Certification of Chief Financial Officer

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

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

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

SIGNATURES

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

		QNB Corp.
Date:	August 8, 2018	By: /s/ David W. Freeman David W. Freeman Chief Executive Officer
Date:	August 8, 2018	By: /s/ Janice McCracken Erkes Janice McCracken Erkes Chief Financial Officer
Date:	August 8, 2018	By: /s/ Mary E. Liddle Mary E. Liddle Chief Accounting Officer, QNB Bank