HEARTLAND FINANCIAL USA INC
Form 10-Q
August 07, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For quarterly period ended June 30, 2014

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

For transition period __________ to __________

Commission File Number: 001-15393

HEARTLAND FINANCIAL USA, INC.
(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

42-1405748
(I.R.S. employer identification number)

1398 Central Avenue, Dubuque, Iowa 52001
(Address of principal executive offices)(Zip Code)

(563) 589-2000
(Registrant's telephone number, including area code)

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 x No o

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 x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Act.

Large accelerated filer ¨	Accelerated Filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the Registrant is a shell company (as defined by Rule 12b-2 of the Securities Exchange Act of 1934). Yes o No x

Indicate the number of shares outstanding of each of the classes of Registrant's common stock as of the latest practicable date: As of August 5, 2014, the Registrant had outstanding 18,467,704 shares of common stock, $1.00 par value per share.

HEARTLAND FINANCIAL USA, INC.
Form 10-Q Quarterly Report
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PART I

ITEM 1. FINANCIAL STATEMENTS
HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

	June 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Cash and due from banks	$98,613	$118,441
Federal funds sold and other short-term investments	4,047	6,829
Cash and cash equivalents	102,660	125,270
Time deposits in other financial institutions	3,105	3,355
Securities:		
Trading, at fair value	—	1,801
Available for sale, at fair value (cost of $1,408,573 at June 30, 2014, and $1,659,456 at December 31, 2013)	1,412,809	1,633,902
Held to maturity, at cost (fair value of $265,169 at June 30, 2014, and $237,437 at December 31, 2013)	257,217	237,498
Other investments, at cost	20,932	21,843
Loans held for sale	87,173	46,665
Loans and leases receivable:		
Held to maturity	3,694,734	3,496,952
Loans covered by loss share agreements	4,379	5,749
Allowance for loan and lease losses	(40,892)	(41,685)
Loans and leases receivable, net	3,658,221	3,461,016
Premises, furniture and equipment, net	133,127	135,714
Other real estate, net	24,395	29,852
Goodwill	35,583	35,583
Other intangible assets, net	32,732	32,959
Cash surrender value on life insurance	81,840	81,110
FDIC indemnification asset	124	249
Other assets	64,000	76,899
TOTAL ASSETS	$5,913,918	$5,923,716
LIABILITIES AND EQUITY		
LIABILITIES:		
Deposits:		
Demand	$1,221,703	$1,238,581
Savings	2,556,784	2,535,242
Time	862,995	892,676
Total deposits	4,641,482	4,666,499
Short-term borrowings	420,494	408,756
Other borrowings	329,715	350,109
Accrued expenses and other liabilities	49,806	58,892
TOTAL LIABILITIES	5,441,497	5,484,256
STOCKHOLDERS' EQUITY:		
Preferred stock (par value $1 per share; authorized 20,604 shares; none issued or outstanding)	—	—
	—	—

Series A Junior Participating preferred stock (par value $1 per share; authorized 16,000 shares; none issued or outstanding)		
Series C Fixed Rate Non-Cumulative Perpetual preferred stock (par value $1 per share; liquidation value $81.7 million; authorized, issued and outstanding 81,698 shares)	81,698	81,698
Common stock (par value $1 per share; authorized 25,000,000 shares; issued 18,467,646 shares at June 30, 2014 and 18,399,156 shares at December 31, 2013)	18,468	18,399
Capital surplus	93,334	91,632
Retained earnings	278,632	265,067
Accumulated other comprehensive income (loss)	289	(17,336)
Treasury stock at cost (0 shares outstanding at both June 30, 2014 and December 31, 2013)	—	—
TOTAL STOCKHOLDERS' EQUITY	472,421	439,460
TOTAL LIABILITIES AND EQUITY	$5,913,918	$5,923,716

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans and leases	$48,101	$39,726	$94,485	$79,553
Interest on securities:				
Taxable	7,447	4,712	15,208	9,371
Nontaxable	3,708	3,360	6,830	6,558
Interest on interest bearing deposits in other financial institutions	7	2	14	6
TOTAL INTEREST INCOME	59,263	47,800	116,537	95,488
INTEREST EXPENSE:				
Interest on deposits	4,577	5,066	9,355	10,142
Interest on short-term borrowings	202	108	428	256
Interest on other borrowings (includes $573 and $524 of interest expense related to derivatives reclassified from accumulated other comprehensive income (loss) for the three months ended June 30, 2014 and 2013, respectively, and $1,094 and $1,029 of interest expense related to derivatives reclassified from accumulated other comprehensive income (loss) for the six months ended June 30, 2014 and 2013, respectively)	3,685	3,702	7,343	7,499
TOTAL INTEREST EXPENSE	8,464	8,876	17,126	17,897
NET INTEREST INCOME	50,799	38,924	99,411	77,591
Provision for loan and lease losses	2,751	1,862	9,082	2,499
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	48,048	37,062	90,329	75,092
NONINTEREST INCOME:				
Service charges and fees	5,254	4,280	10,150	8,288
Loan servicing income	1,393	141	2,904	267
Trust fees	3,343	2,942	6,553	5,846
Brokerage and insurance commissions	1,158	1,087	2,281	2,038
Securities gains, net (includes $854 and $2,067 of net security gains reclassified from accumulated other comprehensive income (loss) for the three months ended June 30, 2014 and 2013, respectively, and $1,635 and $5,494 of net security gains reclassified from accumulated other comprehensive income (loss) for the six months ended June 30, 2014 and 2013, respectively.)	854	2,067	1,635	5,494
Gain (loss) on trading account securities	—	262	(38)	576
Gains on sale of loans held for sale	8,796	13,048	15,175	26,205
Loss on sales/valuations of other real estate and repossessed assets, net	(798)	(1,600)	(921)	(2,101)
Valuation adjustment on mortgage servicing rights	—	—	—	496
Income on bank owned life insurance	339	315	702	720
Other noninterest income	398	716	1,023	1,396
TOTAL NONINTEREST INCOME	20,737	23,258	39,464	49,225
NONINTEREST EXPENSES:				
Salaries and employee benefits	32,563	29,516	64,882	59,256
Occupancy	3,984	3,224	8,034	6,409

Furniture and equipment	2,085	2,065	3,975	4,116
Professional fees	4,214	4,233	8,740	7,776
FDIC insurance assessments	980	861	1,960	1,763
Advertising	1,511	1,248	2,699	2,476
Intangible assets amortization	591	198	1,215	398
Other real estate and loan collection expenses	518	877	1,570	1,716
Other noninterest expenses	7,415	4,944	13,201	9,502
TOTAL NONINTEREST EXPENSES	53,861	47,166	106,276	93,412
INCOME BEFORE INCOME TAXES	14,924	13,154	23,517	30,905
Income taxes (includes $105 and $576 of income tax expense reclassified from accumulated other comprehensive income (loss) for the three months ended June 30, 2014 and 2013, respectively, and $202 and $1,665 of income tax expense reclassified from accumulated other comprehensive income (loss) for the six months ended June 30, 2014 and 2013, respectively)	4,150	3,598	5,853	8,797
NET INCOME	10,774	9,556	17,664	22,108
Net income available to noncontrolling interest, net of tax	—	—	—	(64)
NET INCOME ATTRIBUTABLE TO HEARTLAND	10,774	9,556	17,664	22,044
Preferred dividends and discount	(204)	(205)	(408)	(613)
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	$10,570	$9,351	$17,256	$21,431
EARNINGS PER COMMON SHARE - BASIC	$0.57	$0.55	$0.94	$1.27
EARNINGS PER COMMON SHARE - DILUTED	$0.56	$0.54	$0.92	$1.25
CASH DIVIDENDS DECLARED PER COMMON SHARE	$0.10	$0.10	$0.20	$0.20

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
NET INCOME	$10,774	$9,556	$17,664	$22,108
OTHER COMPREHENSIVE INCOME				
Securities:				
Net change in unrealized gain (loss) on securities	9,772	(37,855)	30,682	(39,537)
Reclassification adjustment for net gain realized in net income	(854)	(2,067)	(1,635)	(5,494)
Net change in non-credit related other than temporary impairment	24	24	48	48
Income taxes	(3,523)	14,906	(11,482)	16,808
Other comprehensive income (loss) on securities	5,419	(24,992)	17,613	(28,175)
Derivatives used in cash flow hedging relationships:				
Net change in unrealized gain (loss) on derivatives	(936)	1,017	(1,075)	1,099
Reclassification adjustment for net loss on derivatives realized in net income	573	524	1,094	1,029
Income taxes	135	(580)	(7)	(794)
Other comprehensive income (loss) on cash flow hedges	(228)	961	12	1,334
Other comprehensive income (loss)	5,191	(24,031)	17,625	(26,841)
Comprehensive income (loss)	15,965	(14,475)	35,289	(4,733)
Less: comprehensive income attributable to noncontrolling interest	—	—	—	(64)
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO HEARTLAND	$15,965	$(14,475)	$35,289	$(4,797)

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

	Six Months Ended June 30, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$17,664	$22,108
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,547	8,262
Provision for loan and lease losses	9,082	2,499
Net amortization of premium on securities	12,497	15,279
Securities gains, net	(1,635)	(5,494)
(Increase) decrease in trading account securities	1,801	(576)
Stock based compensation	1,831	1,546
Loss on sale of OREO and other repossessed property	921	2,102
Loans originated for sale	(402,605)	(891,049)
Proceeds on sales of loans held for sale	377,272	924,878
Net gains on sales of loans held for sale	(15,175)	(26,205)
(Increase) decrease in accrued interest receivable	616	(839)
(Increase) decrease in prepaid expenses	(698)	8,260
Increase (decrease) in accrued interest payable	(908)	25
Capitalization of mortgage servicing rights	(3,344)	(7,209)
Valuation adjustment on mortgage servicing rights	—	(496)
Other, net	1,644	(6,745)
NET CASH PROVIDED BY OPERATING ACTIVITIES	7,510	46,346
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of time deposits in other financial institutions	—	(3,605)
Proceeds from the sale of securities available for sale	509,891	215,935
Proceeds from the sale of other investments	7,356	1,204
Proceeds from the maturity of and principal paydowns on securities available for sale	72,651	135,904
Proceeds from the maturity of and principal paydowns on securities held to maturity	619	514
Proceeds from the maturity of and principal paydowns on other securities	250	—
Purchase of securities available for sale	(349,740)	(480,945)
Purchase of securities held to maturity	(20,944)	—
Purchase of other investments	(6,445)	(852)
Net increase in loans and leases	(212,384)	(24,707)
Capital expenditures	(4,205)	(7,020)
Proceeds on sale of OREO and other repossessed assets	10,663	10,150
NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES	7,712	(153,422)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand deposits and savings accounts	4,664	30,076
Net decrease in time deposit accounts	(29,681)	(34,602)
Net increase in short-term borrowings	11,738	114,555
Proceeds from other borrowings	5,000	160
Repayments of other borrowings	(25,394)	(52,853)

Purchase of noncontrolling interest	—	(2,798)
Purchase of treasury stock	(608)	(860)
Proceeds from issuance of common stock	429	1,398
Excess tax benefits on exercised stock options	119	34
Dividends paid	(4,099)	(3,991)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	(37,832)	51,119
Net decrease in cash and cash equivalents	(22,610)	(55,957)
Cash and cash equivalents at beginning of year	125,270	168,054
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$102,660	$112,097
Supplemental disclosures:		
Cash paid for income/franchise taxes	$1,641	$3,905
Cash paid for interest	$18,034	$17,871
Loans transferred to OREO	$6,097	$10,710
Purchases of securities available for sale, accrued, not paid	$11,175	$4,490

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (Unaudited)
(Dollars in thousands, except per share data)

	Heartland Financial USA, Inc. Stockholders' Equity							
	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Non-controlling Interest	Total Equity
Balance at January 1, 2013	$81,698	$16,828	$50,359	$236,279	$ 16,641	$—	$ 2,734	$404,539
Comprehensive income				22,044	(26,841)		64	(4,733)
Preferred, $7.50 per share				(613)				(613)
Common, $0.20 per share				(3,378)				(3,378)
Purchase of noncontrolling interest							(2,798)	(2,798)
Purchase of 10,050 shares of common stock						(860)		(860)
Issuance of 48,134 shares of common stock		119	805			508		1,432
Commitments to issue common stock			1,546					1,546
Balance at June 30, 2013	$81,698	$16,947	$52,710	$254,332	$ (10,200)	$(352)	$ —	$395,135
Balance at January 1, 2014	$81,698	$18,399	$91,632	$265,067	$ (17,336)	$—	$ —	$439,460
Comprehensive income				17,664	17,625			35,289
Cash dividends declared:								
Preferred, $5.00 per share				(408)				(408)
Common, $0.20 per share				(3,691)				(3,691)
Purchase of noncontrolling interest							—	—
Purchase of 23,350 shares of common stock						(608)		(608)
Issuance of 91,840 shares of common stock		69	(129)			608		548
Commitments to issue common stock			1,831					1,831
Balance at June 30, 2014	$81,698	$18,468	$93,334	$278,632	$ 289	$—	$ —	$472,421

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

The interim unaudited consolidated financial statements contained herein should be read in conjunction with the audited consolidated financial statements and accompanying notes to the consolidated financial statements for the fiscal year ended December 31, 2013, included in the Form 10-K of Heartland Financial USA, Inc. ("Heartland") filed with the Securities and Exchange Commission ("SEC") on March 14, 2014. Accordingly, footnote disclosures which would substantially duplicate the disclosure contained in the audited consolidated financial statements have been omitted.

The financial information of Heartland included herein has been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and has been prepared pursuant to the rules and regulations for reporting on Form 10-Q and Rule 10-01 of Regulation S-X. Such information reflects all adjustments (consisting of normal recurring adjustments), that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the periods presented. The results of the interim period ended June 30, 2014, are not necessarily indicative of the results expected for the year ending December 31, 2014.

Earnings Per Share

Basic earnings per share is determined using net income available to common stockholders and weighted average common shares outstanding. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average common shares and assumed incremental common shares issued. Amounts used in the determination of basic and diluted earnings per share for the three month and six month periods ended June 30, 2014 and 2013, are shown in the table below:

	Three Months Ended June 30,			
(Dollars and number of shares in thousands, except per share data)	2014		2013	
Net income attributable to Heartland	$10,774		$9,556	
Preferred dividends and discount	(204	)	(205	)
Net income available to common stockholders	$10,570		$9,351	
Weighted average common shares outstanding for basic earnings per share	18,458		16,907	
Assumed incremental common shares issued for common stock equivalents	289		297	
Weighted average common shares for diluted earnings per share	18,747		17,204	
Earnings per common share — basic	$0.57		$0.55	
Earnings per common share — diluted	$0.56		$0.54	
Number of antidilutive common stock equivalents excluded from diluted earnings per share computation	95		105	

	Six Months Ended June 30,			
(Dollars and number of shares in thousands, except per share data)	2014		2013	
Net income attributable to Heartland	$17,664		$22,044	
Preferred dividends and discount	(408	)	(613	)
Net income available to common stockholders	$17,256		$21,431	
Weighted average common shares outstanding for basic earnings per share	18,448		16,900	
Assumed incremental common shares issued for common stock equivalents	291		293	
Weighted average common shares for diluted earnings per share	18,739		17,193	

Earnings per common share — basic	$0.94	$1.27
Earnings per common share — diluted	$0.92	$1.25
Number of antidilutive common stock equivalents excluded from diluted earnings per share computation	95	105

Stock-Based Compensation

Heartland may grant, through its Nominating and Compensation Committee (the "Compensation Committee"), non-qualified and incentive stock options, stock appreciation rights, stock awards, restricted stock, restricted stock units and cash incentive awards, under its 2012 Long-Term Incentive Plan (the "Plan"). The Plan, which was approved by stockholders in May 2012 and replaced Heartland's 2005 Long-Term Incentive Plan with respect to grants after such approval, reserved 336,556 shares of common stock at June 30, 2014, for issuance under future awards that may be granted under the Plan to employees and directors of, and service providers to, Heartland or its subsidiaries.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 718, "Compensation-Stock Compensation" requires the measurement of the cost of employee services received in exchange for an award of equity instruments based upon the fair value of the award on the grant date. The cost of the award is based upon its fair value estimated on the date of grant and recognized in the consolidated statements of income over the vesting period of the award. The fair market value of restricted stock and restricted stock units is based on the fair value of the underlying shares of common stock on the date of grant. The fair value of stock options is estimated on the date of grant using the Black-Scholes model.

The amount of tax benefit related to the exercise, vesting, and forfeiture of equity-based awards reflected in additional paid-in-capital, not taxes payable, was $$119,000 and $34,000 during the six months ended June 30, 2014, and 2013, respectively.

Restricted Stock Units

The Plan permits the Compensation Committee to grant restricted stock units ("RSUs"). On March 11, 2014, the Compensation Committee granted time-based RSUs with respect to 67,065 shares of common stock and on January 22, 2013, granted time-based RSUs with respect to 72,595 shares of common stock, to selected officers. The time-based RSUs, which represent the right, without payment, to receive shares of Heartland common stock at a specified date in the future based on specific vesting conditions, vest over five years in three equal installments on the third, fourth and fifth anniversaries of the grant date, will be settled in common stock upon vesting, and will not be entitled to dividends until vested. The time-based RSUs granted in 2014 vest upon a "qualified retirement" (as defined in the RSU agreement) while the RSUs granted in 2013 allow the Compensation Committee to exercise its discretion to provide for vesting upon retirement. In both cases, the retiree is required to sign a non-solicitation and non-compete agreement as a condition to vesting.

In addition to the time-based RSUs referenced in the preceding paragraph, the Compensation Committee granted performance-based RSUs with respect to 32,645 shares of common stock on March 11, 2014, and performance-based RSUs with respect to 40,990 shares of common stock on January 22, 2013, to Heartland executives and subsidiary presidents. These performance-based RSUs vest based first on performance measures tied to Heartland's earnings and loans on December 31, 2014, for the 2014 RSUs, and earnings and assets on December 31, 2013, for the 2013 RSUs, and then on time-based vesting conditions. For the grants awarded in 2014, the portion of the RSUs earned based on performance vest on December 31, 2016, if the executive remains employed on that date, and for the grants awarded in 2013, the portion of the RSUs earned based on performance vest on December 31, 2015, subject to employment on that date.

The Compensation Committee also has the authority to issue shares in conjunction with employment agreements for executive level employees and may also elect to compensate members of the Board of Directors by awarding RSUs. During the six months ended June 30, 2014, 31,525 RSUs were granted under this authority. During the six months ended June 30, 2013, 6,200 RSUs were granted in relation to employment agreements or board members.

A summary of the status of the RSUs as of June 30, 2014 and 2013, and changes during the six months ended June 30, 2014 and 2013, follows:

	2014		2013	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 1	353,070	$18.48	348,897	$15.75
Granted	131,235	26.69	118,785	26.88
Vested	(73,224)	16.65	(35,488)	14.65
Forfeited	(3,901)	19.10	(34,570)	19.32
Outstanding at June 30	407,180	$21.53	397,624	$19.15

Total compensation costs recorded for RSUs were $1.8 million and $1.5 million for the six months ended June 30, 2014, and 2013, respectively. As of June 30, 2014, there were $3.9 million of total unrecognized compensation costs related to the 2005 and 2012 Long-Term Incentive Plans for RSUs which are expected to be recognized through 2019.

Options

Although the Plan provides authority to the Compensation Committee to grant stock options, no options were granted during the first six months of 2014 and 2013. Prior to 2009, options were typically granted annually with an expiration date ten years after the date of grant. Vesting was generally over a five-year service period with portions of a grant becoming exercisable at three years, four years, and five years after the date of grant. A summary of the status of the stock options as of June 30, 2014 and 2013, and changes during the six months ended June 30, 2014 and 2013, follows:

	2014		2013	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at January 1	261,936	$23.60	377,907	$22.62
Granted	—	—	—	—
Exercised	(5,000)	19.13	(37,836)	19.31
Forfeited	(6,500)	26.39	(1,800)	26.68
Outstanding at June 30	250,436	$23.62	338,271	$22.96
Options exercisable at June 30	250,436	$23.62	338,271	$22.96

At June 30, 2014, the vested options totaled 250,436 shares with a weighted average exercise price of $23.62 per share and a weighted average remaining contractual life of 2.48 years. The intrinsic value (the difference between the market price and the aggregate exercise price) for the vested options as of June 30, 2014, was $744,000. The intrinsic value for the total of all options exercised during the six months ended June 30, 2014, was $28,000.

The exercise price of stock options granted is established by the Compensation Committee, but the exercise price for the stock options may not be less than the fair market value of the shares on the date that the option is granted or, if greater, the par value of a share of stock. Each option granted is exercisable in full at any time or from time to time, subject to vesting provisions, as determined by the Compensation Committee and as provided in the option agreement, but such time may not exceed ten years from the grant date. Cash received from options exercised was $96,000 for the six months ended June 30, 2014, and $731,000 for the six months ended June 30, 2013.

Total compensation costs recorded for options were $0 and $10,000 for the six months ended June 30, 2014, and 2013, respectively. There are no unrecorded compensation costs related to options at June 30, 2014.

Subsequent Events

Heartland had no subsequent events requiring recognition as of June 30, 2014 or disclosure through the filing date of this quarterly report on Form 10-Q with the SEC.

Effect of New Financial Accounting Standards

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," to eliminate the diversity in practice and to increase the comparability of financial statements among companies. The guidance requires that a reporting entity generally must show an unrecognized tax benefit, or a portion of an unrecognized tax benefit, for a net operating loss carryforward, similar tax loss or a tax credit carryforward as a reduction of a deferred tax asset. However, the entity should present the unrecognized tax benefit as a liability and not as a reduction of a deferred tax asset if the carryforward or tax loss is not available on the financial statement date to settle any additional income tax liability that would result from the disallowance of the tax position under the applicable tax law, or the applicable tax law does not require the company to use, and the company does not intend to use, the carryforward or tax loss to settle additional income taxes resulting from the disallowance of the tax position. The guidance does not require any new recurring disclosures because it does not affect the recognition or measurement of uncertain tax positions. Heartland adopted this standard on January 1, 2014, and the adoption did not have a material impact on the results of operations, financial position, and liquidity.

In January 2014, the FASB issued ASU 2014-01, "Accounting for Investments in Qualified Affordable Housing Projects." The amendments in ASU 2014-01 to Topic 323, "Equity Investments and Joint Ventures," provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments are effective for fiscal years, and interim periods within those years, beginning after December 31, 2014, and should be applied retrospectively to all periods presented. Early adoption is permitted. Heartland is in the process of evaluating the impact that adoption of this guidance will have on the results of operations, financial position, and liquidity.

In January 2014, the FASB issued ASU 2014-04, "Receivables-Troubled Debt Restructurings by Creditors: Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure." The amendments in ASU 2014-04 clarify that an in-substance foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (i) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (ii) the borrower conveying all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 also requires disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in loans collateralized by residential real estate property that are in the process of foreclosure. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014, with early adoption permitted. Once adopted, an entity can elect either (i) a modified retrospective transition method or (ii) a prospective transition method. The modified retrospective transition method is applied by means of a cumulative-effect adjustment to residential mortgage loans and foreclosed residential real estate properties existing as of the beginning of the period for which the amendments of ASU 2014-04 are effective, with real estate reclassified to loans measured at the carrying value of the real estate at the date of adoption and loans reclassified to real estate measured at the lower of net carrying value of the loan or the fair value of the real estate less costs to sell at the date of adoption. The prospective transition method is applied by means of applying the amendments of ASU 2014-04 to all instances of receiving physical possession of residential real estate properties that occur after the date of adoption. Heartland does not expect the adoption of this standard to have a material impact on the results of operations, financial position, and liquidity.

Reclassifications

In the first quarter of 2014, Heartland revised the classification of mortgage servicing rights income from loan servicing income to gain on sale of loans held for sale. The reclassification is presented in both the current and prior reporting periods. For the three and six months ended June 30, 2013, $4.0 million and $7.2 million, respectively, were reclassified from loan servicing income to gain on sale of loans held for sale.

During the first quarter of 2014, Heartland revised the classification of loss on sales/valuations of other real estate and repossessed assets, net, from other real estate and loan collection expenses to a specific noninterest income classification. This reclassification is presented in both the current and prior reporting periods. For the three and six months ended June 30, 2013, losses of $1.6 million and $2.1 million were reclassified from other real estate and loan collection expenses to loss on sales/valuations of other real estate and repossessed assets, net. This reclassification results in other real estate and loan collection expenses for the three and six months ended June 30, 2013, decreasing from $2.5 million and $3.8 million as previously reported to $877,000 and $1.7 million, respectively.

These reclassifications do not have a material impact on Heartland's financial statements and do not affect the financial results. Heartland believes these reclassifications are more consistent with industry reporting practices.

NOTE 2: SECURITIES

The amortized cost, gross unrealized gains and losses, and estimated fair values of securities available for sale as of June 30, 2014, and December 31, 2013, are summarized in the table below, in thousands:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2014				
U.S. government corporations and agencies	$46,454	$244	$(39)	$46,659
Mortgage-backed securities	1,163,480	12,894	(11,493)	1,164,881
Obligations of states and political subdivisions	193,626	4,201	(1,614)	196,213
Total debt securities	1,403,560	17,339	(13,146)	1,407,753
Equity securities	5,013	43	—	5,056
Total	$1,408,573	$17,382	$(13,146)	$1,412,809
December 31, 2013				
U.S. government corporations and agencies	$220,157	$147	$(2,001)	$218,303
Mortgage-backed securities	1,156,983	9,538	(22,574)	1,143,947
Obligations of states and political subdivisions	277,320	1,706	(12,402)	266,624
Total debt securities	1,654,460	11,391	(36,977)	1,628,874
Equity securities	4,996	32	—	5,028
Total	$1,659,456	$11,423	$(36,977)	$1,633,902

At both June 30, 2014, and December 31, 2013, the amortized cost of the available for sale securities is net of $184,000 of credit related other-than-temporary impairment ("OTTI").

The amortized cost, gross unrealized gains and losses and estimated fair values of held to maturity securities as of June 30, 2014, and December 31, 2013, are summarized in the table below, in thousands:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2014				
Mortgage-backed securities	$5,859	$246	$(552)	$5,553
Obligations of states and political subdivisions	251,358	10,453	(2,195)	259,616
Total	$257,217	$10,699	$(2,747)	$265,169
December 31, 2013				
Mortgage-backed securities	$5,973	$199	$(321)	$5,851
Obligations of states and political subdivisions	231,525	5,801	(5,740)	231,586
Total	$237,498	$6,000	$(6,061)	$237,437

At June 30, 2014, the amortized cost of the held to maturity securities is net of $797,000 of credit related OTTI and $469,000 of non-credit related OTTI. At December 31, 2013, the amortized cost of the held to maturity securities was net of $797,000 of credit related OTTI and $517,000 of non-credit related OTTI.

Approximately 96% of Heartland's mortgage-backed securities are issuances of government-sponsored enterprises.

The amortized cost and estimated fair value of debt securities available for sale at June 30, 2014, by contractual maturity are as follows, in thousands. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without penalties.

	Amortized Cost	Estimated Fair Value
Due in 1 year or less	$5,471	$5,560
Due in 1 to 5 years	30,201	30,492
Due in 5 to 10 years	48,997	49,076
Due after 10 years	155,411	157,744
Total debt securities	240,080	242,872
Mortgage-backed securities	1,163,480	1,164,881
Equity securities	5,013	5,056
Total investment securities	$1,408,573	$1,412,809

The amortized cost and estimated fair value of debt securities held to maturity at June 30, 2014, by contractual maturity are as follows, in thousands. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without penalties.

	Amortized Cost	Estimated Fair Value
Due in 1 year or less	$—	$—
Due in 1 to 5 years	12,573	13,397
Due in 5 to 10 years	41,896	43,734
Due after 10 years	196,889	202,485
Total debt securities	251,358	259,616
Mortgage-backed securities	5,859	5,553
Total investment securities	$257,217	$265,169

Gross gains and losses realized related to the sales of securities available for sale for the three- and six-month periods ended June 30, 2014, and 2013, are summarized as follows, in thousands:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Proceeds from sales	$154,603	$124,344	$509,891	$215,935
Gross security gains	974	2,662	3,446	6,283
Gross security losses	120	595	1,811	789

The following tables summarize, in thousands, the amount of unrealized losses, defined as the amount by which cost or amortized cost exceeds fair value, and the related fair value of investments with unrealized losses in Heartland's securities portfolio as of June 30, 2014, and December 31, 2013. The investments were segregated into two categories: those that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 or more months. The reference point for determining how long an investment was in an unrealized loss position was June 30, 2013, and December 31, 2012, respectively. Securities for which Heartland has taken credit-related OTTI write-downs are categorized as being "less than 12 months" or "12 months or longer" in a continuous loss position based on the point in time that the fair value declined to below the cost basis and not the period of time since the credit-related OTTI write-down.

Securities available for sale	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2014						
U.S. government corporations and agencies	$8,705	$(39)	$—	$—	$8,705	$(39)
Mortgage-backed securities	397,376	(5,905)	303,801	(5,588)	701,177	(11,493)
Obligations of states and political subdivisions	1,899	(4)	61,974	(1,610)	63,873	(1,614)
Total temporarily impaired securities	$407,980	$(5,948)	$365,775	$(7,198)	$773,755	$(13,146)
December 31, 2013						
U.S. government corporations and agencies	$196,345	$(2,001)	$—	$—	$196,345	$(2,001)
Mortgage-backed securities	640,684	(17,064)	118,229	(5,510)	758,913	(22,574)
Obligations of states and political subdivisions	196,987	(11,452)	10,714	(950)	207,701	(12,402)
Total temporarily impaired securities	$1,034,016	$(30,517)	$128,943	$(6,460)	$1,162,959	$(36,977)

Securities held to maturity	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2014						
Mortgage-backed securities	$—	$—	$2,821	$(552)	$2,821	$(552)
Obligations of states and political subdivisions	2,161	(406)	47,029	(1,789)	49,190	(2,195)
Total temporarily impaired securities	$2,161	$(406)	$49,850	$(2,341)	$52,011	$(2,747)
December 31, 2013						
Mortgage-backed securities	$2,170	$(319)	$834	$(2)	$3,004	$(321)
Obligations of states and political subdivisions	47,175	(3,508)	21,505	(2,232)	68,680	(5,740)
Total temporarily impaired securities	$49,345	$(3,827)	$22,339	$(2,234)	$71,684	$(6,061)

Heartland reviews the investment securities portfolio on a quarterly basis to monitor its exposure to OTTI. A determination as to whether a security's decline in fair value is other-than-temporary takes into consideration numerous factors and the relative significance of any single factor can vary by security. Some factors Heartland may consider in the OTTI analysis include the length of time the security has been in an unrealized loss position, changes in security ratings, financial condition of the issuer, as well as security and industry specific economic conditions. In addition, with regard to debt securities, Heartland may also evaluate payment structure, whether there are defaulted payments or expected defaults, prepayment speeds, and the value of any underlying collateral. For certain debt securities in unrealized loss positions, Heartland prepares cash flow analyses to compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. During 2012, Heartland experienced deterioration in the credit support on three private label mortgage-backed securities which resulted in a credit-related OTTI loss. The underlying collateral on these securities experienced an increased level of defaults and a slowing of voluntary prepayments causing the present value of the forward expected cash flows, using prepayment and default vectors, to be below the amortized cost basis of the securities. Based on Heartland's evaluation, a $981,000 OTTI on three private label mortgage-backed securities attributable to credit-related losses was recorded in March 2012. The other-than-temporary credit-related losses were $797,000 in the held to maturity category and $184,000 in the available for sale category.

The remaining unrealized losses on Heartland's mortgage-backed securities are the result of changes in market interest rates or widening of market spreads subsequent to the initial purchase of the securities and not related to concerns regarding the underlying credit of the issuers or the underlying collateral. It is expected that the securities will not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because Heartland has the intent and ability to hold these investments until a market price recovery or to maturity and does not believe it will be required to sell the securities before maturity, these investments are not considered other-than-temporarily impaired.

Unrealized losses on Heartland's obligations of states and political subdivisions are the result of changes in market interest rates or widening of market spreads subsequent to the initial purchase of the securities. Management monitors the credit quality and financial stability of the underlying municipalities. Because the decline in fair value is attributable to changes in interest rates or widening market spreads due to insurance company downgrades and not underlying credit quality, and because Heartland has the intent and ability to hold these investments until a market price recovery or to maturity and does not believe it will be required to sell the securities before maturity, these investments are not considered other-than-temporarily impaired.

There were no gross realized gains or losses on the sale of available for sale securities with OTTI write-downs for the periods ended June 30, 2014, or December 31, 2013.

The following table shows the detail of OTTI write-downs on debt securities included in earnings and the related changes in other accumulated comprehensive income ("AOCI") for the same securities, in thousands:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Recorded as part of gross realized losses:				
Credit related OTTI	$—	$—	$—	$—
Intent to sell OTTI	—	—	—	—
Total recorded as part of gross realized losses	—	—	—	—
Recorded directly to AOCI for non-credit related impairment:				
Residential mortgage backed securities	—	—	—	—
Accretion of non-credit related impairment	(24)	(24)	(48)	(48)
Total changes to AOCI for non-credit related impairment	(24)	(24)	(48)	(48)
Total OTTI losses (accretion) recorded on debt securities, net	$(24)	$(24)	$(48)	$(48)

Heartland has not experienced any OTTI writedowns since the initial impairment charge in 2012.

Included in other securities at June 30, 2014 and December 31, 2013, were shares of stock in each Federal Home Loan Bank (the "FHLB") of Des Moines, Chicago, Dallas, San Francisco, Seattle, and Topeka at an amortized cost of $14.7 million and $15.6 million, respectively.

NOTE 3: LOANS AND LEASES

Loans and leases as of June 30, 2014, and December 31, 2013, were as follows, in thousands:

	June 30, 2014	December 31, 2013
Loans and leases receivable held to maturity:		
Commercial	$1,027,123	$950,197
Commercial real estate	1,623,394	1,529,683
Agricultural and agricultural real estate	389,918	376,735
Residential real estate	341,697	349,349
Consumer	315,234	294,145
Gross loans and leases receivable held to maturity	3,697,366	3,500,109
Unearned discount	(111)	(168)
Deferred loan fees	(2,521)	(2,989)
Total net loans and leases receivable held to maturity	3,694,734	3,496,952
Loans covered under loss share agreements:		
Commercial and commercial real estate	1,208	2,314
Agricultural and agricultural real estate	567	543
Residential real estate	1,995	2,280
Consumer	609	612
Total loans covered under loss share agreements	4,379	5,749
Allowance for loan and lease losses	(40,892)	(41,685)
Loans and leases receivable, net	$3,658,221	$3,461,016

Heartland has certain lending policies and procedures in place that are designed to provide for an acceptable level of credit risk. The board of directors reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management and the board with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming loans and potential problem loans. Diversification in the loan portfolio is also a means of managing risk associated with fluctuations in economic conditions.

The commercial and commercial real estate loan portfolio includes a wide range of business loans, including lines of credit for working capital and operational purposes and term loans for the acquisition of equipment and real estate. Although most loans are made on a secured basis, loans may be made on an unsecured basis where warranted by the overall financial condition of the borrower. Terms of commercial business loans generally range from one to five years. Commercial loans and leases are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The collateral that Heartland requires for most of these loans and leases is based upon the discounted market value of the collateral. The primary repayment risks of commercial loans and leases are that the cash flow of the borrowers may be unpredictable, and the collateral securing these loans may fluctuate in value. Heartland seeks to minimize these risks in a variety of ways. The underwriting analysis includes credit verification, analysis of global cash flows, appraisals and a review of the financial condition of the borrower. Personal guarantees are frequently required as a tertiary form of repayment. In addition, when underwriting loans for commercial real estate, careful consideration is given to the property's operating history, future operating projections, current and projected occupancy, location and physical condition. Heartland also utilizes government guaranteed lending through the U.S. Small Business Administration and the USDA Rural Development Business and Industry Program to assist customers with longer-term funding and to reduce risk.

Agricultural loans, many of which are secured by crops, machinery and real estate, are provided to finance capital improvements and farm operations as well as acquisitions of livestock and machinery. Agricultural loans present unique credit risks relating to adverse weather conditions, loss of livestock due to disease or other factors, declines in market prices for agricultural products and the impact of government regulations. The ultimate repayment of agricultural loans is dependent upon the profitable operation or management of the agricultural entity. In underwriting agricultural loans, lending personnel work closely with their customers to review budgets and cash flow projections for the ensuing crop year. These budgets and cash flow projections are monitored closely during the year and reviewed with the customers at least annually. Lending personnel also work closely with governmental agencies, including the Farm Service Agency, to help agricultural customers obtain credit enhancement products such as loan guarantees or interest assistance.

Heartland originates first-lien, adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a single family residential property. These loans are principally collateralized by owner-occupied properties and are amortized over 10 to 30 years. Heartland typically sells longer-term, low-rate, residential mortgage loans in the secondary market with servicing rights retained. This practice allows Heartland to better manage interest rate risk and liquidity risk. The Heartland bank subsidiaries participate in lending programs sponsored by U.S. government agencies such as Veterans Administration and Federal Home Administration when justified by market conditions.

Consumer lending includes motor vehicle, home improvement, home equity and small personal credit lines. Consumer loans typically have shorter terms, lower balances, higher yields and higher risks of default than one-to-four-family residential mortgage loans. Consumer loan collections are dependent on the borrower's continuing financial stability, and are therefore more likely to be affected by adverse personal circumstances. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate. Heartland's consumer finance subsidiaries, Citizens Finance Co. and Citizens Finance of Illinois Co., typically lend to borrowers with past credit problems or limited credit histories, which comprise approximately 25% of Heartland's total consumer loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Heartland’s policy is to discontinue the accrual of interest income on any loan or lease when, in the opinion of management, there is a reasonable doubt as to the timely collection of the interest and principal, normally when a loan or lease is 90 days past due. When interest accruals are deemed uncollectible, interest credited to income in the current year is reversed and interest accrued in prior years is charged to the allowance for loan and lease losses. Nonaccrual loans and leases are returned to an accrual status when, in the opinion of management, the financial position of the borrower indicates that there is no longer any reasonable doubt as to the timely payment of interest and principal.

Under Heartland’s credit practices, a loan is impaired when, based on current information and events, it is probable that Heartland will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate, except where more practical, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent.

The following table shows the balance in the allowance for loan and lease losses at June 30, 2014, and December 31, 2013, and the related loan balances, disaggregated on the basis of impairment methodology, in thousands. Loans evaluated under ASC 310-10-35 include loans on nonaccrual status and troubled debt restructurings, which are individually evaluated for impairment, and other impaired loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment under ASC 450-20. Heartland has made no significant changes to the accounting for the allowance for loan and lease losses policy during 2014.

	Allowance For Loan and Lease Losses			Gross Loans and Leases Receivable Held to Maturity		
	Ending Balance Under ASC 310-10-35	Ending Balance Under ASC 450-20	Total	Ending Balance Evaluated for Impairment Under ASC 310-10-35	Ending Balance Evaluated for Impairment Under ASC 450-20	Total
June 30, 2014						
Commercial	$1,047	$10,880	$11,927	$9,704	$1,017,419	$1,027,123
Commercial real estate	476	14,204	14,680	25,134	1,598,260	1,623,394
Agricultural and agricultural real estate	57	2,731	2,788	5,613	384,305	389,918
Residential real estate	581	3,234	3,815	8,321	333,376	341,697
Consumer	1,551	5,965	7,516	5,869	309,365	315,234
Unallocated	—	166	166	—	—	—
Total	$3,712	$37,180	$40,892	$54,641	$3,642,725	$3,697,366
December 31, 2013						
Commercial	$2,817	$10,282	$13,099	$14,644	$935,553	$950,197
Commercial real estate	818	13,334	14,152	28,299	1,501,384	1,529,683
Agricultural and agricultural real estate	756	2,236	2,992	16,667	360,068	376,735
Residential real estate	605	3,115	3,720	7,214	342,135	349,349
Consumer	1,721	6,001	7,722	5,137	289,008	294,145
Unallocated	—	—	—	—	—	—
Total	$6,717	$34,968	$41,685	$71,961	$3,428,148	$3,500,109

The following table presents nonaccrual loans, accruing loans past due 90 days or more and troubled debt restructured loans not covered under loss share agreements at June 30, 2014, and December 31, 2013, in thousands. There were no nonaccrual leases, accruing leases past due 90 days or more or restructured leases at June 30, 2014, and December 31, 2013.

	June 30, 2014	December 31, 2013
Nonaccrual loans	$24,321	$29,313
Nonaccrual troubled debt restructured loans	4,755	13,081
Total nonaccrual loans	$29,076	$42,394
Accruing loans past due 90 days or more	$—	$24
Performing troubled debt restructured loans	$12,076	$19,353

The following tables provide information on troubled debt restructured loans that were modified during the three and six months ended June 30, 2014, and June 30, 2013, dollars in thousands:

	Three Months Ended June 30, 2014			2013		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	—	$—	$—	2	$13,203	$13,203
Commercial real estate	1	298	298	—	—	—
Total commercial and commercial real estate	1	298	298	2	13,203	13,203
Agricultural and agricultural real estate	2	3,357	3,357	—	—	—
Residential real estate	1	38	38	1	50	50
Consumer	—	—	—	1	166	166
Total	4	$3,693	$3,693	4	$13,419	$13,419

	Six Months Ended June 30, 2014			2013		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	—	$—	$—	3	$17,873	$17,873
Commercial real estate	1	298	298	—	—	—
Total commercial and commercial real estate	1	298	298	3	17,873	17,873
Agricultural and agricultural real estate	2	3,357	3,357	3	2,576	2,576
Residential real estate	1	38	38	3	696	696
Consumer	—	—	—	1	166	166
Total	4	$3,693	$3,693	10	$21,311	$21,311

The pre-modification and post-modification recorded investment represents amounts as of the date of loan modification. Since the modifications on these loans have been only interest rate concessions and term extensions, not principal reductions, the pre-modification and post-modification recorded investment amounts are the same. At June 30, 2014, there were no commitments to extend credit to any of the borrowers with an existing troubled debt restructuring.

The following tables provide information on troubled debt restructured loans for which there was a payment default during the three months and six months ended June 30, 2014, and June 30, 2013, in thousands, that had been modified during the twelve-month period prior to the default:

	With Payment Defaults During the Following Periods Three Months Ended June 30, 2014		2013	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Commercial	—	$—	1	$4,670

Commercial real estate	—	—	—	—
Total commercial and commercial real estate	—	—	1	4,670
Agricultural and agricultural real estate	—	—	—	—
Residential real estate	—	—	—	—
Consumer	—	—	—	—
Total	—	$—	1	$4,670

	With Payment Defaults During the Following Periods Six Months Ended June 30,			
	2014		2013	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Commercial	—	$—	1	$4,670
Commercial real estate	—	—	—	—
Total commercial and commercial real estate	—	—	1	4,670
Agricultural and agricultural real estate	—	—	—	—
Residential real estate	—	—	—	—
Consumer	—	—	—	—
Total	—	$—	1	$4,670

Heartland's internal rating system is a series of grades reflecting management's risk assessment, based on its analysis of the borrower's financial condition. The "pass" category consists of all loans that are not in the "nonpass" category, categorized into a range of loan grades that reflect increasing, though still acceptable, risk. Movement of risk through the various grade levels in the pass category is monitored for early identification of credit deterioration. The "nonpass" category consists of special mention, substandard, doubtful and loss loans. The "special mention" rating is attached to loans where the borrower exhibits negative financial trends due to borrower specific or systemic conditions that, if left uncorrected, threaten its capacity to meet its debt obligations. The borrower is believed to have sufficient financial flexibility to react to and resolve its negative financial situation. These credits are closely monitored for improvement or deterioration. The "substandard" rating is assigned to loans that are inadequately protected by the current sound net worth and paying capacity of the borrower and may be further at risk due to deterioration in the value of collateral pledged. Well-defined weaknesses jeopardize liquidation of the debt. These loans are still considered collectible, however, a distinct possibility exists that Heartland will sustain some loss if deficiencies are not corrected. Substandard loans may exhibit some or all of the following weaknesses: deteriorating trends, lack of earnings, inadequate debt service capacity, excessive debt and/or lack of liquidity. The "doubtful" rating is assigned to loans where identified weaknesses make collection or liquidation in full, on the basis of existing facts, conditions and values, highly questionable and improbable. These borrowers are usually in default, lack liquidity and capital, as well as, resources necessary to remain an operating entity. Specific pending events, such as capital injections, liquidations or perfection of liens on additional collateral, may strengthen the credit, thus deferring classification of the loan as loss until exact status can be determined. The "loss" rating is assigned to loans considered uncollectible. As of June 30, 2014, Heartland had no loans classified as doubtful or loss. Loans are placed on "nonaccrual" when management does not expect to collect payments of principal and interest in full or when principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection.

The following table presents loans and leases not covered by loss share agreements by credit quality indicator at June 30, 2014, and December 31, 2013, in thousands:

	Pass	Nonpass	Total
June 30, 2014			
Commercial	$940,681	$86,442	$1,027,123
Commercial real estate	1,469,964	153,430	1,623,394
Total commercial and commercial real estate	2,410,645	239,872	2,650,517
Agricultural and agricultural real estate	364,248	25,670	389,918
Residential real estate	324,114	17,583	341,697
Consumer	305,426	9,808	315,234
Total gross loans and leases receivable held to maturity	$3,404,433	$292,933	$3,697,366
December 31, 2013			
Commercial	$871,825	$78,372	$950,197
Commercial real estate	1,390,820	138,863	1,529,683
Total commercial and commercial real estate	2,262,645	217,235	2,479,880
Agricultural and agricultural real estate	335,821	40,914	376,735
Residential real estate	333,161	16,188	349,349
Consumer	284,148	9,997	294,145
Total gross loans and leases receivable held to maturity	$3,215,775	$284,334	$3,500,109

The nonpass category in the table above is comprised of approximately 70% special mention and 30% substandard as of June 30, 2014. The percent of nonpass loans on nonaccrual status as of June 30, 2014, was 10%. As of December 31, 2013, the nonpass category in the table above was comprised of approximately 59% special mention, 38% substandard, and 3% doubtful. The percent of nonpass loans on nonaccrual status as of December 31, 2013, was 15%. Loans delinquent 30 to 89 days as a percent of total loans were 0.25% at June 30, 2014, compared to .30% at December 31, 2013. Changes in credit risk are monitored on a continuous basis and changes in risk ratings are made when identified. All impaired loans are reviewed at least annually.

The following table sets forth information regarding Heartland's accruing and nonaccrual loans and leases not covered by loss share agreements at June 30, 2014, and December 31, 2013, in thousands:

	Accruing Loans and Leases						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Nonaccrual	Total Loans and Leases
June 30, 2014							
Commercial	$623	$50	$—	$673	$1,019,720	$6,730	$1,027,123
Commercial real estate	2,717	848	—	3,565	1,607,593	12,236	1,623,394
Total commercial and commercial real estate	3,340	898	—	4,238	2,627,313	18,966	2,650,517
Agricultural and agricultural real estate	13	—	—	13	387,979	1,926	389,918
Residential real estate	857	—	—	857	335,235	5,605	341,697
Consumer	3,364	856	—	4,220	308,435	2,579	315,234
Total gross loans and leases receivable held to maturity	$7,574	$1,754	$—	$9,328	$3,658,962	$29,076	$3,697,366
December 31, 2013							
Commercial	$697	$741	$—	$1,438	$935,508	$13,251	$950,197
Commercial real estate	3,042	199	24	3,265	1,511,618	14,800	1,529,683
Total commercial and commercial real estate	3,739	940	24	4,703	2,447,126	28,051	2,479,880
Agricultural and agricultural real estate	818	—	—	818	369,907	6,010	376,735
Residential real estate	1,199	56	—	1,255	342,735	5,359	349,349
Consumer	2,624	1,089	—	3,713	287,458	2,974	294,145
Total gross loans and leases receivable held to maturity	$8,380	$2,085	$24	$10,489	$3,447,226	$42,394	$3,500,109

The majority of Heartland's impaired loans are those that are nonaccrual or have had their terms restructured in a troubled debt restructuring. The following tables present, for impaired loans not covered by loss share agreements and by category of loan, the unpaid contractual balance at June 30, 2014, and December 31, 2013; the outstanding loan balance recorded on the consolidated balance sheets at June 30, 2014, and December 31, 2013; any related allowance recorded for those loans as of June 30, 2014, and December 31, 2013; the average outstanding loan balance recorded on the consolidated balance sheets during the three months and six months ended June 30, 2014, and year ended December 31, 2013; and the interest income recognized on the impaired loans during the three months and six months ended June 30, 2014, and year ended December 31, 2013, in thousands:

	Unpaid Contractual Balance	Loan Balance	Related Allowance Recorded	Quarter-to-Date Avg. Loan Balance	Quarter-to-Date Interest Income Recognized	Year-to-Date Avg. Loan Balance	Year-to-Date Interest Income Recognized
June 30, 2014							
Impaired loans with a related allowance:							
Commercial	$7,649	$7,573	$1,047	$6,408	$41	$7,053	$45
Commercial real estate	3,492	3,289	476	3,268	25	3,618	33
Total commercial and commercial real estate	11,141	10,862	1,523	9,676	66	10,671	78
Agricultural and agricultural real estate	3,368	3,368	57	1,427	68	4,254	70
Residential real estate	1,796	1,796	581	2,221	6	2,252	10
Consumer	4,348	4,339	1,551	4,191	29	4,321	60
Total loans held to maturity	$20,653	$20,365	$3,712	$17,515	$169	$21,498	$218
Impaired loans without a related allowance:							
Commercial	$2,791	$2,131	$—	$2,580	$21	$3,969	$40
Commercial real estate	25,052	21,845	—	23,239	15	23,019	287
Total commercial and commercial real estate	27,843	23,976	—	25,819	36	26,988	327
Agricultural and agricultural real estate	3,397	2,245	—	4,375	3	4,546	7
Residential real estate	6,961	6,525	—	6,491	34	5,859	64
Consumer	1,530	1,530	—	1,893	2	1,769	17
Total loans held to maturity	$39,731	$34,276	$—	$38,578	$75	$39,162	$415
Total impaired loans held to maturity:							
Commercial	$10,440	$9,704	$1,047	$8,988	$62	$11,022	$85
Commercial real estate	28,544	25,134	476	26,507	40	26,637	320
Total commercial and commercial real estate	38,984	34,838	1,523	35,495	102	37,659	405
Agricultural and agricultural real estate	6,765	5,613	57	5,802	71	8,800	77
Residential real estate	8,757	8,321	581	8,712	40	8,111	74
Consumer	5,878	5,869	1,551	6,084	31	6,090	77
	$60,384	$54,641	$3,712	$56,093	$244	$60,660	$633

Total impaired loans held to maturity

	Unpaid Contractual Balance	Loan Balance	Related Allowance Recorded	Year-to-Date Avg. Loan Balance	Year-to-Date Interest Income Recognized
December 31, 2013					
Impaired loans with a related allowance:					
Commercial	$7,901	$7,901	$2,817	$5,343	$38
Commercial real estate	9,164	8,909	818	7,686	282
Total commercial and commercial real estate	17,065	16,810	3,635	13,029	320
Agricultural and agricultural real estate	13,818	13,818	756	7,537	354
Residential real estate	2,460	2,460	605	3,179	13
Consumer	3,485	3,485	1,721	3,490	100
Total loans held to maturity	$36,828	$36,573	$6,717	$27,235	$787
Impaired loans without a related allowance:					
Commercial	$7,724	$6,743	$—	$9,394	$89
Commercial real estate	24,830	19,390	—	25,676	538
Total commercial and commercial real estate	32,554	26,133	—	35,070	627
Agricultural and agricultural real estate	2,849	2,849	—	9,985	189
Residential real estate	5,345	4,754	—	4,198	80
Consumer	1,652	1,652	—	1,515	37
Total loans held to maturity	$42,400	$35,388	$—	$50,768	$933
Total impaired loans held to maturity:					
Commercial	$15,625	$14,644	$2,817	$14,737	$127
Commercial real estate	33,994	28,299	818	33,362	820
Total commercial and commercial real estate	49,619	42,943	3,635	48,099	947
Agricultural and agricultural real estate	16,667	16,667	756	17,522	543
Residential real estate	7,805	7,214	605	7,377	93
Consumer	5,137	5,137	1,721	5,005	137
Total impaired loans held to maturity	$79,228	$71,961	$6,717	$78,003	$1,720

On July 2, 2009, Heartland acquired all deposits of The Elizabeth State Bank in Elizabeth, Illinois through its subsidiary Galena State Bank & Trust Co. based in Galena, Illinois, in a whole bank loss sharing transaction facilitated by the FDIC. As of July 2, 2009, The Elizabeth State Bank had loans of $42.7 million. The estimated fair value of the loans acquired was $37.8 million.

The acquired loans and other real estate owned are covered by two loss share agreements between the FDIC and Galena State Bank & Trust Co., which affords Galena State Bank & Trust Co. significant loss protection. Under the loss share agreements, the FDIC covers 80% of the covered loan and other real estate owned losses (referred to as covered assets) up to $10 million and 95% of losses in excess of that amount. The term for loss sharing on non-residential real estate losses is five years with respect to losses and eight years with respect to recoveries, while the term for loss sharing on residential real estate loans is ten years with respect to losses and recoveries. The reimbursable losses from the FDIC are based on the book value of the relevant loan as determined by the FDIC at the date of the transaction. New loans made after the acquisition are not covered by the loss share agreements.

The Elizabeth State Bank acquisition was accounted for under the acquisition method of accounting in accordance with ASC 805, “Business Combinations.” Purchased loans acquired in a business combination, which include loans purchased in The Elizabeth State Bank acquisition, are recorded at estimated fair value on their purchase date, but the purchaser cannot carry over the related allowance for loan and lease losses. Purchased loans are accounted for under

ASC 310-30, “Loans and Debt Securities with Deteriorated Credit Quality,” when the loans have evidence of credit deterioration since origination and it is probable at the date of the acquisition that Heartland will not collect all contractually required principal and interest payments. Evidence of credit quality deterioration at the purchase date included statistics such as past due and nonaccrual status. Generally, acquired loans that meet Heartland’s definition for nonaccrual status fall within the scope of ASC 310-30. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference which is included in the carrying value of the loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan and lease losses. Subsequent increases in cash flows result in a reversal of the provision for loan and lease losses to the extent of prior charges, or a reclassification of the difference from nonaccretable to accretable with a positive impact on future interest income. Further, any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows.

The carrying amount of the loans covered by these loss share agreements at June 30, 2014, and December 31, 2013, consisted of purchased impaired and nonimpaired loans as summarized in the following table, in thousands:

	June 30, 2014			December 31, 2013		
	Impaired Purchased Loans	Non Impaired Purchased Loans	Total Covered Loans	Impaired Purchased Loans	Non Impaired Purchased Loans	Total Covered Loans
Commercial and commercial real estate	$—	$1,208	$1,208	$549	$1,765	$2,314
Agricultural and agricultural real estate	—	567	567	—	543	543
Residential real estate	—	1,995	1,995	—	2,280	2,280
Consumer loans	520	89	609	538	74	612
Total Covered Loans	$520	$3,859	$4,379	$1,087	$4,662	$5,749

On the acquisition date, the preliminary estimate of the contractually required payments receivable for all loans with evidence of credit deterioration since origination acquired in the acquisition was $13.8 million and the estimated fair value of the loans was $9.0 million. At June 30, 2014, and December 31, 2013, a majority of these loans were valued based upon the liquidation value of the underlying collateral, because the expected cash flows are primarily based on the liquidation of underlying collateral and the timing and amount of the cash flows could not be reasonably estimated. There was no allowance for loan and lease losses related to these ASC 310-30 loans at June 30, 2014, and December 31, 2013.

On the acquisition date, the preliminary estimate of the contractually required payments receivable for all nonimpaired loans acquired in the acquisition was $28.9 million and the estimated fair value of the loans was $28.7 million.

NOTE 4: ALLOWANCE FOR LOAN AND LEASE LOSSES

Changes in the allowance for loan and lease losses for the three and six months ended June 30, 2014, and June 30, 2013, were as follows, in thousands:

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Balance at March 31, 2014	$11,633	$13,010	$2,571	$3,671	$7,376	$312	$38,573
Charge-offs	(148)	(161)	(125)	(55)	(911)	—	(1,400)
Recoveries	208	514	2	30	214	—	968
Provision	234	1,317	340	169	837	(146)	2,751
Balance at June 30, 2014	$11,927	$14,680	$2,788	$3,815	$7,516	$166	$40,892

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Balance at December 31, 2013	$13,099	$14,152	$2,992	$3,720	$7,722	$—	$41,685
Charge-offs	(7,065)	(1,084)	(1,636)	(204)	(2,069)	—	(12,058)

Recoveries	407	1,294	4	56	422	—	2,183
Provision	5,486	318	1,428	243	1,441	166	9,082
Balance at June 30, 2014	$11,927	$14,680	$2,788	$3,815	$7,516	$166	$40,892

Commercial	Commercial Real Estate	Agricultural	Residential