HEARTLAND FINANCIAL USA INC
Form 10-Q
November 10, 2008

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 September 30, 2008
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For transition period __________ to __________

Commission File Number: 0-24724

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) 589-2100
(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 þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Act.
Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨ Smaller reporting company ¨
(Do not check if a 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 ¨ No þ

Indicate the number of shares outstanding of each of the classes of Registrant's common stock as of the latest practicable date: As of November 6, 2008, the Registrant had outstanding 16,248,625 shares of common stock, $1.00

par value per share.

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

Part I

Part II

PART I

ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Cash and due from banks	$ 30,537	$ 46,468
Federal funds sold and other short-term investments	36,537	364
Cash and cash equivalents	67,074	46,832
Securities:		
Trading, at fair value	1,962	1,888
Available for sale, at fair value (cost of $741,243 at September 30, 2008, and $672,499 at December 31, 2007)	733,820	682,383
Held to maturity, at cost (fair value of $23,574 at September 30, 2008, and $5,754 at December 31, 2007)	24,361	5,678
Loans held for sale	9,812	12,679
Gross loans and leases:		
Held to maturity	2,364,259	2,280,167
Allowance for loan and lease losses	(34,845)	(32,993)
Loans and leases, net	2,329,414	2,247,174
Premises, furniture and equipment, net	120,225	120,285
Other real estate, net	9,387	2,195
Goodwill	40,207	40,207
Other intangible assets, net	8,332	8,369
Cash surrender value on life insurance	55,684	55,532
Other assets	45,704	40,904
TOTAL ASSETS	$ 3,445,982	$ 3,264,126
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Demand	$ 373,193	$ 381,499
Savings	1,042,364	855,036
Time	1,152,350	1,139,764
Total deposits	2,567,907	2,376,299
Short-term borrowings	176,543	354,146
Other borrowings	440,146	263,607
Accrued expenses and other liabilities	36,074	39,474
TOTAL LIABILITIES	3,220,670	3,033,526
STOCKHOLDERS' EQUITY:		
Preferred stock (par value $1 per share; authorized, 184,000 shares; none issued or outstanding)	-	-
Series A Junior participating preferred stock (par value $1 per share; authorized, 16,000 shares; none issued or outstanding)	-	-

Common stock (par value $1 per share; authorized, 20,000,000 shares; issued 16,611,671 shares at September 30, 2008, and December 31, 2007)	16,612	16,612
Capital surplus	37,701	37,269
Retained earnings	182,227	173,891
Accumulated other comprehensive income (loss)	(4,043)	6,506
Treasury stock at cost (358,780 shares at September 30, 2008, and 184,655 shares at December 31, 2007)	(7,185)	(3,678)
TOTAL STOCKHOLDERS' EQUITY	225,312	230,600
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 3,445,982	$ 3,264,126

See accompanying notes to consolidated financial statements.

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

	Quarter Ended		Nine Months Ended	
	Sept. 30, 2008	Sept. 30, 2007	Sept. 30, 2008	Sept. 30, 2007
INTEREST INCOME:				
Interest and fees on loans and leases	$ 40,990	$ 47,406	$ 124,444	$ 140,712
Interest on securities:				
Taxable	8,228	5,446	22,728	16,010
Nontaxable	1,670	1,513	4,996	4,414
Interest on federal funds sold and other short-term investments	85	310	267	310
Interest on interest bearing deposits in other financial institutions	3	2	10	20
TOTAL INTEREST INCOME	50,976	54,677	152,445	161,466
INTEREST EXPENSE:				
Interest on deposits	15,622	20,477	48,375	58,325
Interest on short-term borrowings	776	2,764	4,049	10,545
Interest on other borrowings	4,692	4,199	13,562	10,762
TOTAL INTEREST EXPENSE	21,090	27,440	65,986	79,632
NET INTEREST INCOME	29,886	27,237	86,459	81,834
Provision for loan and lease losses	7,083	575	14,213	6,769
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	22,803	26,662	72,246	75,065
NONINTEREST INCOME:				
Service charges and fees, net	3,125	2,861	8,620	8,287
Loan servicing income	1,094	1,068	3,585	3,103
Trust fees	2,070	2,089	6,159	6,265
Brokerage and insurance commissions	942	820	2,717	2,158
Securities gains, net	5	31	1,015	303
Gain (loss) on trading account securities, net	(33)	(7)	(467)	80
Impairment loss on securities	(4,688)	-	(4,804)	-
Gains on sale of loans	295	604	1,279	2,051
Income (loss) on bank owned life insurance	(247)	595	596	1,212
Gain on sale of merchant credit card services	5,200	-	5,200	-
Other noninterest income	117	(145)	772	161
TOTAL NONINTEREST INCOME	7,880	7,916	24,672	23,620
NONINTEREST EXPENSES:				
Salaries and employee benefits	15,000	14,301	44,459	42,680
Occupancy	2,262	2,004	6,799	5,941
Furniture and equipment	1,662	1,669	5,201	5,124
Outside services	3,096	2,374	8,254	7,011
Advertising	1,012	886	2,853	2,694
Intangible assets amortization	236	241	708	652
Other noninterest expenses	3,392	3,272	9,588	9,970
TOTAL NONINTEREST EXPENSES	26,660	24,747	77,862	74,072
INCOME BEFORE INCOME TAXES	4,023	9,831	19,056	24,613

Income taxes		1,018		2,906		5,081		7,403
INCOME FROM CONTINUING OPERATIONS		3,005		6,925		13,975		17,210
Discontinued operations:								
Income from discontinued operations before income taxes		-		-		-		2,756
Income taxes		-		-		-		1,085
INCOME FROM DISCONTINUED OPERATIONS		-		-		-		1,671
NET INCOME	$	3,005	$	6,925	$	13,975	$	18,881
EARNINGS PER COMMON SHARE – BASIC	$	0.18	$	0.42	$	0.86	$	1.15
EARNINGS PER COMMON SHARE – DILUTED	$	0.18	$	0.42	$	0.85	$	1.14
EARNINGS PER COMMON SHARE FROM CONTINUING OPERATIONS – BASIC	$	0.18	$	0.42	$	0.86	$	1.04
EARNINGS PER COMMON SHARE FROM CONTINUING OPERATIONS– DILUTED	$	0.18	$	0.42	$	0.85	$	1.04
CASH DIVIDENDS DECLARED PER COMMON SHARE	$	0.10	$	0.09	$	0.30	$	0.27

See accompanying notes to consolidated financial statements.

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

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at January 1, 2007	$ 16,572	$ 37,963	$ 154,308	$ 868	$ -	$ 209,711
Net income			18,881			18,881
Unrealized gain (loss) on securities available for sale arising during the period				2,184		2,184
Unrealized gain (loss) on derivatives arising during the period				235		235
Reclassification adjustment for net security gains realized in net income				(303)		(303)
Income taxes				(786)		(786)
Comprehensive income						20,211
Cash dividends declared:						
Common, $0.27 per share			(4,411)			(4,411)
Purchase of 303,786 shares of common stock					(7,832)	(7,832)
Issuance of 184,360 shares of common stock	40	(1,801)			5,174	3,413
Commitments to issue common stock		1,183				1,183
Balance at September 30, 2007	$ 16,612	$ 37,345	$ 168,778	$ 2,198	$ (2,658)	$ 222,275
Balance at December 31, 2007	$ 16,612	$ 37,269	$ 173,891	$ 6,506	$ (3,678)	$ 230,600
Cumulative effect from adoption of EITF 06-4			(791)			(791)
Balance at January 1, 2008	16,612	37,269	173,100	6,506	(3,678)	229,809

Net income			13,975			13,975
Unrealized gain (loss) on securities available for sale arising during the period				(21,096)		(21,096)
Unrealized gain (loss) on derivatives arising during the period				563		563
Reclassification adjustment for net security losses realized in net income				3,789		3,789
Income taxes				6,195		6,195
Comprehensive income						3,426
Cash dividends declared:						
Common, $0.30 per share			(4,848)			(4,848)
Purchase of 306,864 shares of common stock					(6,126)	(6,126)
Issuance of 132,739 shares of common stock		(444)			2,619	2,175
Commitments to issue common stock		876				876
Balance at September 30, 2008	$ 16,612	$ 37,701	$ 182,227	$ (4,043)	$ (7,185)	$ 225,312

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended	
	September 30, 2008	September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 13,975	$ 18,881
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,028	6,635
Provision for loan and lease losses	14,213	6,769
Net amortization of premium on securities	(330)	143
Securities gains, net	(1,015)	(303)
Increase in trading account securities	(74)	(471)
Loss on impairment of securities	4,804	-
Stock-based compensation	876	1,183
Loans originated for sale	(203,758)	(233,626)
Proceeds on sales of loans	207,904	241,460
Net gains on sales of loans	(1,279)	(2,051)
(Increase) decrease in accrued interest receivable	1,538	(422)
Decrease in accrued interest payable	(3,626)	(745)
Other, net	(12,847)	(16,702)
Net cash provided by operating activities – continuing operations	27,409	20,751
Net cash provided by operating activities – discontinued operations	-	10
NET CASH PROVIDED BY OPERATING ACTIVITIES	27,409	20,761
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from the sale of securities available for sale	131,482	36,897
Proceeds from the maturity of and principal paydowns on securities available for sale	133,869	118,820
Proceeds from the maturity of and principal paydowns on securities held to maturity	121	24
Purchase of securities available for sale	(337,576)	(183,024)
Purchase of securities held to maturity	(18,782)	(1,157)
Net increase in loans and leases	(92,645)	(121,548)
Purchase of bank owned life insurance policies	-	(20,500)
Capital expenditures	(6,544)	(16,925)
Proceeds on sale of OREO and other repossessed assets	1,349	359
Net cash used by investing activities – continuing operations	(188,726)	(187,054)
Net cash provided by investing activities – discontinued operations	-	22,631
NET CASH USED BY INVESTING ACTIVITIES	(188,726)	(164,423)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand deposits and savings accounts	179,022	38,824
Net increase in time deposit accounts	12,586	101,509
Net decrease in short-term borrowings	(177,603)	(17,061)
Proceeds from other borrowings	221,972	62,114
Repayments of other borrowings	(45,433)	(17,921)
Purchase of treasury stock	(6,126)	(7,832)
Proceeds from issuance of common stock	1,723	2,568
Excess tax benefits on exercised stock options	266	845
Dividends paid	(4,848)	(4,411)

Net cash provided by financing activities – continuing operations		181,559		158,635
Net cash used by financing activities – discontinued operations		-		(32,525)
NET CASH PROVIDED BY FINANCING ACTIVITIES		181,559		126,110
Net increase (decrease) in cash and cash equivalents		20,242		(17,552)
Cash and cash equivalents at beginning of year		46,832		49,143
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	67,074	$	31,591
Supplemental disclosures:				
Cash paid for income/franchise taxes	$	7,646	$	16,668
Cash paid for interest	$	69,612	$	80,377
Securities transferred from available for sale to trading	$	541	$	-
Acquisition:				
Net assets acquired	$	-	$	650
Cash paid for acquisition	$	-	$	(50)
Cash acquired		-		-
Net cash paid for acquisition	$	-	$	(50)

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, 2007, included in Heartland Financial USA, Inc.'s ("Heartland") Form 10-K filed with the Securities and Exchange Commission on March 17, 2008. 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 September 30, 2008, are not necessarily indicative of the results expected for the year ending December 31, 2008.

Earnings Per Share

Basic earnings per share is determined using net income and weighted average common shares outstanding. Diluted earnings per share is computed by dividing net income 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 nine-month periods ended September 30, 2008 and 2007, are shown in the tables below:

	Three Months Ended	
(Dollars and numbers in thousands, except per share data)	Sept. 30, 2008	Sept. 30, 2007
Net income	$ 3,005	$ 6,925
Weighted average common shares outstanding for basic earnings per share	16,264	16,447
Assumed incremental common shares issued upon exercise of stock options	91	97
Weighted average common shares for diluted earnings per share	16,355	16,544
Earnings per common share – basic	$ 0.18	$ 0.42
Earnings per common share – diluted	$ 0.18	$ 0.42

	Nine Months Ended	
(Dollars and numbers in thousands, except per share data)	Sept. 30, 2008	Sept. 30, 2007
Income from continuing operations	$ 13,975	$ 17,210
Income from discontinued operations	-	1,671
Net income	$ 13,975	$ 18,881
Weighted average common shares outstanding for basic earnings per share	16,315	16,487
Assumed incremental common shares issued upon exercise of stock options	77	133
Weighted average common shares for diluted earnings per share	16,392	16,620
Earnings per common share – basic	$ 0.86	$ 1.15
Earnings per common share – diluted	$ 0.85	$ 1.14
Earnings per common share from continuing operations – basic	$ 0.86	$ 1.04

Earnings per common share from continuing operations – diluted	$	0.85	$	1.04
Earnings per common share from discontinued operations – basic	$	-	$	0.10
Earnings per common share from discontinued operations – diluted	$	-	$	0.10

Stock-Based Compensation

Options are typically granted annually with an expiration date ten years after the date of grant. Vesting is 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. The 2008 standard stock option agreement provides that the options become fully exercisable and expire if not exercised within six months of the date of retirement at age 65 or later. Prior period stock option agreements included early retirement provisions at age 55 provided that the officer has provided ten years of service to Heartland. A summary of the status of the stock options as of September 30, 2008 and 2007, and changes during the nine months ended September 30, 2008 and 2007, follows:

	2008		2007	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at January 1	733,012	$ 18.61	815,300	$ 14.46
Granted	164,400	18.60	146,750	29.65
Exercised	(98,549)	11.56	(194,788)	9.86
Forfeited	(16,000)	24.96	(14,500)	25.24
Outstanding at September 30	782,863	$ 19.36	752,762	$ 18.40
Options exercisable at September 30	277,713	$ 13.60	300,554	$ 11.60
Weighted-average fair value of options granted during the nine-month periods ended September 30	$ 4.81		$ 7.69	

At September 30, 2008, the vested options totaled 277,713 shares with a weighted average exercise price of $13.60 per share and a weighted average remaining contractual life of 3.79 years. The intrinsic value for the vested options as of September 30, 2008, was $3.2 million. The intrinsic value for the total of all options exercised during the nine months ended September 30, 2008, was $1.3 million, and the total fair value of shares vested during the nine months ended September 30, 2008, was $876 thousand. At September 30, 2008, shares available for issuance under the 2005 Long-Term Incentive Plan totaled 474,810.

The fair value of the 2008 and 2007 stock options granted was estimated utilizing the Black Scholes valuation model. The fair value of a share of common stock on the grant date of the 2008 options was $18.60. The fair value of a share of common stock on the grant date of the 2007 options was $27.85. Significant assumptions include:

	2008	2007
Risk-free interest rate	3.10%	4.74%
Expected option life	6.4 years	6.2 years
Expected volatility	26.96%	24.20%
Expected dividends	1.99%	1.25%

The option term of each award granted was based upon Heartland's historical experience of employees' exercise behavior. Expected volatility was based upon historical volatility levels and future expected volatility of Heartland's common stock. Expected dividend yield was based on a set dividend rate. Risk free interest rate reflects the average of the yields on the 5 year and 7 year zero coupon U.S. Treasury bond. Cash received from options exercised for the nine months ended September 30, 2008, was $1.1 million, with a related tax benefit of $266 thousand. Cash received from options exercised for the nine months ended September 30, 2007, was $1.9 million, with a related tax benefit of $845 thousand.

Total compensation costs recorded were $864 thousand and $1.2 million for the nine months ended September 30, 2008 and 2007, respectively, for stock options, restricted stock awards and shares to be issued under the 2006 Employee Stock Purchase Plan. As of September 30, 2008, there was $2.8 million of total unrecognized compensation costs related to the 2005 Long-Term Incentive Plan for stock options and restricted stock awards which is expected to be recognized through 2012.

Fair Value Measurements

On January 1, 2008, Heartland adopted Statement of Financial Accounting Standards No. 157 (“FAS 157”), Fair Value Measurements. FAS 157 defines fair value, establishes a framework for measuring fair value under U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. FAS 157 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances. Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FAS 157 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. FAS 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. Under FAS 157, Heartland bases fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For assets and liabilities recorded at fair value, it is Heartland’s policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in FAS 157.

Fair value measurements for assets and liabilities where there exists limited or no observable market data, and therefore, are based primarily upon estimates, are often calculated based upon current pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other such factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values. Additional information regarding disclosures of fair value is presented in Note 5.

Heartland will apply the fair value measurement and disclosure provisions of FAS 157 effective January 1, 2009, to nonfinancial assets and nonfinancial liabilities measured on a nonrecurring basis. Heartland measures the fair value of the following on a nonrecurring basis: (1) long-lived assets, (2) foreclosed assets, (3) goodwill and other intangibles and (4) indefinite-lived assets.

Effect of New Financial Accounting Standards

In September 2006, the Emerging Issues Task Force Issue 06-4 (“EITF 06-4”), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements, was ratified. EITF 06-4 addresses accounting for separate agreements which split life insurance policy benefits between an employer and employee and requires the employer to recognize a liability for future benefits payable to the employee under these agreements. The effects of applying EITF 06-4 must be recognized through either a change in accounting principle through an adjustment to equity or through the retrospective application to all prior periods. For calendar year companies, EITF 06-4 is effective beginning January 1, 2008. Heartland adopted EITF 06-4 on January 1, 2008, which resulted in a $791 thousand adjustment to Heartland’s equity on January 1, 2008.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (“FAS 159”), The Fair Value Option for Financial Assets and Financial Liabilities, which allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, FAS 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. FAS 159 is effective for all financial statements issued for fiscal years beginning after November 15, 2007. Heartland adopted FAS 159 on January 1, 2008, and the adoption did not have an impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised 2007) Business Combinations (“SFAS No. 141R”) and Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (“SFAS No. 160”). SFAS No. 141R and SFAS No. 160 require significant changes in the accounting and reporting for business acquisitions and the reporting of a noncontrolling interest in a subsidiary. Among many changes under SFAS No. 141R, an acquirer will record 100% of all assets and liabilities at fair value at the acquisition date with changes possibly recognized in earnings, and acquisition related costs will be expensed rather than capitalized. SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary. Key changes under the standard are that noncontrolling interests in a subsidiary will be reported as part of equity, losses allocated to a noncontrolling interest can result in a deficit balance, and changes in ownership interests that do not result in a change of control are accounted for as equity transactions and upon a loss of control, gain or loss is recognized and the remaining interest is remeasured at fair value on the date control is lost. SFAS No. 141R and SFAS No. 160 apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is not permitted. Heartland will adopt these statements on January 1, 2009.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (“FAS 161”), Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133, which changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. FAS 161 is effective for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Heartland is currently evaluating the impact of FAS 161 on its consolidated financial statement disclosures.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162 (“FAS 162”), The Hierarchy of Generally Accepted Accounting Principles, which identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented inconformity with GAAP in the United States (the “U.S. GAAP hierarchy”). The current U.S. GAAP hierarchy is set forth in the American Institute of Certified Public Accountants Statement of Auditing Standard No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The FASB has concluded that the U.S. GAAP hierarchy should reside in the accounting literature established by the FASB and issued FAS 162 to achieve that result. FAS 162 is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to Interim Auditing Standards AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. Heartland does not expect the adoption of FAS 162 to have an impact on its consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1 (“FSP EITF 03-6-1”), Determining Whether Instruments Granted In Share-Based Payment Transactions Are Participating Securities, which clarified that all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders. Awards of this nature are considered participating securities and the two-class method of computing basic and diluted earnings per share must be applied. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented shall be adjusted retrospectively. Early application is not permitted. Heartland does not expect the adoption of FSP EITF 03-6-1 to have an impact on its consolidated financial statements as none of its unvested restricted stock participates with common shareholders in dividends declared and paid.

In October 2008, the FASB issued FASB Staff Position No. 157-3 (“FAS 157-3”), Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, which clarifies the application of FAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective upon issuance, including prior periods for which financial statements have not been issued. Heartland adopted this guidance effective September 30, 2008, and the adoption did not have an impact on its consolidated financial statements.

The SEC released Staff Accounting Bulletin No. 109 (“SAB No. 109”) in November 2007. SAB No. 109 provides guidance on written loan commitments that are accounted for at fair value through earnings. SAB No. 109 supersedes SAB No. 105 which provided guidance on derivative loan commitments pursuant to SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”. SAB No. 105 stated that in measuring the fair value of a derivative loan commitment it would be inappropriate to incorporate the expected net future cash flows related to the associated servicing of the loan. SAB No. 109, consistent with the guidance in SFAS No. 156 and SFAS No. 159, requires that expected net future cash flows related to the associated servicing of the loan be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB No. 109 is effective for fiscal quarters beginning after December 15, 2007. Heartland adopted SAB No. 109 on January 1, 2008, and the adoption of this issue did not have a material impact on its consolidated financial statements.

NOTE 2: CORE DEPOSIT PREMIUM AND OTHER INTANGIBLE ASSETS

The gross carrying amount of intangible assets and the associated accumulated amortization at September 30, 2008, and December 31, 2007, are presented in the table below, in thousands:

	September 30, 2008		December 31, 2007	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles	$ 9,757	$ 6,882	$ 9,757	$ 6,252
Mortgage servicing rights	7,641	3,058	6,505	2,592
Customer relationship intangible	1,177	303	1,177	226
Total	$ 18,575	$ 10,243	$ 17,439	$ 9,070
Unamortized intangible assets		$ 8,332		$ 8,369

Projections of amortization expense for mortgage servicing rights are based on existing asset balances and the existing interest rate environment as of September 30, 2008. Heartland’s actual experience may be significantly different depending upon changes in mortgage interest rates and market conditions. There was no valuation allowance on mortgage servicing rights at September 30, 2008, or December 31, 2007. The fair value of Heartland’s mortgage servicing rights was estimated at $7.6 million and $6.4 million at September 30, 2008, and December 31, 2007, respectively.

The following table shows the estimated future amortization expense for amortized intangible assets, in thousands:

	Core Deposit Intangibles	Mortgage Servicing Rights	Customer Relationship Intangible	Total
Three months ending December 31, 2008	$ 216	$ 339	$ 26	$ 581
Year ending December 31,				
2009	748	1,212	102	2,062
2010	465	1,010	100	1,575
2011	450	808	99	1,357
2012	421	607	55	1,083
2013	405	404	45	854
Thereafter	170	203	447	820

NOTE 3: SHORT-TERM BORROWINGS

On April 28, 2008, Heartland’s credit agreement was renewed with two of the four unaffiliated banks, which resulted in a reduction in the amount Heartland could borrow at any one time under this unsecured revolving credit line from $60.0 million to $40.0 million. On June 30, 2008, an additional unaffiliated bank was added to this credit agreement and thereby increased the amount Heartland may borrow at any one time back to $60.0 million.

NOTE 4: DERIVATIVE FINANCIAL INSTRUMENTS

On occasion, Heartland uses derivative financial instruments as part of its interest rate risk management, including interest rate swaps, caps, floors and collars. Heartland’s objectives in using derivatives are to add stability to its net interest margin and to manage its exposure to movements in interest rates.

To reduce the potentially negative impact a downward movement in interest rates would have on its interest income, Heartland entered into the following two transactions. On April 4, 2006, Heartland entered into a three-year interest rate collar transaction with a notional amount of $50.0 million. The collar was effective on April 4, 2006, and matures on April 4, 2009. Heartland is the payer on prime at a cap strike rate of 8.95% and the counterparty is the payer on prime at a floor strike rate of 7.00%. As of September 30, 2008, and December 31, 2007, the fair market value of this collar transaction was recorded as an asset of $502 thousand and $391 thousand, respectively.

On September 19, 2005, Heartland entered into a five-year interest rate collar transaction on a notional amount of $50.0 million. The collar has an effective date of September 21, 2005, and a maturity date of September 21, 2010. Heartland is the payer on prime at a cap strike rate of 9.00% and the counterparty is the payer on prime at a floor strike rate of 6.00%. As of September 30, 2008, and December 31, 2007, the fair market value of this collar transaction was recorded as an asset of $741 thousand and $387 thousand, respectively.

For accounting purposes, the two collar transactions above are designated as cash flow hedges of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Heartland's prime-based loans that reset whenever prime changes. The hedged transactions for the two hedging relationships are designated as the first prime-based interest payments received by Heartland each calendar month during the term of the collar that, in aggregate for each period, are interest payments on principal from specified portfolios equal to the notional amount of the collar.

Prepayments in the hedged loan portfolios are treated in a manner consistent with the guidance in SFAS 133 Implementation Issue No. G25, Cash Flow Hedges: Using the First-Payments-Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans, which allows the designated forecasted transactions to be the variable, prime-rate-based interest payments on a rolling portfolio of prepayable interest-bearing loans using the first-payments-received technique, thereby allowing interest payments from loans that prepay to be replaced with interest payments from new loan originations. Based on Heartland's assessments, both at inception and throughout the life of the hedging relationship, it is probable that sufficient prime-based interest receipts will exist through the maturity dates of the collars.

To reduce the potentially negative impact an upward movement in interest rates would have on its net interest income, Heartland entered into the following four cap transactions. For accounting purposes, these four cap transactions are designated as cash flow hedges of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, above the cap strike rate associated with the interest payments made on $65.0 million of Heartland's subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) that reset quarterly on a specified reset date. At inception, Heartland asserted that the underlying principal balance will remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments will exist through the maturity date of the caps.

The first transaction executed was a twenty-three month interest rate cap transaction on a notional amount of $20.0 million. The cap has an effective date of February 1, 2007, and a maturity date of January 7, 2009. Should 3-month LIBOR exceed 5.5% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest deferral feature that is mirrored in the cap transaction. As of September 30, 2008, and December 31, 2007, this cap transaction had no fair market value.

The second transaction executed on February 1, 2007, was a twenty-five month interest rate cap transaction on a notional amount of $25.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap has an effective date of February 1, 2007, and a maturity date of March 17, 2009. Should 3-month LIBOR exceed 5.5% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest rate deferral feature that is mirrored in the cap transaction. As of September 30, 2008, and December 31, 2007, this cap transaction had no fair market value.

The third transaction executed on January 15, 2008, was a fifty-five month interest rate cap transaction on a notional amount of $20.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap has an effective date of January 15, 2008, and a maturity date of September 1, 2012. Should 3-month LIBOR exceed 5.12% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.12%. The floating-rate subordinated debentures contain an interest rate deferral feature that is mirrored in the cap transaction. As of September 30, 2008, the fair market value of this cap transaction was recorded as an asset of $230 thousand.

The fourth transaction executed on March 27, 2008, was a twenty-eight month interest rate cap transaction on a notional amount of $20.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap has an effective date of January 7, 2009, and a maturity date of April 7, 2011. Should 3-month LIBOR exceed 5.5% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest rate deferral feature that is mirrored in the cap transaction. As of September 30, 2008, the fair market value of this cap transaction was recorded as an asset of $59 thousand.

For both the collar and cap transactions described above, the effective portion of changes in the fair values of the derivatives is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings (interest income on loans or interest expense on borrowings) when the hedged transactions affect earnings. Ineffectiveness resulting from the hedging relationship, if any, is recorded as a gain or loss in earnings as part of noninterest income. Heartland uses the “Hypothetical Derivative Method” described in SFAS 133 Implementation Issue No. G20, Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge, for its quarterly prospective and retrospective assessments of hedge effectiveness, as well as for measurements of hedge ineffectiveness. All components of the derivative instruments’ change in the fair value were included in the assessment of hedge effectiveness. No ineffectiveness was recognized for the cash flow hedge transactions for the nine months ended September 30, 2008.

A portion of the September 19, 2005, collar transaction did not meet the retrospective hedge effectiveness test at March 31, 2008. The failure was on a portion of the $50.0 million notional amount. That portion, $14.3 million, was designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Dubuque Bank and Trust Company’s prime-based loans. The failure of this hedge relationship was caused by paydowns which reduced the designated loan pool from $14.3 million to $9.6 million. This hedge failure resulted in the recognition of a gain of $198 thousand during the quarter ended March 31, 2008, which consists of the mark to market gain on the collar transaction of $212 thousand and a reclassification of unrealized losses out of other comprehensive income to earnings of $14 thousand. During the quarter ended June 30, 2008, the mark to market adjustment on this collar transaction was recorded as a loss of $173 thousand. During the quarter ended September 30, 2008, the mark to market adjustment on this collar transaction was recorded as a gain of $63 thousand.

For the nine months ended September 30, 2008, the change in net unrealized gains of $563 thousand for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in stockholders’ equity, before income taxes of $203 thousand. For the nine months ended September 30, 2007, the change in net unrealized losses of $235 thousand for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in shareholders’ equity, before income taxes of $87 thousand.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received or made on Heartland’s variable-rate assets and liabilities. For the nine months ended September 30, 2008, the change in net unrealized losses on cash flow hedges reflects a reclassification of $63 thousand of net unrealized losses from accumulated other comprehensive income to interest income or interest expense. For the next twelve months, Heartland estimates that an additional $84 thousand will be reclassified from accumulated other comprehensive income to interest income.

By using derivatives, Heartland is exposed to credit risk if counterparties to derivative instruments do not perform as expected. Heartland minimizes this risk by entering into derivative contracts with large, stable financial institutions and Heartland has not experienced any losses from counterparty nonperformance on derivative instruments. Furthermore, Heartland also periodically monitors counterparty credit risk in accordance with the provisions of SFAS 133.

NOTE 5: FAIR VALUE

Heartland utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale, trading securities and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, Heartland may be required to record at fair value other assets on a non-recurring basis such as loans held for sale, loans held to maturity and certain other assets including, but not limited to, mortgage servicing rights. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Fair Value Hierarchy

Under FAS 157, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments in active markets.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, or similar instruments in markets that are not active, and model-based valuation techniques for all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following is a description of valuation methodologies used for assets recorded at fair value and for estimation of fair value for financial instruments not recorded at fair value.

Assets

Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury and other U.S. government and agency securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include agency mortgage-backed securities and private collateralized mortgage obligations, municipal bonds and corporate debt securities. Level 3 securities consist primarily of auction rate securities. Heartland has utilized auction rate securities in previous periods as a higher-yielding alternative investment for fed funds. Heartland purchased $10.7 million of auction rate securities in February of 2008. This portfolio consisted of securities issued by various state governmental entities and includes securities backed by student loans that are guaranteed under the Federal Family Education Loan Program. Auction rate securities are primarily debt instruments with long-term maturities for which interest rates are reset periodically through an auction process, which typically occurs every 28 days. The auction process results in the interest rate being reset on the underlying securities until the next reset or auction date. A failed auction occurs when there are insufficient bids for the number of instruments being offered. Upon a failed auction, the then present holders of the instruments continue to hold them and the instrument carries an interest rate based upon certain predefined formulas. In February 2008, the market for these securities began to show signs of illiquidity as auctions for several securities failed on their scheduled auction dates. Shortly thereafter, liquidity left the market causing the traditional auction process to fail. As a result, Heartland was not able to access these funds until the securities were redeemed by the issuer. Due to the illiquidity in the market for auction rate securities, Heartland had classified these investments as Level 3 for purposes of reporting under FAS 157. In April 2008, $1.0 million of the $10.7 million was redeemed at par value and in September 2008, the remaining $9.7 million was redeemed at par value. All of the related auction rate securities paid interest as defined by the predetermined formula. The remaining $200 thousand of securities classified as Level 3 is related to an investment in a partnership.

Trading Assets

Trading assets are recorded at fair value and consist of securities held for trading purposes. The valuation method for trading securities is the same as the methodology used for securities classified as available for sale.

Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, Heartland classifies loans held for sale subjected to nonrecurring fair value adjustments as Level 2.

Loans Held to Maturity

Heartland does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Under Heartland’s credit policies, all nonaccrual loans are defined as impaired loans. Once a loan is identified as individually impaired, management measures impairment in accordance with FAS 114, Accounting by Creditors for Impairment of a Loan. 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. Heartland’s allowance methodology requires specific reserves for all impaired loans. At September 30, 2008, substantially all of the total impaired loans were based on the fair value of the collateral. In accordance with FAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, Heartland records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, Heartland records the impaired loan as nonrecurring Level 3.

Derivative Financial Instruments

Currently, Heartland uses interest rate caps, floors and collars to manage its interest rate risk. The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair values of interest rate options are determined using the market standard methodology of discounting the future expected cash receipts that would occur if variable interest rates fell below (rise above) the strike rate of the floors (caps). The variable interest rates used in the calculation of projected receipts on the floor (cap) are based on an expectation of future interest rates derived from observable market interest rate curves and volatilities. To comply with the provisions of FAS No. 157, Heartland incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, Heartland has considered the impact of netting any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees.

Although Heartland has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of September 30, 2008, Heartland has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, Heartland has determined that its derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

Mortgage Servicing Rights

Mortgage servicing rights are subject to impairment testing. The carrying values of these rights are reviewed quarterly for impairment based upon the calculation of fair value as performed by an outside third party. For purposes of measuring impairment, the rights are stratified into certain risk characteristics including note type, note rate, prepayment trends and external market factors. If the valuation model reflects a value less than the carrying value, mortgage servicing rights are adjusted to fair value through a valuation allowance. As such, Heartland classifies mortgage servicing rights subjected to nonrecurring fair value adjustments as Level 2.

The table below presents, in thousands, Heartland's assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2008, aggregated by the level in the fair value hierarchy within which those measurements fall:

	Total Fair Value Sept. 30, 2008	Level 1	Level 2	Level 3
Trading securities	$ 1,962	$ 1,962	$ -	$ -
Available-for-sale securities	733,820	113,320	620,300	200
Derivative assets	1,244	-	1,244	-
Total assets at fair value	$ 737,026	$ 115,282	$ 621,544	$ 200

The changes in Level 3 assets that are measured at fair value on a recurring basis are summarized in the following table, in thousands:

	Fair Value
Balance at January 1, 2008	$ 200
Purchases	10,700
Redemptions	(10,700)
Balance at September 30, 2008	$ 200

The table below presents Heartland’s assets measured at fair value on a nonrecurring basis, in thousands:

	Carrying Value at September 30, 2008				Nine Months Ended Sept. 30, 2008
	Total	Level 1	Level 2	Level 3	Total Losses
Impaired loans	$ 23,890	$ -	$ -	$ 23,890	$ 4,147

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

SAFE HARBOR STATEMENT

This document (including information incorporated by reference) contains, and future oral and written statements of Heartland and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of Heartland. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of Heartland's management and on information currently available to management, are generally identifiable by the use of words such as "believe", "expect", "anticipate", "plan", "intend", "estimate", "may", "will", "would", "could", "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and Heartland undertakes no obligation to update any statement in light of new information or future events.

Heartland's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors which could have a material adverse effect on the operations and future prospects of Heartland and its subsidiaries are detailed in the "Risk Factors" section included under Item 1A. of Part I of Heartland's 2007 Form 10-K filed with the Securities and Exchange Commission on March 17, 2008. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

CRITICAL ACCOUNTING POLICIES

The process utilized by Heartland to estimate the adequacy of the allowance for loan and lease losses is considered a critical accounting policy for Heartland. The allowance for loan and lease losses represents management's estimate of identified and unidentified probable losses in the existing loan portfolio. Thus, the accuracy of this estimate could have a material impact on Heartland's earnings. The adequacy of the allowance for loan and lease losses is determined using factors that include the overall composition of the loan portfolio, general economic conditions, types of loans, loan collateral values, past loss experience, loan delinquencies, and potential losses from identified substandard and doubtful credits. Nonperforming loans and large non-homogeneous loans are specifically reviewed for impairment and the allowance is allocated on a loan by loan basis as deemed necessary. Homogeneous loans and loans not specifically evaluated are grouped into pools to which a loss percentage, based on historical experience, is allocated. The adequacy of the allowance for loan and lease losses is monitored on an ongoing basis by the loan review staff, senior management and the banks' boards of directors. Specific factors considered by management in establishing the allowance included the following:

* Heartland has continued to experience growth in more complex commercial loans as compared to relatively lower-risk residential real estate loans.

* During the last several years, Heartland has entered new geographical markets in which it had little or no previous lending experience.

* Heartland has experienced an increase in net charge-offs and nonperforming loans during the most recent quarters.

There can be no assurances that the allowance for loan and lease losses will be adequate to cover all loan losses, but management believes that the allowance for loan and lease losses was adequate at September 30, 2008. While management uses available information to provide for loan and lease losses, the ultimate collectibility of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions. Should the economic climate continue to deteriorate, borrowers may experience difficulty, and the level of nonperforming loans, charge-offs, and delinquencies could rise and require further increases in the provision for loan and lease losses. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan and lease losses carried by the Heartland subsidiaries. Such agencies may require Heartland to make additional provisions to the allowance based upon their judgment about information available to them at the time of their examinations.

GENERAL

Heartland's results of operations depend primarily on net interest income, which is the difference between interest income from interest earning assets and interest expense on interest bearing liabilities. Noninterest income, which includes service charges and fees, trust income, brokerage and insurance commissions and gains on sale of loans, also affects Heartland's results of operations. Heartland's principal operating expenses, aside from interest expense, consist of compensation and employee benefits, occupancy and equipment costs and provision for loan and lease losses.

Net income was $3.0 million, or $0.18 per diluted share, for the quarter ended September 30, 2008, compared to $6.9 million, or $0.42 per diluted share, earned during the third quarter of 2007. Return on average equity was 5.26 percent and return on average assets was 0.35 percent for the third quarter of 2008, compared to 12.72 percent and 0.86 percent, respectively, for the same quarter in 2007.

Earnings for the third quarter of 2008 were significantly impacted by the provision for loan losses, which was $7.1 million for the third quarter of 2008 compared to $575 thousand for the third quarter of 2007. This increase in the loan loss provision was due, in large part, to the continued softening of the economy and reduced real estate values, particularly in the Phoenix market. Earnings in the third quarter of 2008 were also negatively impacted by a $4.6 million impairment loss on Fannie Mae preferred stock, which was offset by a $5.2 million gain on the sale of Heartland's merchant bankcard processing services.

Net interest margin was 3.96 percent during the third quarter of 2008, the third straight quarter that net interest margin improved. During the third quarter of 2008, net interest income on a tax-equivalent basis increased $2.7 million or 10 percent compared to the same quarter in 2007. Average earning assets increased $209.4 million or 7 percent during the comparable quarterly periods. Noninterest income remained at $7.9 million during both the third quarter of 2008 and 2007. In addition to the $5.2 million gain on the sale of the merchant bankcard processing services, the other category showing notable improvement during the third quarter of 2008 was service charges and fees. The additional income in these categories was partially offset by $4.7 million of impairment losses on securities, decreased gains on sale of loans and a loss on the cash surrender value of bank owned life insurance. For the third quarter of 2008, noninterest expense increased $1.9 million or 8 percent from the same period in 2007. The largest component of noninterest expense, salaries and employee benefits, increased $699 thousand or 5 percent during the third quarter of 2008 compared to the third quarter of 2007. Occupancy expense increased during the quarter, primarily as a result of the opening of six new banking offices during 2007 and the 2008 opening of Heartland's 10th bank subsidiary, Minnesota Bank & Trust. The other category of noninterest expense that increased significantly during the third quarter of 2008 was outside services, resulting primarily from additional legal fees related to collection efforts on nonperforming loans and additional Federal Deposit Insurance Corporation ("FDIC") assessments as a majority of the FDIC credits at Heartland's bank subsidiaries were utilized during 2007.

Net income recorded for the first nine months of 2008 was $14.0 million, or $0.85 per diluted share, compared to $18.9 million, or $1.14 per diluted share, recorded during the first nine months of 2007. Return on average equity was 8.04 percent and return on average assets was 0.56 percent for the first nine months of 2008, compared to 11.89 percent and 0.80 percent, respectively, for the same period in 2007.

The 2007 results were impacted by the sale of Rocky Mountain Bank's branch banking office in Broadus, Montana, which was completed on June 22, 2007. The results of operations of the branch are reflected on the income statement as discontinued operations for the nine-month period ended on September 30, 2007, which included a $2.4 million pre-tax gain recorded as a result of the sale. Income from continuing operations during the first nine months of 2008 was $14.0 million, or $0.85 per diluted share, a decrease of $3.2 million or 19 percent over the $17.2 million, or $1.04 per diluted share, earned during the same period in 2007. The provision for loan losses for the nine-month comparative period was $14.2 million during 2008 compared to $6.8 million during 2007. The provision for loan losses increased as a result of loan growth, an increase in nonperforming loans and the impact historical losses have on the calculation of the adequacy of Heartland's allowance for loan and lease losses. The nine-month performance during 2008 was positively affected by increased net interest income and growth in noninterest income.

For the nine-month period ended September 30, 2008, net interest income on a tax-equivalent basis increased $4.7 million or 6 percent when compared to the same period in 2007. During this same nine-month comparative period, Heartland's average earning assets increased $198.2 million or 7 percent. Noninterest income increased $1.1 million or 4 percent over the same nine-month period in 2007. In addition to the $5.2 million gain on the sale of merchant bankcard processing services, noninterest income during the first nine months of 2008 was positively affected by growth in service charges and fees, loan servicing income, brokerage and insurance commissions and securities gains. The improvements in these categories were partially offset by $4.8 million of impairment losses on securities and increased losses on trading account securities, reduced gains on sale of loans and a loss in the cash surrender value of bank owned life insurance. For the nine-month comparative period in 2008, noninterest expense increased $3.8 million or 5 percent when compared to the same nine-month period in 2007. Again, the largest component of noninterest expense, salaries and employee benefits, grew by $1.8 million or 4 percent during this nine-month comparative period. Occupancy expense increased during the nine-month comparative periods, primarily as a result of the aforementioned expansion activities. The other category of noninterest expense that increased significantly during the 2008 nine-month period was outside services, resulting primarily from the aforementioned additional legal fees and FDIC assessments.

At September 30, 2008, total assets had increased $181.9 million or 7 percent annualized since year-end 2007. For the same period, total loans and leases increased $84.1 million or 5 percent annualized. This growth was primarily distributed among the commercial, agricultural and consumer loan categories at $39.8 million, $19.7 million and $25.0 million, respectively. In order to provide the investing community with a perspective on how the growth in both loans and deposits during the first nine months of the year equates to performance on an annualized basis, the growth rates on these two categories have been reflected as an annualized percentage throughout this report. These annualized numbers were calculated by multiplying the growth percentage for the first nine months of the year by 1.33.

Total deposits had grown by $191.6 million or 11 percent annualized since year-end 2007. Growth in deposits was weighted more heavily in Heartland's Western markets. Demand deposits experienced a decrease of $8.3 million or 3 percent annualized since year-end 2007. Savings deposit balances experienced an increase of $187.3 million or 29 percent annualized since year-end 2007. Time deposits, exclusive of brokered deposits, remained at $1.1 billion. At September 30, 2008, brokered time deposits totaled $81.9 million or 3 percent of total deposits compared to $69.0 million or 3 percent of total deposits at year-end 2007. A large portion of the growth in savings deposits is attributable to the January 2008 introduction of a new retail interest-bearing checking account product, the third quarter 2008 introduction of a premium money market account that featured a teaser interest rate of 5 percent through year-end 2008 and the conversion of several retail repurchase agreement sweep accounts to a new money market sweep product initially rolled out to business depositors during the second quarter of 2008.

NET INTEREST INCOME

Net interest margin, expressed as a percentage of average earning assets, was 3.96 percent during the third quarter of 2008 compared to 3.87 percent for the third quarter of 2007. For the nine-month periods ended on September 30, net interest margin, expressed as a percentage of average earning assets, was 3.92 percent during 2008 and 3.98 percent during 2007. Affecting the net interest margin throughout the second half of 2007 and first nine months of 2008 was the impact of foregone interest on Heartland's nonperforming loans, which had balances of $43.9 million at September

30, 2008, compared to $31.8 million at year-end 2007 and $30.4 million at September 30, 2007. Additionally, early in the third quarter of 2007, a $20.5 million investment was made in bank owned life insurance upon which interest expense associated with the funding of this investment is reflected in net interest margin while the corresponding earnings on this investment are recorded as noninterest income.

Net interest income on a tax-equivalent basis totaled $30.9 million during the third quarter of 2008, an increase of $2.7 million or 10 percent from the $28.2 million recorded during the third quarter of 2007. For the nine-month period during 2008, net interest income on a tax-equivalent basis was $89.3 million, an increase of $4.7 million or 6 percent from the $84.6 million recorded during the first nine months of 2007. These increases occurred as Heartland's interest bearing liabilities repriced downward more quickly than its interest bearing assets. Also contributing to these increases was the $209.4 million or 7 percent growth in average earning assets during the third quarter of 2008 compared to the same quarter in 2007 and the $198.2 million or 7 percent growth in average earning assets during the first nine months of 2008 compared to the same nine months of 2007.

On a tax-equivalent basis, interest income in the third quarter of 2008 totaled $52.0 million compared to $55.6 million in the third quarter of 2007, a decrease of $3.6 million or 7 percent. For the first nine months of 2008, interest income on a tax-equivalent basis decreased $8.9 million or 5 percent over the same period in 2007. Nearly half of the loans in Heartland's commercial and agricultural loan portfolios are floating rate loans that reprice immediately upon a change in the national prime interest rate, thus changes in the national prime rate impact interest income more quickly than if there were more fixed rate loans. The national prime interest rate was 8.25 percent for the first eight months of 2007. During the first nine months of 2008, the national prime interest rate decreased 225 basis points, ranging from 7.25 percent on January 1, 2008, to 5.00 percent on September 30, 2008. A large portion of Heartland's floating rate loans that reprice immediately have a floor interest rate which they have now met. Additionally, Heartland has two $50.0 million derivative transactions on the loan portfolio that are at their floor interest rates. Accordingly, management believes the negative impact of further reductions in the national prime interest rate on Heartland's interest income in future periods should be softened.

Interest expense for the third quarter of 2008 was $21.1 million compared to $27.4 million in the third quarter of 2007, a decrease of $6.3 million or 23 percent. On a nine-month comparative basis, interest expense decreased $13.6 million or 17 percent. Interest rates paid on Heartland's deposits and borrowings were significantly lower during the first nine months of 2008 compared to the first nine months of 2007. Through the third quarter, Heartland experienced a reduction in funding costs as higher rate certificates of deposit rolled over at lower rates. Management believes deposit costs will begin to level off as competitor banks seeking to improve their liquidity positions push rates upward. Approximately 51 percent of Heartland's certificate of deposit accounts, at a weighted average rate of 3.39 percent, will mature within the next six months.

Heartland attempts to manage its balance sheet to minimize the effect that a change in interest rates has on its net interest margin. Heartland plans to continue to work toward improving both its earning asset and funding mix through targeted organic growth strategies, which management believes will result in additional net interest income. Heartland's net interest income simulations reflect a well-balanced and manageable interest rate posture. Management supports a pricing discipline in which the focus is less on price and more on the unique value provided to business and retail clients. Item 3 of this Form 10-Q contains additional information about the results of Heartland's most recent net interest income simulations.

In order to reduce the potentially negative impact a downward movement in interest rates would have on net interest income on the loan portfolio, Heartland has certain derivative transactions currently open: a five-year collar transaction on a notional $50.0 million entered into in September 2005 and a three-year collar transaction on a notional $50.0 million entered into in April 2006. Additionally, in August 2006, Heartland entered into a leverage structured wholesale repurchase agreement transaction. This wholesale repurchase agreement in the amount of $50.0 million initially had a variable interest rate that reset quarterly to the 3-month LIBOR rate plus 29.375 basis points. Within this contract was an interest floor option that resulted when the 3-month LIBOR rate fell to 4.40 percent or lower. If that situation occurred, the rate paid would have been decreased by two times the difference between the 3-month LIBOR rate and 4.40 percent. In order to effectuate this wholesale repurchase agreement, a $55.0 million government agency bond was acquired. On the date of the contract, the interest rate on the securities was nearly equivalent to the interest rate being paid on the repurchase agreement contract. As the general level of interest rates declined during 2007, this transaction was restructured to reduce the risk of rising rates in the future. The unrealized gains were utilized to reduce the maximum rate to 3.06 percent until August 28, 2009, when it is callable. If not called, the funding will remain in place until November 28, 2010. Within this contract is an interest rate cap option that will reduce the interest rate being paid when the 3-month LIBOR rate exceeds 5.15 percent.

On February 1, 2007, Heartland entered into two interest rate cap transactions on a total notional amount of $45.0 million to reduce the potentially negative impact an upward rate environment would have on net interest income. These two-year contracts were acquired with the counterparty as the payer on 3-month LIBOR at a cap strike rate of 5.50 percent and were designated as a cash flow hedge against the LIBOR based variable-rate interest payments on Heartland’s subordinated debentures associated with two of its trust preferred capital securities. On January 15, 2008, Heartland entered into another interest rate cap transaction on a notional amount of $20.0 million to further reduce the potentially negative impact an upward rate environment would have on net interest income. This fifty-five month contract was acquired with the counterparty as the payer on 3-month LIBOR at a cap strike rate of 5.12 percent and was designated as a cash flow hedge against the LIBOR based variable-rate interest payments on Heartland’s subordinated debentures associated with another of its trust preferred capital securities. Additionally, on March 28, 2008, Heartland entered into a twenty-eight month interest rate cap transaction on a notional amount of $20.0 million to extend the maturity date on a portion of the February 2007 transactions. This cap has an effective date of January 7, 2009, and a maturity date of April 7, 2011. Should 3-month LIBOR exceed 5.5 percent on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.5 percent. Note 4 to the consolidated financial statements contains additional information about Heartland’s derivative transactions.

The table below sets forth certain information relating to Heartland’s average consolidated balance sheets and reflects the yield on average earning assets and the cost of average interest bearing liabilities for the periods indicated. Dividing income or expense by the average balance of assets or liabilities derives such yields and costs. Average balances are derived from daily balances. Nonaccrual loans and loans held for sale are included in each respective loan category.

ANALYSIS OF AVERAGE BALANCES, TAX EQUIVALENT YIELDS AND RATES1
For the quarters ended September 30, 2008 and 2007
(Dollars in thousands)

	2008			2007		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
EARNING ASSETS						
Securities:						
Taxable	$ 622,376	$ 8,228	5.26%	$ 474,366	$ 5,446	4.55%
Nontaxable1	153,996	2,441	6.31	136,834	2,271	6.58
Total securities	776,372	10,669	5.47	611,200	7,717	5.01
Interest bearing deposits	654	3	1.82	764	2	1.04
Federal funds sold	18,419	85	1.84	24,180	310	5.09
Loans and leases:						
Commercial and commercial real estate1	1,651,002	26,910	6.48	1,609,044	31,757	7.83
Residential mortgage	223,267	3,570	6.36	239,447	4,069	6.74
Agricultural and agricultural real estate1	241,541	4,191	6.90	227,630	4,650	8.10
Consumer	216,651	5,081	9.33	199,823	5,351	10.62
Direct financing leases, net	7,078	105	5.90	11,320	171	5.99
Fees on loans	-	1,356	-	-	1,589	-
Less: allowance for loan and lease losses	(34,776)	-	-	(32,647)	-	-
Net loans and leases	2,304,763	41,213	7.11	2,254,617	47,587	8.37
Total earning assets	3,100,208	$ 51,970	6.67%	2,890,761	$ 55,616	7.63%
NONEARNING ASSETS	298,991			285,954		
TOTAL ASSETS	$ 3,399,199			$ 3,176,715		
INTEREST BEARING LIABILITIES						
Interest bearing deposits						
Savings	$ 981,108	$ 4,777	1.94%	$ 850,988	$ 6,021	2.81%
Time, $100,000 and over	374,170	3,527	3.75	305,748	3,848	4.99
Other time deposits	759,999					