HEARTLAND FINANCIAL USA INC
Form 10-Q
August 08, 2013

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, 2013

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 7, 2013, the Registrant had outstanding 16,934,726 shares of common stock, $1.00 par value per share.

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

PART I

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

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Cash and due from banks	$105,127	$160,223
Federal funds sold and other short-term investments	6,970	7,831
Cash and cash equivalents	112,097	168,054
Time deposits in other financial institutions	3,605	—
Securities:		
Trading, at fair value	956	380
Available for sale, at fair value (cost of $1,533,939 at June 30, 2013, and $1,472,565 at December 31, 2012)	1,522,418	1,506,075
Held to maturity, at cost (fair value of $55,195 at June 30, 2013, and $55,982 at December 31, 2012)	55,199	55,502
Loans held for sale	88,541	96,165
Loans and leases receivable:		
Held to maturity	2,832,377	2,821,549
Loans covered by loss share agreements	6,275	7,253
Allowance for loan and lease losses	(37,623)	(38,715)
Loans and leases receivable, net	2,801,029	2,790,087
Premises, furniture and equipment, net	129,938	128,294
Other real estate, net	34,763	35,822
Goodwill	30,627	30,627
Other intangible assets, net	22,056	18,486
Cash surrender value on life insurance	75,992	75,480
FDIC indemnification asset	282	749
Other assets	82,253	84,832
TOTAL ASSETS	$4,959,756	$4,990,553
LIABILITIES AND EQUITY		
LIABILITIES:		
Deposits:		
Demand	$1,029,784	$974,232
Savings	1,978,962	2,004,438
Time	832,388	866,990
Total deposits	3,841,134	3,845,660
Short-term borrowings	339,181	224,626
Other borrowings	336,332	389,025
Accrued expenses and other liabilities	47,974	126,703
TOTAL LIABILITIES	4,564,621	4,586,014
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 16,947,138 shares at June 30, 2013 and 16,827,835 shares at December 31, 2012)	16,947	16,828
Capital surplus	52,710	50,359
Retained earnings	254,332	236,279
Accumulated other comprehensive income (loss)	(10,200)	16,641
Treasury stock at cost (12,977 shares at June 30, 2013, and 0 shares at December 31, 2012)	(352)	—
TOTAL STOCKHOLDERS' EQUITY	395,135	401,805
Noncontrolling interest	—	2,734
TOTAL EQUITY	395,135	404,539
TOTAL LIABILITIES AND EQUITY	$4,959,756	$4,990,553

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		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
INTEREST INCOME:				
Interest and fees on loans and leases	$39,726	$39,382	$79,553	$77,781
Interest on securities:				
Taxable	4,712	5,026	9,371	12,598
Nontaxable	3,360	2,619	6,558	4,890
Interest on federal funds sold	—	1	—	1
Interest on interest bearing deposits in other financial institutions	2	2	6	2
TOTAL INTEREST INCOME	47,800	47,030	95,488	95,272
INTEREST EXPENSE:				
Interest on deposits	5,066	5,604	10,142	11,379
Interest on short-term borrowings	108	224	256	437
Interest on other borrowings (includes $524 and $1,029 of interest expense related to derivatives reclassified from accumulated other comprehensive income for the three and six months ended June 30, 2013, respectively)	3,702	4,025	7,499	8,086
TOTAL INTEREST EXPENSE	8,876	9,853	17,897	19,902
NET INTEREST INCOME	38,924	37,177	77,591	75,370
Provision for loan and lease losses	1,862	3,000	2,499	5,354
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	37,062	34,177	75,092	70,016
NONINTEREST INCOME:				
Service charges and fees	4,280	3,712	8,288	7,296
Loan servicing income	4,106	3,056	7,477	4,816
Trust fees	2,942	2,660	5,846	5,273
Brokerage and insurance commissions	1,087	939	2,038	1,849
Securities gains, net (includes $2,067 and $5,494 of net security gains reclassified from accumulated other comprehensive income for the three and six months ended June 30, 2013, respectively)	2,067	4,951	5,494	8,894
Gain on trading account securities	262	49	576	46
Impairment loss on securities	—	—	—	(981)
Gains on sale of loans	9,083	12,689	18,995	21,191
Valuation adjustment on mortgage servicing rights	—	(194)	496	(181)
Income on bank owned life insurance	315	267	720	749
Other noninterest income	716	149	1,396	2,714
TOTAL NONINTEREST INCOME	24,858	28,278	51,326	51,666
NONINTEREST EXPENSES:				
Salaries and employee benefits	29,516	25,384	59,256	49,380
Occupancy	3,224	2,534	6,409	5,016
Furniture and equipment	2,065	1,517	4,116	2,963
Professional fees	4,233	3,961	7,776	6,721
FDIC insurance assessments	861	807	1,763	1,671
Advertising	1,248	1,304	2,476	2,375

Intangible assets amortization	198	122	398	253
Net loss on repossessed assets	2,477	1,307	3,817	4,211
Other noninterest expenses	4,944	4,523	9,502	9,009
TOTAL NONINTEREST EXPENSES	48,766	41,459	95,513	81,599
INCOME BEFORE INCOME TAXES	13,154	20,996	30,905	40,083
Income taxes (includes $576 and $1,665 of income tax expense reclassified from accumulated other comprehensive income for the three and six months ended June 30, 2013, respectively)	3,598	7,032	8,797	13,304
NET INCOME	9,556	13,964	22,108	26,779
Net (income) loss available to noncontrolling interest, net of tax	—	(7)	(64)	19
NET INCOME ATTRIBUTABLE TO HEARTLAND	9,556	13,957	22,044	26,798
Preferred dividends and discount	(205)	(1,021)	(613)	(2,042)
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	$9,351	$12,936	$21,431	$24,756
EARNINGS PER COMMON SHARE - BASIC	$0.55	$0.79	$1.27	$1.50
EARNINGS PER COMMON SHARE - DILUTED	$0.54	$0.77	$1.25	$1.48
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		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
NET INCOME	$9,556	$13,964	$22,108	$26,779
OTHER COMPREHENSIVE INCOME				
Securities:				
Net change in unrealized gain (loss) on securities available for sale	(37,855)	2,113	(39,537)	8,965
Reclassification adjustment for net gain realized in net income	(2,067)	(4,951)	(5,494)	(7,913)
Net change in non-credit related other than temporary impairment	24	23	48	(660)
Income taxes	14,906	1,039	16,808	(161)
Other comprehensive income (loss) on securities available for sale	(24,992)	(1,776)	(28,175)	231
Derivatives used in cash flow hedging relationships:				
Unrealized gain (loss) on derivatives	1,017	(1,380)	1,099	(1,453)
Reclassification adjustment for net loss on derivatives realized in net income	524	491	1,029	985
Income taxes	(580)	329	(794)	172
Other comprehensive income (loss) on cash flow hedges	961	(560)	1,334	(296)
Other comprehensive income (loss)	(24,031)	(2,336)	(26,841)	(65)
Comprehensive income (loss)	(14,475)	11,628	(4,733)	26,714
Less: comprehensive (income) loss attributable to noncontrolling interest	—	(7)	(64)	19
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO HEARTLAND	$(14,475)	$11,621	$(4,797)	$26,733

See accompanying notes to consolidated financial statements.

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

	Six Months Ended June 30, 2013	June 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$22,108	$26,779
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,525	3,533
Provision for loan and lease losses	2,499	5,354
Net amortization of premium on securities	15,279	9,576
Securities gains, net	(5,494)	(8,894)
Increase in trading account securities	(576)	(46)
Impairment loss on securities	—	981
Stock based compensation	1,546	1,184
Loss on sale of OREO and other repossessed property	2,102	2,683
Loans originated for sale	(891,049)	(625,194)
Proceeds on sales of loans held for sale	917,668	626,629
Net gains on sales of loans held for sale	(18,995)	(21,191)
Increase in accrued interest receivable	(839)	(661)
Decrease in prepaid expenses	8,260	2,572
Increase (decrease) in accrued interest payable	25	(1,305)
Valuation adjustment on mortgage servicing rights	(496)	181
Other, net	(10,217)	(3,883)
NET CASH PROVIDED BY OPERATING ACTIVITIES	46,346	18,298
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of time deposits in other financial institutions	(3,605)	—
Proceeds from the sale of securities available for sale	217,139	341,151
Proceeds from the maturity of and principal paydowns on securities available for sale	135,904	161,109
Proceeds from the maturity of and principal paydowns on securities held to maturity	514	764
Purchase of securities available for sale	(481,797)	(517,773)
Net increase in loans and leases	(24,707)	(159,895)
Purchase of bank owned life insurance policies	—	(4,571)
Capital expenditures	(7,020)	(7,776)
Proceeds on sale of OREO and other repossessed assets	10,150	18,585
NET CASH USED BY INVESTING ACTIVITIES	(153,422)	(168,406)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand deposits and savings accounts	30,076	118,226
Net increase (decrease) in time deposit accounts	(34,602)	6,568
Net increase (decrease) in short-term borrowings	114,555	(20,596)
Proceeds from other borrowings	160	10,695
Repayments of other borrowings	(52,853)	(5,972)
Purchase of noncontrolling interest	(2,798)	—
Purchase of treasury stock	(860)	(1,222)
Proceeds from issuance of common stock	1,398	667
Excess tax benefits on exercised stock options	34	76

Dividends paid	(3,991)	(5,337)
NET CASH PROVIDED BY FINANCING ACTIVITIES	51,119	103,105
Net decrease in cash and cash equivalents	(55,957)	(47,003)
Cash and cash equivalents at beginning of year	168,054	129,834
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$112,097	$82,831
Supplemental disclosures:		
Cash paid for income/franchise taxes	$3,905	$4,090
Cash paid for interest	$17,871	$20,284
Loans transferred to OREO	$10,710	$14,562
Purchases of securities available for sale, accrued, not paid	$4,490	$46,338

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, 2012	$81,698	$16,612	$43,333	$198,182	$ 12,147	$(1,754)	$ 2,675	$352,893
Comprehensive income				26,798	(46)		(19)	26,733
Preferred, $25.00 per share				(2,042)				(2,042)
Common, $0.20 per share				(3,295)				(3,295)
Purchase of 66,415 shares of common stock						(1,222)		(1,222)
Issuance of 49,514 shares of common stock			(294)			1,037		743
Commitments to issue common stock			1,184					1,184
Balance at June 30, 2012	$81,698	$16,612	$44,223	$219,643	$ 12,101	$(1,939)	$ 2,656	$374,994
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)
Cash dividends declared:								
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 32,211 shares of common stock						(860)		(860)
Issuance of 138,537 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

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, 2012, included in the Form 10-K of Heartland Financial USA, Inc. ("Heartland") filed with the Securities and Exchange Commission on March 15, 2013. 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, 2013, are not necessarily indicative of the results expected for the year ending December 31, 2013.

Heartland evaluated subsequent events through the filing date of its quarterly report on Form 10-Q with the SEC.

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, 2013 and 2012, are shown in the tables below:

	Three Months Ended	
(Dollars and number of shares in thousands, except per share data)	June 30, 2013	June 30, 2012
Net income attributable to Heartland	$9,556	$13,957
Preferred dividends and discount	(205)	(1,021)
Net income available to common stockholders	$9,351	$12,936
Weighted average common shares outstanding for basic earnings per share	16,907	16,474
Assumed incremental common shares issued for common stock equivalents	297	244
Weighted average common shares for diluted earnings per share	17,204	16,718
Earnings per common share — basic	$0.55	$0.79
Earnings per common share — diluted	$0.54	$0.77
Number of antidilutive common stock equivalents excluded from diluted earnings per share computation	105	500

	Six Months Ended	
(Dollars and number of shares in thousands, except per share data)	June 30, 2013	June 30, 2012
Net income attributable to Heartland	$22,044	$26,798
Preferred dividends and discount	(613)	(2,042)
Net income available to common stockholders	$21,431	$24,756
Weighted average common shares outstanding for basic earnings per share	16,900	16,482
Assumed incremental common shares issued for common stock equivalents	293	240
Weighted average common shares for diluted earnings per share	17,193	16,722
Earnings per common share — basic	$1.27	$1.50

Earnings per common share — diluted	$1.25	$1.48
Number of antidilutive common stock equivalents excluded from diluted earnings per share computation	105	500

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 430,869 shares of common stock at June 30, 2013, 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 value of stock options is estimated on the date of grant using the Black-Scholes model. 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.

Options

Although the Plan provides authority to the Compensation Committee to grant stock options, no options were granted during the first six months of 2013 and 2012. 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, 2013 and 2012, and changes during the six months ended June 30, 2013 and 2012, follows:

	2013			2012		
	Shares		Weighted-Average Exercise Price	Shares		Weighted-Average Exercise Price
Outstanding at January 1	377,907		$22.62	570,762		$21.06
Granted	—		—	—		—
Exercised	(37,836	)	19.31	(33,333	)	11.38
Forfeited	(1,800	)	26.68	(7,667	)	21.72
Outstanding at June 30	338,271		$22.96	529,762		$21.66
Options exercisable at June 30	338,271		$22.96	482,712		$21.96

At June 30, 2013, the vested options totaled 338,271 shares with a weighted average exercise price of $22.96 per share and a weighted average remaining contractual life of 3.15 years. The intrinsic value for the vested options as of June 30, 2013, was $1.8 million. The intrinsic value for the total of all options exercised during the six months ended June 30, 2013, was $309,000.

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 for the six months ended June 30, 2013, was $731,000, with a related tax benefit of $34,000. Cash received from options exercised for the six months ended June 30, 2012, was $379,000, with a related tax benefit of $76,000.

Restricted Stock Units

The Plan also permits the Compensation Committee to grant other stock-based benefits, including restricted stock units ("RSUs"). On January 22, 2013, the Compensation Committee granted time-based RSUs with respect to 72,595 shares of common stock and on January 17, 2012, granted time-based RSUs with respect to 94,001 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 2012 time-based RSUs terminate upon termination of employment, except that they continue to vest after retirement if retirement occurs after the employee has attained age 62 and has provided at least five years of service to

Heartland. The 2013 time-based RSUs may vest at retirement, at the discretion of the Compensation Committee, provided that the participant signs a non-solicitation and non-compete agreement.

In addition to the time-based RSUs referenced in the preceding paragraph, the Compensation Committee granted performance-based RSUs with respect to 40,990 shares of common stock on January 22, 2013, and performance-based RSUs with respect to 49,801 shares of common stock on January 17, 2012, to Heartland executives and subsidiary presidents. These performance-based RSUs vest based first on performance measures tied to Heartland's earnings and assets on December 31 of the grant year, and then on time-based vesting conditions. For the grants awarded in 2013, vesting occurs on December 31, 2015, and for the grants awarded in 2012, vesting occurs on December 31, 2014.

Total compensation costs recorded for stock options and RSUs were $1.5 million, and $1.2 million for the six months ended June 30, 2013 and 2012, respectively. As of June 30, 2013, there were $3.8 million of total unrecognized compensation costs related to the 2005 and 2012 Long-Term Incentive Plans for stock options and RSUs which are expected to be recognized through 2016.

Pending Acquisitions

On June 12, 2013, Heartland entered into a definitive merger agreement with Morrill Bancshares, Inc., the parent company of Morrill & Janes Bank and Trust Company ("Bank"), based in Merriam, Kansas. As of March 31, 2013 the Bank had total assets of approximately $751 million, including $366 million of loans. According to the terms of the agreement, shareholders of Morrill Bancshares, Inc. will receive Heartland common stock and cash valued at approximately $61.5 million. Morrill Bancshares will merge into Heartland, and the Bank will become a subsidiary of Heartland. The transaction is subject to approval by bank regulatory authorities and is expected to close no later than October 31, 2013.

Effect of New Financial Accounting Standards

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment," which permits an entity to make a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset, other than goodwill, is impaired. Currently, entities are required to quantitatively test indefinite-lived intangible assets for impairment at least annually and more frequently if indicators of impairment exist. Under the new standard, if an entity concludes, based on an evaluation of all relevant qualitative factors, that it is not more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, it will not be required to perform the quantitative impairment test for that asset. Heartland adopted this standard on January 1, 2013, and the adoption did not have an impact on the results of operations, financial position and liquidity.

In September 2012, the FASB issued ASU No. 2012-06, "Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution," to address diversity in practice about how to subsequently measure an indemnification asset for a government-assisted acquisition that includes a loss-sharing agreement. This guidance requires a reporting entity to account for a change in the subsequent measurement of the indemnification asset on the same basis as the changes in the asset subject to indemnification. Heartland adopted this standard on January 1, 2013, and the adoption did not have a material impact on the accounting for its loss share receivable from the FDIC under its various loss share agreements.

In February 2013, the FASB issued ASU No. 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," to address further disclosure of reclassification amounts out of other comprehensive income. The guidance requires that a reporting entity present, either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and income statement line items affected by the reclassification. Heartland adopted this standard on January 1, 2013, and the adoption did not have an impact on the results of operations, financial position and liquidity.

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Tax Credit 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, or NOL, carryforward, similar tax loss or 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. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013, and should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Early adoption and retrospective application are both permitted. Heartland does not expect the adoption of this standard to have a material impact on the results of operations, financial position, and liquidity.

NOTE 2: SECURITIES

The amortized cost, gross unrealized gains and losses, and estimated fair values of securities available for sale as of June 30, 2013, and December 31, 2012, are summarized in the table below, in thousands:

Securities available for sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2013				
U.S. government corporations and agencies	$3,992	$126	$—	$4,118
Mortgage-backed securities	1,065,779	10,639	(16,245)	1,060,173
Obligations of states and political subdivisions	443,216	9,162	(15,956)	436,422
Total debt securities	1,512,987	19,927	(32,201)	1,500,713
Equity securities	20,952	753	—	21,705
Total	$1,533,939	$20,680	$(32,201)	$1,522,418
December 31, 2012				
U.S. government corporations and agencies	$21,002	$443	$(1)	$21,444
Mortgage-backed securities	1,027,234	19,002	(10,035)	1,036,201
Obligations of states and political subdivisions	403,077	23,560	(192)	426,445
Total debt securities	1,451,313	43,005	(10,228)	1,484,090
Equity securities	21,252	733	—	21,985
Total	$1,472,565	$43,738	$(10,228)	$1,506,075

At both June 30, 2013, and December 31, 2012, 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, 2013, and December 31, 2012, are summarized in the table below, in thousands:

Securities held to maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2013				
Mortgage-backed securities	$6,931	$323	$(327)	$6,927
Obligations of states and political subdivisions	48,268	—	—	48,268
Total	$55,199	$323	$(327)	$55,195
December 31, 2012				
Mortgage-backed securities	$7,040	$492	$(12)	$7,520
Obligations of states and political subdivisions	48,462	—	—	48,462
Total	$55,502	$492	$(12)	$55,982

At June 30, 2013, the amortized cost of the held to maturity securities is net of $797,000 of credit related OTTI and $564,000 of non-credit related OTTI. At December 31, 2012, $797,000 of credit related OTTI and $612,000 of non-credit related OTTI was recorded.

Approximately 83% 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, 2013, 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.

Securities available for sale	Amortized Cost	Estimated Fair Value
Due in 1 year or less	$3,491	$3,541
Due in 1 to 5 years	33,469	34,752
Due in 5 to 10 years	54,216	55,442
Due after 10 years	356,032	346,805
Total debt securities	447,208	440,540
Mortgage-backed securities	1,065,779	1,060,173
Equity securities	20,952	21,705
Total investment securities	$1,533,939	$1,522,418

The amortized cost and estimated fair value of debt securities held to maturity at June 30, 2013, 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.

Securities held to maturity	Amortized Cost	Estimated Fair Value
Due in 1 year or less	$—	$—
Due in 1 to 5 years	1,282	1,282
Due in 5 to 10 years	9,350	9,350
Due after 10 years	37,636	37,636
Total debt securities	48,268	48,268
Mortgage-backed securities	6,931	6,927
Total investment securities	$55,199	$55,195

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

Securities sold	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Proceeds from sales	$124,344	$216,787	217,139	$341,151
Gross security gains	2,662	5,366	6,283	9,380
Gross security losses	595	415	789	486

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, 2013, and December 31, 2012. 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, 2012, and December 31, 2011, 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, 2013						
U.S. government corporations and agencies	$—	$—	$—	$—	$—	$—
Mortgage-backed securities	567,337	(15,408)	23,970	(837)	591,307	(16,245)
Obligations of states and political subdivisions	246,262	(15,956)	—	—	246,262	(15,956)
Total temporarily impaired securities	$813,599	$(31,364)	$23,970	$(837)	$837,569	$(32,201)
December 31, 2012						
U.S. government corporations and agencies	$1,517	$(1)	$—	$—	$1,517	$(1)
Mortgage-backed securities	332,842	(9,121)	24,489	(914)	357,331	(10,035)
Obligations of states and political subdivisions	22,503	(192)	—	—	22,503	(192)
Total temporarily impaired securities	$356,862	$(9,314)	$24,489	$(914)	$381,351	$(10,228)

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, 2013						
Mortgage-backed securities	$—	$—	$3,055	$(327)	$3,055	$(327)
Obligations of states and political subdivisions	—	—	—	—	—	—
Total temporarily impaired securities	$—	$—	$3,055	$(327)	$3,055	$(327)
December 31, 2012						
Mortgage-backed securities	$—	$—	$3,296	$(12)	$3,296	$(12)
Obligations of states and political subdivisions	—	—	—	—	—	—
Total temporarily impaired securities	$—	$—	$3,296	$(12)	$3,296	$(12)

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 the first quarter of 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 published credit ratings of these securities and the 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, 2013, or December 31, 2012.

The following table shows the detail of total OTTI write-downs included in earnings, in thousands:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Available for sale debt securities:				
Mortgage backed securities	$—	$—	$—	$184
Held to maturity debt securities:				
Mortgage backed securities	—	—	—	797
Total debt security OTTI write-downs included in earnings	$—	$—	$—	$981

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,	
	2013	2012	2013	2012
Recorded as part of gross realized losses:				
Credit related OTTI	$—	$—	$—	$981
Intent to sell OTTI	—	—	—	—
Total recorded as part of gross realized losses	—	—	—	981
Recorded directly to AOCI for non-credit related impairment:				
Residential mortgage backed securities	—	—	—	683
Accretion of non-credit related impairment	(24)	(23)	(48)	(23)
Total changes to AOCI for non-credit related impairment	(24)	(23)	(48)	660
Total OTTI losses (accretion) recorded on debt securities, net	$(24)	$(23)	$(48)	$1,641

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

NOTE 3: LOANS AND LEASES

Loans and leases as of June 30, 2013, and December 31, 2012, were as follows, in thousands:

	June 30, 2013	December 31, 2012
Loans and leases receivable held to maturity:		
Commercial	$709,908	$712,308
Commercial real estate	1,294,975	1,289,184
Agricultural and agricultural real estate	327,490	328,311
Residential real estate	248,604	249,689
Consumer	254,825	245,678
Gross loans and leases receivable held to maturity	2,835,802	2,825,170
Unearned discount	(347)	(676)
Deferred loan fees	(3,078)	(2,945)
Total net loans and leases receivable held to maturity	2,832,377	2,821,549
Loans covered under loss share agreements:		
Commercial and commercial real estate	2,519	3,074
Agricultural and agricultural real estate	441	748
Residential real estate	2,493	2,645
Consumer	822	786
Total loans covered under loss share agreements	6,275	7,253
Allowance for loan and lease losses	(37,623)	(38,715)
Loans and leases receivable, net	$2,801,029	$2,790,087

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 a discount from the 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 subsidiary, Citizens Finance Co., typically lends to borrowers with past credit problems or limited credit histories, which comprise approximately 27% 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 a creditor 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, 2013, and December 31, 2012, 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 changes to the accounting for the allowance for loan and lease losses policy during 2013.

	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, 2013						
Commercial	$682	$8,754	$9,436	$20,668	$689,240	$709,908
Commercial real estate	800	12,871	13,671	29,997	1,264,978	1,294,975
Agricultural and agricultural real estate	904	2,151	3,055	20,168	307,322	327,490
Residential real estate	915	2,665	3,580	7,950	240,654	248,604
Consumer	1,928	5,953	7,881	4,919	249,906	254,825
Total	$5,229	$32,394	$37,623	$83,702	$2,752,100	$2,835,802
December 31, 2012						
Commercial	$1,350	$10,038	$11,388	$9,031	$703,277	$712,308
Commercial real estate	1,112	13,361	14,473	45,583	1,243,601	1,289,184
Agricultural and agricultural real estate	109	2,029	2,138	16,128	312,183	328,311
Residential real estate	783	2,760	3,543	7,443	242,246	249,689
Consumer	1,270	5,903	7,173	5,391	240,287	245,678
Total	$4,624	$34,091	$38,715	$83,576	$2,741,594	$2,825,170

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, 2013, and December 31, 2012, in thousands. There were no nonaccrual leases, accruing leases past due 90 days or more or restructured leases at June 30, 2013, and December 31, 2012.

	June 30, 2013	December 31, 2012
Nonaccrual loans	$35,219	$38,675
Nonaccrual troubled debt restructured loans	5,784	4,481
Total nonaccrual loans	$41,003	$43,156
Accruing loans past due 90 days or more	6	—
Performing troubled debt restructured loans	$32,661	$21,121

The following tables provide information on troubled debt restructured loans that were modified during the three months and six months ended June 30, 2013, and June 30, 2012, in thousands:

	Three Months Ended June 30,					
	2013			2012		
	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	1,380	1,380
Total commercial and commercial real estate	2	13,203	13,203	1	1,380	1,380
Agricultural and agricultural real estate	—	—	—	3	1,014	1,014
Residential real estate	1	50	50	1	1,005	1,005
Consumer	1	166	166	—	—	—
Total	4	$13,419	$13,419	5	$3,399	$3,399

	Six Months Ended June 30,					
	2013			2012		
	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	—	—	—	2	1,398	1,398
Total commercial and commercial real estate	3	17,873	17,873	2	1,398	1,398
Agricultural and agricultural real estate	3	2,576	2,576	3	1,014	1,014
Residential real estate	3	696	696	1	1,005	1,005
Consumer	1	166	166	—	—	—
Total	10	$21,311	$21,311	6	$3,417	$3,417

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.

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, 2013, and June 30, 2012, 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, 2013		Three Months Ended June 30, 2012	
	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, 2013		Six Months Ended June 30, 2012	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Commercial	1	$4,670	—	$—
Commercial real estate	—	—	1	640
Total commercial and commercial real estate	1	4,670	1	640
Agricultural and agricultural real estate	—	—	—	—
Residential real estate	—	—	—	—
Consumer	—	—	—	—
Total	1	$4,670	1	$640

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, 2013, 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, 2013, and December 31, 2012, in thousands:

	Pass	Nonpass	Total
June 30, 2013			
Commercial	$653,984	$55,924	$709,908
Commercial real estate	1,148,846	146,129	1,294,975
Total commercial and commercial real estate	1,802,830	202,053	2,004,883
Agricultural and agricultural real estate	281,217	46,273	327,490
Residential real estate	230,338	18,266	248,604
Consumer	244,542	10,283	254,825
Total gross loans and leases receivable held to maturity	$2,558,927	$276,875	$2,835,802
December 31, 2012			
Commercial	$661,118	$51,190	$712,308
Commercial real estate	1,134,784	154,400	1,289,184
Total commercial and commercial real estate	1,795,902	205,590	2,001,492
Agricultural and agricultural real estate	286,264	42,047	328,311
Residential real estate	227,925	21,764	249,689
Consumer	235,232	10,446	245,678
Total gross loans and leases receivable held to maturity	$2,545,323	$279,847	$2,825,170

The nonpass category in the table above is comprised of approximately 53% special mention and 47% substandard as of June 30, 2013. The percent of nonpass loans on nonaccrual status as of June 30, 2013, was 15%. As of December 31, 2012, the nonpass category in the table above was comprised of approximately 50% special mention and 50% substandard. The percent of nonpass loans on nonaccrual status as of December 31, 2012, was 15%. The substandard loans at June 30, 2013, included a $13.0 million loan to a bank holding company that is current and accruing, but that is secured by stock of subsidiary banks that have recently experienced significant reductions to capital as a result of loan impairment charges. This loan was classified as a performing troubled debt restructured loan as of June 30, 2013. Loans delinquent 30 to 89 days as a percent of total loans were 0.29% at June 30, 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, 2013, and December 31, 2012, 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, 2013							
Commercial	$603	$98	$—	$701	$702,979	$6,228	$709,908
Commercial real estate	1,417	755	—	2,172	1,274,617	18,186	1,294,975
Total commercial and commercial real estate	2,020	853	—	2,873	1,977,596	24,414	2,004,883
Agricultural and agricultural real estate	304	—	—	304	319,907	7,279	327,490
Residential real estate	1,374	629	—	2,003	240,608	5,993	248,604
Consumer	2,965	581	6	3,552	247,956	3,317	254,825
Total gross loans and leases receivable held to maturity	$6,663	$2,063	$6	$8,732	$2,786,067	$41,003	$2,835,802
December 31, 2012							
Commercial	$1,143	$525	$—	$1,668	$708,459	$2,181	$712,308
Commercial real estate	1,631	494	—	2,125	1,259,112	27,947	1,289,184
Total commercial and commercial real estate	2,774	1,019	—	3,793	1,967,571	30,128	2,001,492
Agricultural and agricultural real estate	687	—	—	687	324,545	3,079	328,311
Residential real estate	1,278	234	—	1,512	241,860	6,317	249,689
Consumer	2,434	803	—	3,237	238,809	3,632	245,678
Total gross loans and leases receivable held to maturity	$7,173	$2,056	$—	$9,229	$2,772,785	$43,156	$2,825,170

The majority of Heartland's impaired loans are those that are nonaccrual, are past due 90 days or more and still accruing 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, 2013, and December 31, 2012; the outstanding loan balance recorded on the consolidated balance sheets at June 30, 2013, and December 31, 2012; any related allowance recorded for those loans as of June 30, 2013, and December 31, 2012; the average outstanding loan balance recorded on the consolidated balance sheets during the three months and six months ended June 30, 2013, and year ended December 31, 2012; and the interest income recognized on the impaired loans during the three months and six months ended June 30, 2013, and year ended December 31, 2012, 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, 2013							
Impaired loans with a related allowance:							
Commercial	$1,427	$1,427	$682	$2,063	$11	$2,345	$30
Commercial real estate	9,950	9,729	800	8,725	132	7,199	282
Total commercial and commercial real estate	11,377	11,156	1,482	10,788	143	9,544	312
Agricultural and agricultural real estate	16,019	16,019	904	6,250	80	3,876	168
Residential real estate	3,571	3,515	915	3,488	13	3,404	31
Consumer	3,362	3,362	1,928	3,378	25	3,429	50
Total loans held to maturity	$34,329	$34,052	$5,229	$23,904	$261	$20,253	$561
Impaired loans without a related allowance:							
Commercial	$20,082	$19,241	$—	$10,352	$8	$7,917	$12
Commercial real estate	28,735	20,268	—	25,188	69	30,184	113
Total commercial and commercial real estate	48,817	39,509	—	35,540	77	38,101	125
Agricultural and agricultural real estate	4,149	4,149	—	13,931	68	12,870	121
Residential real estate	4,989	4,435	—	4,118	22	3,923	39
Consumer	1,733	1,557	—	1,611	9	1,506	15
Total loans held to maturity	$59,688	$49,650	$—	$55,200	$176	$56,400	$300
Total impaired loans held to maturity:							
Commercial	$21,509	$20,668	$682	$12,415	$19	$10,262	$42
Commercial real estate	38,685	29,997	800	33,913	201	37,383	395
Total commercial and commercial real estate	60,194	50,665	1,482	46,328	220	47,645	437
Agricultural and agricultural real estate	20,168	20,168	904	20,181	148	16,746	289
Residential real estate	8,560	7,950	915	7,606	35	7,327	70
Consumer	5,095	4,919	1,928	4,989	34	4,935	65

Total impaired loans held to maturity	$94,017	$83,702	$5,229	$79,104	$437	$76,653	$861

	Unpaid Contractual Balance	Loan Balance	Related Allowance Recorded	Year-to-Date Avg. Loan Balance	Year-to-Date Interest Income Recognized
December 31, 2012					
Impaired loans with a related allowance:					
Commercial	$2,904	$2,904	$1,350	$5,082	$88
Commercial real estate	6,403	6,384	1,112	12,671	813
Total commercial and commercial real estate	9,307	9,288	2,462	17,753	901
Agricultural and agricultural real estate	1,493	1,493	109	379	83
Residential real estate	3,197	3,170	783	2,737	89
Consumer	3,876	3,836	1,270	3,781	204
Total loans held to maturity	$17,873	$17,787	$4,624	$24,650	$1,277
Impaired loans without a related allowance:					
Commercial	$6,596	$6,127	$—	$3,813	$186
Commercial real estate	48,967	39,199	—	41,814	689
Total commercial and commercial real estate	55,563	45,326	—	45,627	875
Agricultural and agricultural real estate	14,654	14,635	—	13,728	539
Residential real estate	4,741	4,273	—	3,861	65
Consumer	1,708	1,555	—	1,630	18
Total loans held to maturity	$76,666	$65,789	$—	$64,846	$1,497
Total impaired loans held to maturity:					
Commercial	$9,500	$9,031	$1,350	$8,895	$274
Commercial real estate	55,370	45,583	1,112	54,485	1,502
Total commercial and commercial real estate	64,870	54,614	2,462	63,380	1,776
Agricultural and agricultural real estate	16,147	16,128	109	14,107	622
Residential real estate	7,938	7,443	783	6,598	154
Consumer	5,584	5,391	1,270	5,411	222
Total impaired loans held to maturity	$94,539	$83,576	$4,624	$89,496	$2,774

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, 2013, and December 31, 2012, consisted of purchased impaired and nonimpaired loans as summarized in the following table, in thousands:

	June 30, 2013			December 31, 2012		
	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	$539	$1,980	$2,519	$598	$2,476	$3,074
Agricultural and agricultural real estate	—	441	441	—	748	748
Residential real estate	—	2,493	2,493	—	2,645	2,645
Consumer loans	463	359	822	89	697	786
Total Covered Loans	$1,002	$5,273	$6,275	$687	$6,566	$7,253

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, 2013, and December 31, 2012, 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, 2013, and December 31, 2012.

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 months and six months ended June 30, 2013, and June 30, 2012, were as follows, in thousands:

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Leases	Unallocated	Total
Balance at March 31, 2013	$9,299	$15,190	$2,195	$3,266	$7,578	$—	$—	$37,528
Charge-offs	(721)	(688)	—	(141)	(1,223)	—	—	(2,773)
Recoveries	124	579	87	19	197	—	—	1,006
Provision	734	(1,410)	773	436	1,329	—	—	1,862
Balance at June 30, 2013	$9,436	$13,671	$3,055	$3,580	$7,881	$—	$—	$37,623

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Leases	Unallocated	Total
Balance at December 31, 2012	$11,388	$14,473	$2,138	$3,543	$7,173	$—	$—	$38,715
Charge-offs	(1,259)	(1,931)	(23)	(406)	(2,218)	—	—	(5,837)
Recoveries	905	765	99	26	451	—	—	2,246
Provision	(1,598)	364	841	417	2,475	—	—	2,499
Balance at June 30, 2013	$9,436	$13,671	$3,055	$3,580	$7,881	$—	$—	$